



## **SUPPORTIVE HOUSING AS A SOLUTION TO HOMELESSNESS**

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## **ANCILLARY JOINT VENTURES: SUPPORTIVE HOUSING HOW TO COMPLY WITH LOW INCOME HOUSING TAX CREDIT REQUIREMENTS**

**Presented by: Michael I. Sanders, Esquire  
Powell Goldstein, LLP  
Washington, DC**

- **Types of Joint Ventures**
  - Ancillary
  - Whole
  - Exempt Only
  - Investment Type

### The IRS's Two-Prong "Close Scrutiny" Test

**The two-prong test requires that:**

- (i)** the activities of the partnership further charitable purposes; and
- (ii)** the structure of the partnership insulates the exempt organization from potential conflicts between its charitable purposes and its general partnership obligations, and minimizes the likelihood that the arrangement will generate private benefit.

The IRS has released a draft of the revised Form 990, which makes significant changes to the current version, which includes a 10-page core form and 15 schedules. *Part VII, Statement Regarding General Activities*, includes questions about partnerships, LLC's and disregarded entities. Many of the questions in this part will trigger the need to complete one or more schedules, including *Schedule R: Related Organizations*.

The revised *Form 1023, Exemption Application*, now includes a schedule that must be completed by any organization engaged in the provision of low-income housing. The questions delve into joint ventures and charitable purposes of such organization.

**Schedule F. Homes for the Elderly or Handicapped and Low-Income Housing (Continued)**

**Section II Homes for the Elderly or Handicapped**

- 1a** Do you provide housing for the elderly? If "Yes," describe who qualifies for your housing in terms of age, infirmity, or other criteria and explain how you select persons for your housing.  Yes  No
- b** Do you provide housing for the handicapped? If "Yes," describe who qualifies for your housing in terms of disability, income levels, or other criteria and explain how you select persons for your housing.  Yes  No
- 2a** Do you charge an entrance or founder's fee? If "Yes," describe what this charge covers, whether it is a one-time fee, how the fee is determined, whether it is payable in a lump sum or on an installment basis, whether it is refundable, and the circumstances, if any, under which it may be waived.  Yes  No
- b** Do you charge periodic fees or maintenance charges? If "Yes," describe what these charges cover and how they are determined.  Yes  No
- c** Is your housing affordable to a significant segment of the elderly or handicapped persons in the community? Identify your community. Also, if "Yes," explain how you determine your housing is affordable.  Yes  No
- 3a** Do you have an established policy concerning residents who become unable to pay their regular charges? If "Yes," describe your established policy.  Yes  No
- b** Do you have any arrangements with government welfare agencies or others to absorb all or part of the cost of maintaining residents who become unable to pay their regular charges? If "Yes," describe these arrangements.  Yes  No
- 4** Do you have arrangements for the healthcare needs of your residents? If "Yes," describe these arrangements.  Yes  No
- 5** Are your facilities designed to meet the physical, emotional, recreational, social, religious, and/or other similar needs of the elderly or handicapped? If "Yes," describe these design features.  Yes  No

**Section III Low-Income Housing**

- 1** Do you provide low-income housing? If "Yes," describe who qualifies for your housing in terms of income levels or other criteria, and describe how you select persons for your housing.  Yes  No
- 2** In addition to rent or mortgage payments, do residents pay periodic fees or maintenance charges? If "Yes," describe what these charges cover and how they are determined.  Yes  No
- 3a** Is your housing affordable to low income residents? If "Yes," describe how your housing is made affordable to low-income residents.  Yes  No
- Note. Revenue Procedure 96-32, 1996-1 C.B. 717, provides guidelines for providing low-income housing that will be treated as charitable. (At least 75% of the units are occupied by low-income tenants or 40% are occupied by tenants earning not more than 120% of the very low-income levels for the area.)
- b** Do you impose any restrictions to make sure that your housing remains affordable to low-income residents? If "Yes," describe these restrictions.  Yes  No
- 4** Do you provide social services to residents? If "Yes," describe these services.  Yes  No

The Pension Protection Act of 2006 imposed new reporting requirements on small exempt organizations, so that beginning in 2008, organizations with gross receipts of \$25,000 or less must file an electronic notice, *Form 990-N* (e-Postcard). Supporting organizations with gross receipts of \$25,000 or less (except those supporting religious organizations) cannot file *Form 990-N*, but must file the *Form 990* or *990-EZ*.

### The Second Prong

- **The partnership or joint venture must be structured in such a way as to:**
  - (i) protect the exempt organization's assets from exposure to unnecessary risk for the benefit of the for profit partners; and
  - (ii) minimize the potential for private inurement or private benefit.

