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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: SEP 2 6 2003

Contact Person:

Identification Number:

Contact Telephone:

T:EO:BR2

Employer Identification Number:

LEGEND:

"A" =
"B" =
"C" =
"a" =
"b" =

UIL NO.

501.36-01
512.01-00
512.02-00
513.32-00

Dear Sir or Madam:

This is in reply to your request for rulings concerning the federal tax consequences of your participation in a joint venture that will expand your current tax-exempt activities. The proposed transaction is described below.

You are exempt from income taxes under section 501(c)(3) of the Internal Revenue Code. You were established in 1969 to create affordable housing and combat blight in "B." You have participated in a number of programs to create and maintain affordable housing. In 1996, you established "A", to act as your "lending arm." You and "A" have overlapping boards and officers. In practice, "A" is controlled by you.

"A" has provided small businesses with access to over "a" through its loan and grant programs, alone and through the Small Business Administration. It has become one of the largest Micro-Loan producers in the state. It established a new fund for small businesses needing more than the $35,000 that is the limit for the SBA Micro-Loan Program. The U.S. Treasury has authorized this fund to make loans of up to $75,000 to eligible borrowers. Eligibility criteria include meeting SBA size limits for the industry, being outside traditional bank lending criteria, and being either a minority or women-owned business.

As a support to borrowers and grant recipients, "A" also provides extensive technical

owned business.

As a support to borrowers and grant recipients, "A" also provides extensive technical assistance. This program, known as "C" teaches planning skills, financial goal-setting, communications, selling, and contingency planning. "A" also offers business training sessions and technical assistance to eligible proprietors to obtain Minority and Women Business Enterprise certification. You believe that the technical assistance and sound underwriting are responsible for the extremely low default rate: only five of "A"'s more than two hundred loans have ended in default.

You have identified an additional gap in availability of credit that includes borrowers who otherwise fall within your permitted class, but who need larger loans than "A" is authorized to provide and may be unable to obtain them from conventional sources. The increased use of credit scoring is the primary reason they are unable to obtain conventional funding.

You have identified a vehicle through which you can further your mission of advancing the economic development by bridging this funding gap. Rather than diverting the resources and efforts of "A" for this new project, you propose to amend your articles of incorporation to expand your purposes to include:

> promote community development by making grants and loans which benefit targeted populations of low-income persons and other persons who lack adequate access to capital and credit

You believe that many of the businesses that borrow from "A" will "graduate" to this new program as their businesses grow and their financing needs increase.

The program that you propose to use is the SBA 7(a) program. SBA 7(a) encourages commercial lenders to make loans by adding a federal guarantee for a portion of the loan. Among the criteria that the SBA requires for lenders under this program is that they be supervised by a state or federal regulatory agency satisfactory to the SBA. The State Bank Law specifies the types of entities that may be supervised by the State Banking Department. Those that are not traditional banking institutions must have at least $2 million of paid-up "capital stock." Because neither you, nor your proposed new entity is a traditional banking institution, you would be subject to the capital stock requirement.

However, you are prohibited by the Not-for-Profit Corporation law under which you were organized from issuing capital stock. Therefore, you propose to organize and become a member of a Limited Liability Corporation (LLC), which can issue equity interests to

investors. You will organize it as a joint venture with for-profit lenders. The leading commercial lenders in the area have given evidence of interest in participating. You will contribute "b" cash in return for a Class C interest. Your interest in the gains and profits will be no less than proportionate to your contribution. The cash contribution to the LLC represents less than 3% of your available consolidated assets.

You will also provide services to the LLC: underwriting, loan servicing, technical assistance to the borrowers, and accounting. You will lease space to the LLC for its offices. Service fees and rental payments made by the LLC to you will be based upon an allocation of actual internal costs, as determined by an independent consultant.

The nine-member Board of Managers of the LLC will be selected by the Class A and the Class C interest holders. (Class B members are non-voting.) You will appoint 5 members, and the Class A interest holders will appoint 4 members, who may be officers of the for-profit investors. The operating agreement will ensure that you will always appoint a majority of board members. The definition of a quorum will include a requirement that a majority of the Board members present must have been appointed by the Class C interest holder. The operating agreement will state that the Board's duty to further your exempt purposes shall override any duty to operate the LLC for the financial benefit of any member. It will specify that any decision of the Board to forego an activity or action which is not in furtherance of your exempt purposes or which fails to obtain your approval shall not constitute a breach of the duty of loyalty to the for-profit members. Furthermore, the positions of Chairman of the Board and CEO of the LLC shall be reserved for your appointees, and you will have the unilateral right to remove them. Majority approval of the Board will be required for most decisions, including: annual budget, distribution of earnings, distribution of assets other than cash, appointment of key employees, engaging in business activities other than the 7(a) loan program and other "major" decisions. Your approval is also required to make any fundamental changes to the LLC's structure (e.g. dissolution), its purposes, and any of its organizational documents.