### Favorable IRS Criteria

- **Factors that bear favorably upon the IRS' determination:**
  - Limited contractual liability of the exempt partner.
  - Limited rate of return to the limited (for profit) partners.
  - Exempt organization's right of first refusal on the sale of the partnership assets.
  - Lack of control over the partnership by limited partners (e.g., parties are "unrelated" and no limited partner serves as an officer or director of the exempt organization).
  - The presence of additional general partners obligated to protect the interest of the limited partners.

- No obligation on the part of the exempt organization to return the limited partners' capital contribution from the exempt organization's funds.
- Profit is not a primary motivation.
- All transactions with the limited partners are made at arms length and are reasonable.
- Lack of "negative" or unfavorable factors and/or improper guarantees.

- **IRS Non-Profit Guaranty Issue – April 2006 IRS Guidance -- (Arose in context of Low-Income Housing Safe Harbor).**
  - **Written representations**
  - **Governing documents not required**
  - **Phase I environment report**
  - **Construction period including initial lease-up: fixed price/bonded contractor**
  - **Operating deficit guarantee limitation**
  - **Tax credit adjuster limitation**
  - **Repurchase guarantee cap**
  - **Limitation on investor consent rights**
  - **Removal of non-profit general partner limitation**

- **Impermissible Private Benefit**
- **Rev. Rul. 98-15: Voting Control, Charitable Override, Day-to-Day Management**
- ***Redlands Case***
- ***St. David's Case***

On March 4, 2004, a Federal District Court jury in the Western District of Texas, rendered a verdict in favor of *St. David's Health Care System*, reconfirming *St. David's* status as a tax-exempt healthcare entity after its joint venture with the for-profit Columbia/HCA Healthcare Corporation ("HCA"). The instructions given to the jury closely followed the opinion issued by the Fifth Circuit Court of Appeals on November 7, 2003, which decided the appeal of the Federal District Court's opinion in response to a summary judgment motion. That District Court opinion was vacated and the case remanded back to the District Court for a jury trial due to genuine issues of material fact.

In *St. David's* the Appellate Court (Fifth Circuit), provided a road map for the District Court to follow to resolve the only factual issue that remained in the case: Whether *St. David's* ceded control over the partnership to HCA. The instructions given by the District Court judge to the jury followed the Appellate Court's opinion and legal standards. Excerpts from the jury instructions are as follows:

14. "Control" as used in these instructions does not mean control over every aspect of Partnership operations, but sufficient control over the partnership to ensure that Partnership operations are conducted primarily for charitable purposes, and only incidentally for the private benefit of HCA. Such control may be (1) formal control through majority voting power on the governing board; or (2) effective control through exercise of *St. David's* rights, powers, or binding commitments under the Partnership agreements.

15. ... In determining whether *St. David's* retained sufficient effective control, you should consider all the facts and circumstances, including, but not limited to, (i) any applicable powers or rights allocated to *St. David's* in the Partnership's governing documents, (ii) evidence of *St. David's* ability and willingness, if any, to enforce any such powers, (iii) the structure of the Partnership, (iv) the management of the Partnership, and (v) the actual operation and subsequent activities of the Partnership.

The jury responded to a single interrogatory: "Do you find *St. David's* proved by a preponderance of the evidence that it is entitled to a tax exemption for tax year 1996?" The jury answered "We do".

The IRS appeal of the jury verdict was settled out of court by the parties.

**Issue: Do the “Control Rules” of 98-15 apply to “ancillary” ventures which involve less than all the assets of the Charity?**

**Rev. Rul. 2004-51 addresses whether an exempt organization that contributes a portion of its assets to a limited liability company formed with a for profit corporation can still qualify for exempt status. It also discusses the UBIT question. Both issues are decided favorably for the charity.**

**There is a 50/50 governing board – the fact pattern involves a University that conducts seminars for school teachers. It forms an LLC with a for-profit company which conducts interactive video training programs.**

**The University has the exclusive right to approve the curriculum, training materials and instructors and determine the standards for successful completion of the seminars; that is, it “controls” the education content.**

**The for-profit will have the exclusive right to select the locations and approve personnel such as camera operators.**

**Thus, there is a clean split between control of the educational and the administrative side.**

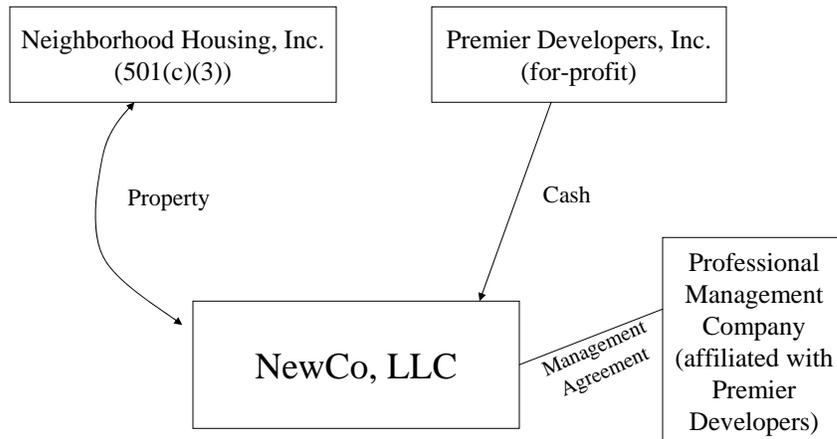
**Held: no effect on exemption: traditional UBIT analysis: the LLC's activities are substantially related to the University's exempt purpose.**

**The ruling demonstrates that “control” of the entire venture is not essential; control can be ‘bifurcated’, as long as the exempt organization controls the substantive, “charitable” aspects. Moreover, given the exempt organization’s exclusive control over the venture’s charitable aspects, the need for an affirmative charitable “override” is no longer required.**

However, the inquiry does not stop there, because prior to reaching its conclusion about exempt status, the Service sets forth what it views as the relevant legal standards: applicable provisions of the Internal Revenue Code, Treasury Regulation, and Rev. Rul. 98-15, *Redlands* and *St. David's*. It is the Service's reliance upon the foregoing, that raises questions as to the significance of this otherwise "plain vanilla" ruling. Implicitly, the ruling suggests, but does not state, that given a different set of facts, the cited legal standards would govern the analysis.

They *imply* that the analysis in ancillary joint ventures will follow the principles set down in Rev. Rul. 98-15, *Redlands* and *St. David's*, that control over the joint venture, or at a minimum, "bifurcated" control over the charitable aspects of the venture, is necessary to avoid unrelated business income as well as loss of exemption, at least in the context of a "substantial" activity.

## Ancillary Joint Venture: ASC



**“UBIT PLUS CONTROL” TEST.** An interesting question in the analysis in Rev. Rul. 2004-51, is whether the Service is now applying a “UBIT plus Control” test, which applies the standard UBIT analysis to ancillary joint ventures involving exempt organizations, and superimposes upon that standard the “control test” of Rev. Rul. 98-15, *Redlands* and *St. David’s* – so that even if the activity of the partnership is “substantially related” to the exempt organization’s purpose, it will be deemed to be an “unrelated” trade or business if the exempt organization cedes effective control over the substantive aspects of the venture to the for-profit entity.

Stated another way, what this ruling implies is that, given other factual patterns or scenarios *not* presented in the ruling, even a substantially related activity may cause loss of exemption, or generate UBIT to the nonprofit, if the nonprofit cedes control to the for-profit, at least as to the “charitable” or substantive aspects of the venture.

### **Low-income Housing Tax Credit (LIHTC): Compliance Requirements**

- Program created by federal law in 1986 and administered by State Housing Credit Agencies
- A dollar for dollar reduction in the Taxpayer’s federal income tax liability
- LIHTC claimed by Taxpayer over a 10-year Credit Period
- Available to Taxpayers that build or acquire and substantially rehabilitate rental housing that satisfies tenant income and gross rent requirements throughout 15-year compliance Period
  - Project owners will also be subject to tenant income and gross rent requirements for an Extended use Period – 15 additional years beyond the Compliance Period

- Federal law allocates LIHTC to each State annually
  - \$1.90 per capita in 2006, indexed for inflation
  - \$2,000,000 minimum per State
  - Additional LIHTC now available in GO Zone (areas affected by Hurricanes Rita and Katrina)
- State Agencies receive applications from sponsors/developers and award allocations to selected projects
- Projects financed with Tax-Exempt Bonds may be eligible for LIHTC without obtaining allocation through the application process
  - 50% of the aggregate basis of the land must be financed with the proceeds of Tax-Exempt Bonds

## Calculating the LIHTC Applicable Percentage

- Applicable Percentage: The percentage that will yield over the 10-year credit period a credit with a present value equal to a specified percentage (70% or 30%) of Eligible Basis
- Present value is determined by reference to average annual Federal mid-term and long-term rates, and therefore changes from month to month.
  - For September 2007, the Applicable Percentages are:
    - For the 70% Present Value Credit (also known as the 9% Credit) – 8.15%
    - For the 30% Present Value Credit (also known as the 4% Credit) – 3.49%
- Whether a project will qualify for the 70% Present Value Credits or the 30% Present Value Credits depends on whether the project is federally subsidized