All of the businesses to which you will lend will have been denied loans by commercial lending sources. Most will be owned by members of minority groups, women, or low-income individuals. In other cases, your underwriting process will ensure that the businesses to which loans are made: (1) are located within a distressed area; (2) will use the funds for businesses which employ individuals who fall into a targeted population or live within a distressed area; or (3) will use the funds to provide necessary services or products that are otherwise unavailable to residents of distressed areas.

You have requested the following rulings:

1. The expansion of your tax-exempt corporate purposes to include lending to small businesses in the targeted populations described above and to provide technical and borrowing services, and your participation in those activities, will not, alone or in the aggregate adversely affect your status under Sections 170(b)(1)(A(vi), 501(a), 501(c)(3), or 509(a)(1) of the Code.

2. The creation of the LLC and your execution of the LLC's operating agreement and related agreements, the carrying out of the transactions (including leasing space to the LLC, providing services to the LLC and the sale of the loans by the LLC) contemplated by these agreements, and your participation in the operation and ownership of the LLC will not, alone or in the aggregate, adversely affect your status under Sections 170(b)(1)(A(vi), 501(a), 501(c)(3), or 509(a)(1) of the Code.

3. The transfer of a portion of your assets to the LLC in exchange for the Class C membership interest in the LLC will not adversely affect your status under Sections 170(b)(1)(A(vi), 501(a), 501(c)(3), or 509(a)(1) of the Code.

4. The distributive share of LLC profits, gains, deductions and losses allocated to or received by you with respect to the Class C interest in the LLC (whether attributable to interest on loans made by the LLC or to the proceeds from the sale of such loans) will not arise from an unrelated trade or business, as defined in Section 513 of the Code, will not result in UBTI to you under Section 512 of the Code, and will not be subject to tax under Section 511 of the Code.

5. The payments received by you under the loan service agreement with the LLC will not arise from an unrelated trade or business, as defined in Section 513 of the Code, will not result in UBTI to you under Section 512 of the Code, and will not be subject to tax under Section 511 of the Code.

6. The payments received by you under the lease agreement entered into with the LLC will not be treated as income derived from debt-financed property (as defined in Section 514 of the Code), will be excluded from UBTI as provided in Section 512(b)(3) of the Code, and will not be subject to tax under Section 511 of the Code.

Section 501(c)(3) of the Internal Revenue Code (the Code) recognizes organizations as exempt from federal income tax organizations that are organized and operated exclusively for charitable purposes, no part of the net earnings of which inure to the benefit of any private shareholder or individual.

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in Section 512) of organizations exempt from tax under section 501(c).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived from any unrelated trade or business that an organization carries on regularly.

Section 512(b)(3) of the Code excludes from unrelated business taxable income rents from real property.

Section 512(b)(13) of the Code provides different rules for income that an exempt organization receives from an entity that it controls. The definition of control for this paragraph is either: ownership by vote or value of more than 50 percent of the stock in a corporation or ownership of more than 50 percent of the profits interest or capital interest in a partnership, or ownership of more than 50 percent of the beneficial interests in the entity.

Section 513 of the Code defines the term "unrelated trade or business" as one that is not substantially related to the exercise or performance by an organization of its charitable purpose or function constituting the basis for its exemption.

Section 514 of the Code includes in unrelated business tax income a percentage of gross income derived from property held to produce income, with respect to which there is an acquisition indebtedness, unless substantially all the use of the property is substantially related to the performance by the organization of its charitable function.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes

specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities are not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized and operated exclusively for exempt purposes unless it serves a public rather than a private interest.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" includes the promotion of social welfare by organizations designed to relieve the poor and distressed, to lessen neighborhood tensions, or to combat community deterioration.

Section 1.501(c)(3)-1(e)(1) of the regulations states that an organization exempt under section 501(c)(3) of the Code may operate a trade or business as a substantial part of its activities if the operation of such trade or business is in furtherance of the organization's exempt purposes. Exemption will be denied to an organization that is organized or operated for the primary purpose of carrying on an unrelated trade or business.

Section 1.513(c)(3)-1(d)(2) of the regulations states that a trade or business is related to exempt purposes only where the conduct of the business activities has causal relationship to the achievement of exempt purposes, and it is substantially related for the purpose of section 513 only if the causal relationship is a substantial one. Thus, for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 1.513-1(d)(4) provides that gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of an unrelated trade or business.