- 2 Basic Types of LIHTC Projects:
  - New Construction
  - Acquisitions and Rehab

	New Construction	Acquisition and Rehab
Federally Subsidized	4% Credit	4% Credit
Non-federally Subsidized	9% Credit	Acquisition: 4% Credit Rehab: 9% Credits

### Calculating the LIHTC Eligible Basis

- Rehabilitation Credits are available if, during any 24 month period, rehabilitation expenditures exceed the greater of:
  - \$3,000 per unit
  - 10% of the adjusted basis of the building  
(determined as of the first day of the period)

## LIHTC Rules for Eligibility

- **Minimum Set-Aside Tests:** a Qualified Low-Income Housing Project must meet one of 3 Minimum Set-Aside Tests
  - **20-50 Test:** At least 20% of the residential rental units must be rent-restricted and occupied by individuals, whose income is no more than 50% of area median gross income (AMI), adjusted for family size
  - **40-60 Test:** At least 40% of the residential rental units must be rent-restricted and occupied by individuals, whose income is no more than 60% of AMI, adjusted for family size
  - **25-60 Test:** Applicable in New York City only. At least 25% of the residential rental units must be rent-restricted and occupied by individuals, whose income is no more than 60% of AMI, adjusted for family size.
    - AMI is determined and published by HUD

- **Gross Rent Test:** a unit is rent-restricted if gross rent does not exceed 30% of the qualifying income level
  - **Maximum permissible rent is computed assuming occupancy of 1 person for a studio apartment and 1.5 persons for each bedroom in an apartment with one or more bedrooms**
  - **Rental assistance payments received under Federal, State or local housing programs are not taken into account in calculating rent limits – utility allowances charged to tenants are taken into account**

## LIHTC Compliance Tax Credit Compliance Period

- 15 years from beginning of Credit Period
- Project must comply with applicable Minimum Set-Aside Test throughout Compliance Period
- Subject to State Credit Agency Compliance Monitoring Program
- Noncompliance can result in recapture

- **Principal Compliance Requirements:**
  - **Gross rent for any LIHTC unit may not exceed 30% of the maximum qualifying income for that unit**
  - **Taxpayer must obtain tenant income certification and supporting documentation**
    - Small increases in tenant income will not raise compliance issue
    - However, in a mixed-income project, if a tenant's income rises above 140% of the maximum qualifying income, the next available unit must be rented to a qualifying low-income tenant

- **In mixed-income projects, vacant units that were last occupied by qualified low-income tenants will continue to be considered as occupied by low-income tenants for LIHTC purposes, provided:**
  - Reasonable attempts are made to rent the unit; and
  - No other units of comparable or smaller size are rented to nonqualified individuals
- **Taxpayer must certify annually to IRS that the project has complied continuously with applicable Minimum Set-Aside Test**

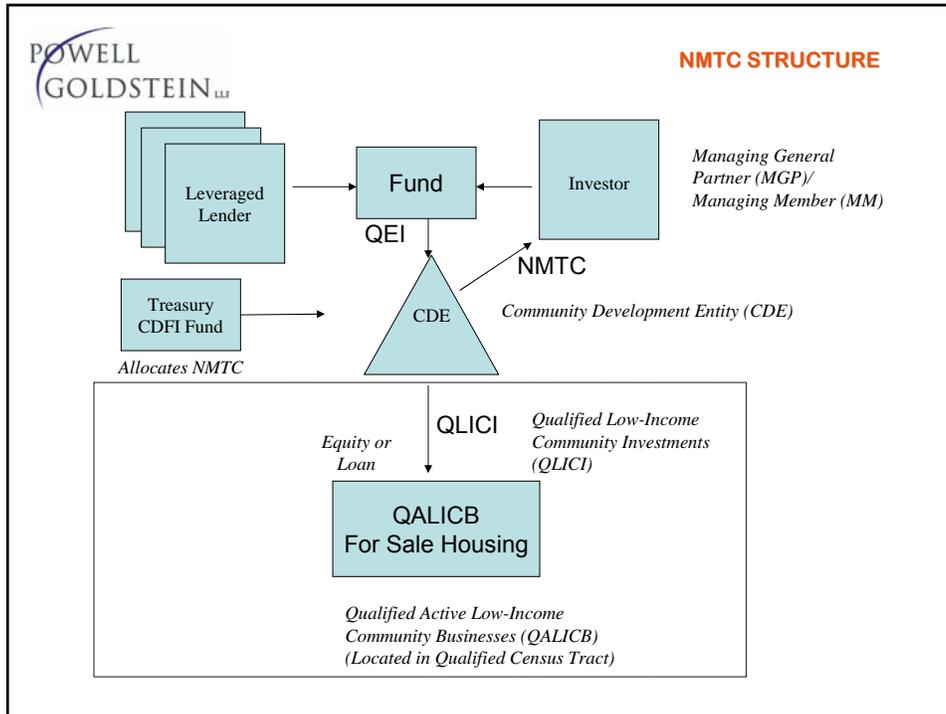
### NMTC Program Overview Applicable to Ancillary Joint Ventures