Rev. Rul. 74-587, 1974-2 C.B. 162 held that a community development organization must do more than encourage business development to be recognized as an exempt organization. It must help needy individuals, target economically disadvantaged or depressed

areas, assist those who are unable to obtain funds from conventional sources because of the financial risks or discrimination, and help those who offer the greatest potential community benefit by training and employing the unemployed. The direct recipients of the aid need not be a charitable class as long as they act as the charitable instruments to accomplish the charitable purposes and only incidentally benefit businesses or others who are not a charitable class.

Rev. Rul. 77-111, 1977-1 C.B. 144 laid out the factors by which the Service will determine whether a community development organization furthers charitable purposes. The three factors are: whether assistance is provided to help local businesses (rather than national), whether the assistance is provided on noncommercial terms, and whether there is a nexus between the business entities assisted and relieving the problems of a disadvantaged area or a disadvantaged group.

Rev. Rul. 98-15, 1998-1 C.B. 718 contrasts two joint ventures to illustrate the characteristics that define a joint venture in which an exempt organization may participate with a for-profit partner. Situation 1 explicitly approves formation of a LLC by an exempt hospital organization, although in that ruling, the other member is an unrelated for-profit entity. In that situation the venture is governed by a majority of disinterested people, of whom a majority represents the exempt partner. A majority vote is needed for major decisions. The governing instrument contains a charitable purpose that is explicitly given priority when it conflicts with the business interests of the venture. Returns of capital and distributions of earnings are proportional to ownership. The management company has no previous ties to any parties, was hired for a reasonable term, subject to the ability of the venture to terminate for cause. Situation 1 concludes that the hospital organization's principal activity continues to be the provision of hospital care, even when such activities are conducted through a LLC, because, inter alia, the tax-exempt hospital retains control over the LLC and the LLC serves charitable purposes.

The second situation lacks many of the above features that allow the exempt organization to control the venture and thereby ensure that its charitable purpose will be furthered and that any benefit to private parties will be incidental to the charitable purpose. For example, the exempt organization does not have a majority voice on the governing

board. There is no explicit charitable purpose in the governing instrument. The management company and the officers are related to the for-profit partner, and the management company has discretion to enter into all but "unusually large" contracts without board approval, and may unilaterally extend the management agreement. The Revenue Ruling concludes that in the second situation the organization has failed to establish that it will be operated exclusively for exempt purposes when it formed the joint venture.

The Court in *Redlands Surgical Services v. Commissioner*, 113 TC 47 (July 19,1999) stated that merely entering a partnership with private parties in which they receive returns on their capital investment does not impermissibly confer private benefit. However, a detailed examination of the Redlands surgery center venture convinced the court that the petitioner had ceded control to private parties having an independent economic interest in the activity and no obligation to promote charitable purposes ahead of profit making. Therefore, the applicant was not operated exclusively for exempt purposes. The Court pointed to the long-term management contract with a party related to the for-profit, giving the manager broad discretion and a fee based upon gross revenue. Furthermore, the record did not show that the nonprofit had any role in negotiating the contract. To the contrary, the contract was executed for both parties by the same individual, indicating self-dealing. The petitioner also lacked informal control: it did not have the resources or the ability to oversee the operations.

You plan expansion of your exempt purposes to include lending to small businesses in the targeted populations of small businesses owned by women and minorities that have been unable to obtain capital through commercial channels, and to provide technical services to these borrowers. The Service has long recognized that lending to small businesses may relieve the poor and distressed, lessen neighborhood tension, eliminate discrimination, and combat community deterioration. See Rev. Ruls. 77-111 and 74-587, *supra*. An organization must show that the assistance is provided to an economically depressed area, that it benefits a disadvantaged group, such as minorities or the unemployed, and that it aids businesses that have actually experienced difficulty in obtaining conventional financing due to the deteriorated area in which they are located or to the minority ownership of the business.

You have submitted information to show that the area you serve contains many distressed communities. In addition, you have and intend to continue through the new venture, to target minority and women-owned small businesses that have experienced

difficulty in obtaining conventional financing. You have stated that you will consider the community benefits of your loans. When your loans are not made directly to members of targeted populations, you intend to lend to businesses that will create or retain jobs for individuals in targeted populations or in distressed areas, provide important services such as childcare to the residents of distressed areas, or will otherwise contribute to the economic revitalization of distressed areas. The SBA regulates the interest and other terms of the loans. You will provide technical assistance and training to the borrowers to enable them to become eligible for traditional capital sources. You have shown that your activities do assist a charitable class and only incidentally benefit private parties as defined in Rev. Ruls. 77-111 and 74-587.

You have structured the LLC to further your charitable purposes and for you to retain control over its on-going operation. Similar to the operating agreement in situation 1 of Rev. Rul. 98-15, your operating agreement has a charitable purpose and explicitly directs the Board to further the charitable purpose in any conflict with the financial benefit of any member. Your agreement protects the Board against claims of failing its fiduciary duty by providing that any decision to forego an activity or action which is not in furtherance of your exempt purpose shall not constitute a breach of loyalty to the for-profit members. The operating agreement provides that the duty of the Board to operate in furtherance of its exempt purposes shall override any duty to operate the LLC for the financial benefit of any of its members. The LLC's purposes will be the same as yours.

Your Operating agreement assures that you will appoint a majority of the Board, the Chairman of the Board, and Chief Executive Officer of the LLC. Majority approval, held by you, will be necessary for most decisions, including: the annual budget, distribution of earnings, appointment of key employees, and engaging in activities other than the SBA 7(a) program. You may receive a disproportionately greater percentage interest in the profits (but not the losses) of the LLC, but all of the other interest holders will obtain gains, profits and losses in proportion to their capital contributions. Your own employees will perform much of the work involved in operating the LLC, including underwriting, loan servicing and technical assistance to the borrowers. By providing these services, you exercise additional control over the day-to-day management of the LLC's business and remove the issue of whether a private party will receive more than incidental benefit through contract arrangements. These features were cited in Situation 1 of Rev. Rul. 98-15, as demonstrating the control of the exempt organization over the LLC in which it participated, and that the for-profit members are not benefiting more than incidentally. Because you have voting control of the Board, approval for decisions relating to the LLC's operations as well as major decisions regarding the LLC's organizational documents, and appoint both the Chairman of the Board and the LLC's Chief Executive Officer, you satisfy the requirements that you control the LLC.

Redlands, supra. Also, your contributions to the LLC represent a relative small portion of your assets and will not impair your ability to continue to conduct your other charitable activities.

For the reasons discussed above, we agree that the activities of the LLC have a substantial causal relationship to your exempt purposes. Therefore, your distributive share of the profits, gains, deductions, and losses in the LLC will arise from a related trade or business as defined in section 1.513(c)(3)-1(d)(2). Income from such related business will not be subject to tax under Section 511 of the Code.

Similarly, payments received by you under a loan service agreement with the LLC will be income from a business that is substantially related to your exempt purpose and will not be subject to tax under Section 511 of the Code. None of the rental income that you will receive from the LLC will be subject to unrelated business income tax. You have not incurred debt to acquire the office space that you will lease to the LLC. Income from the LLC will not be subject to the controlled entity rule for two reasons. You own less than a 50% interest in the LLC's capital or profits, which is the definition of control that is relevant for Section 512(b)(13). Furthermore, even if you were regarded as "controlling" the LLC, its income would be treated as related.

According, based upon your representations, and subject to the conditions and limitations on your issuance of loans for charitable purposes, we rule as follows:

1. The expansion of your tax-exempt corporate purposes to include lending to small businesses in the targeted populations described above and to provide technical and borrowing services, and your participation in those activities, will not, alone or in the aggregate adversely affect your status under Sections 170(b)(1)(A)(vi), 501(a), 501(c)(3), or 509(a)(1) of the Code.

2. The creation of the LLC and your execution of the LLC's operating agreement and related agreements, the carrying out of the transactions (including leasing space to the LLC, providing services to the LLC and the sale of the loans by the LLC) contemplated by these agreements, and your participation in the operation and ownership of the LLC will not, alone or in the aggregate, adversely affect your status under Sections 170(b)(1)(A(vi), 501(a), 501(c)(3), or 509(a)(1) of the Code.

3. The transfer of a portion of your assets to the LLC in exchange for the Class C membership interest in the LLC will not adversely affect your status under Sections 170(b)(1)(A(vi), 501(a), 501(c)(3), or 509(a)(1) of

the Code.

4. The distributive share of LLC profits, gains, deductions and losses allocated to or received by you with respect to the Class C interest in the LLC (whether attributable to interest on loans made by the LLC or to the proceeds form the sale of such loans) will not arise from an unrelated trade or business, as defined in Section 513 of the Code, will not result in UBTI to you under Section 512 of the Code, and will not be subject to tax under Section 511 of the Code.

5. The payments received by you under the loan service agreement with the LLC will not arise from an unrelated trade or business, as defined in Section 513 of the Code, will not result in UBTI to you under Section 512 of the Code, and will not be subject to tax under Section 511 of the Code.

6. The payments received by you under the lease agreement entered into with the LLC will not be treated as income derived from debt-financed property (as defined in Section 514 of the Code), will be excluded from UBTI as provided in Section 512(b)(3) of the Code, and will not be subject to tax under Section 511 of the Code.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Because this letter could help resolve any future questions about your income tax responsibilities, please keep a copy of this ruling in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

(signed) Terrell M. Berkovsky

Terrell M. Berkovsky
Manager Exempt Organizations
Technical Group 2