- **The Community Renewal Tax Relief Act of 2000**  
-- \$15 billion in NMTC to be allocated through 2007

<b>Purpose:</b>	To attract investment in distressed communities and promote economic growth.
<b>What does it provide?</b>	39% tax credit on the capital invested in a community development entity (CDE), over 7 years (5% in yrs 1-3; 6% in yrs 4-7).
<b>Who applies for the credit?</b>	Only a certified Community Development Entity (CDE) can apply for an allocation of federal tax credits.
<b>Who benefits from the credit?</b>	The investor/lender (typically national banks, insurance companies) making an investment in a CDE gets a tax credit of \$0.39 for every \$1 invested. The CDE directs capital into qualified projects or businesses. A "leveraged" structure is available.
<b>Eligible Investments:</b>	<ul style="list-style-type: none"> <li>▪ Low-income community businesses includes <u>e.g.</u> hospitals, charter schools</li> <li>▪ Commercial or mixed-use real estate projects (at least 20% of gross income from commercial component).</li> </ul>

- Four rounds allocated by CDFI Fund (Treasury) to CDEs to date; \$11.5B of NMTC investment authority or qualified investments allocated thus far (\$4.49B in tax credits)
- Special GO Zone allocation for an additional \$1B of NMTC investment authority. \$600M allocated along with 4<sup>th</sup> Round. \$400M to be allocated in 5<sup>th</sup> Round.
- Recent legislation has extended program through 2008 to provide an additional \$3.5B.
- Highly competitive process: Applications have oversubscribed available allocations by approximately 10 times.

- Credits are controlled by CDE, not by developer.
- Basis for credit is amount invested in CDE, not project cost.
- CDEs have one year to complete investments into projects/businesses



**POWELL GOLDSTEIN<sub>LLP</sub>** **ARE IRS' "CONTROL" RULES WORKING?**

- Exempt organizations are finding the “control requirements” too restrictive and, as a consequence, are increasingly reluctant to enter into joint ventures.
- Those organizations that do enter into joint ventures with for-profit organizations are so restricted by the “control requirement” that many tend to be conservative to the point of failure.
- See, Appendix, “Can the Commercial Model of ‘Unorthodox’ Joint Ventures Meet the Service’s Control Objectives?”, *Taxation of Exempts, November/December 2005*.

## What Should IRS Do?

The IRS could institute several practical policies to assist these charities in obtaining the resources to carry out their charitable missions, such as applying intermediate sanctions to nonprofits that engage in joint ventures that violate exemption laws instead of revoking exempt status. This sanction would allow exempt organizations to relinquish some control over the noncharitable aspects of a joint venture, without concern that their charitable status may be revoked.

Finally, the IRS should publish guidance based on practical situations in the low income housing tax credit area, such as Rev. Rul. 2004-51 in the educational context and Ltr. Rul. 200528029, in the trade association context, that governs nonprofit participation in joint ventures. This is the kind of practical guidance the low-income housing industry recently received, permitting them to provide limited guarantees in LIHTC joint ventures.



Atlanta ■ Washington ■ Dallas

**Michael I. Sanders**  
**msanders@pogolaw.com**

One Atlantic Center  
Fourteenth Floor  
1201 West Peachtree Street, NW  
Atlanta, GA 30309  
Tel. 404.572.6600  
Fax. 404.572.6999

901 New York Avenue, NW  
Third Floor  
Washington, DC 20001  
Tel. 202.347.0066  
Fax. 202.624.7222

JP Morgan Chase Tower  
2200 Ross Avenue  
Suite 3200  
Dallas, TX 75201  
Tel. 214.721.8000  
Fax. 214.721.8100

**[www.pogolaw.com](http://www.pogolaw.com)**

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