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IRS Tax Exemptions and Affordable Housing: Old Standards for New Times

by Janet E. Stearns
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For more than twenty years, the Internal Revenue Service has recognized the provision of low- and moderate-income housing as a charitable activity, and has granted section 501(c)(3) tax exemptions to qualifying organizations. Over this period of time, many new models of affordable housing have been established. The large public housing projects in our urban centers have been replaced with an array of housing types for the poor, including scattered housing, homeownership for low- and moderate-income persons, and mixed-income developments. This development has led the IRS to question whether an organization that serves a mix of persons, only some of whom are poor, qualifies for exemption under section 501(c)(3) of the Internal Revenue Code.



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In order to stem perceived abuses by private developers and management companies, the IRS has issued a safe harbor guideline that sets forth strict numerical standards to be applied in determining whether an affordable housing organization basing its exemption on relief of the poor is entitled to a charitable exemption. Housing organizations that fail to meet the safe harbor may still qualify for a charitable exemption by demonstrating through facts and circumstances that they relieve poverty or promote social welfare.

This article will analyze the standard for tax exemption of affordable housing organizations under section 501(c)(3) of the Internal Revenue Code, and will discuss the impact of a narrow interpretation of this standard by the IRS on affordable housing organizations currently holding or seeking charitable tax-exempt status.

The IRS Standard

Section 501(c)(3) of the Internal Revenue Code, which sets forth the standards for charitable tax exemption, provides that an organization must be organized and operated exclusively for charitable purposes. Pursuant to the Treasury Regulations, at section 1.501(c)(3)-1(d)(2), the term "charitable" includes (1)

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relief of the poor and distressed or of the underprivileged and (2) the promotion of social welfare by lessening neighborhood tensions, eliminating prejudice and discrimination, or combating community deterioration.

When the IRS first recognized the provision of low- and moderate-income housing as a charitable activity in Revenue Ruling 70-585, 1970-2 C.B. 115, it did not identify qualifying income limits but rather looked generally to the facts and circumstances of the proposed housing development. That revenue ruling describes four types of housing developments and concludes that housing for persons of moderate (but not low) income does not promote social welfare and will not be considered charitable for purposes of tax exemption, whereas housing that serves the poor or that eliminates prejudice, lessens neighborhood tensions, or combats community deterioration will qualify.

The origins of the current IRS position with respect to the charitable tax exemption of affordable housing organizations can be found in its *Exempt Organizations Continuing Professional Education Technical Instruction Program* (1991), a training manual intended to educate exempt organization specialists nation-

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wide in important policy directions. The manual features a chapter entitled "Low Income Housing as a Charitable Activity," which provides important insights into the mindset of the IRS. It affirms that "poor" means "needy" in the sense that a person cannot afford decent housing without forgoing the basic necessities of life. And the chapter begins to explore a definition of poor by reference to numerical tests used in different sections in the Internal Revenue Code. What it fails to do, however, is to specify the percentage of units in an affordable housing project that must be available to the poor in order to determine whether a housing organization is relieving poverty.

Subsequent to the publication of the training manual, the IRS published in the *Internal Revenue Manual* 1992 (§ 7664.342), a safe harbor guideline for housing organizations that rely on the relief of the poor and distressed as the basis of charitable exemption. This guideline apparently precipitated sufficient controversy in the housing community that a notice was published in the *Internal Revenue Bulletin* on January 4, 1993, inviting public comment on appropriate modifications.¹ Because the guideline will be actively debated in the next few months, this is a critical time for housing advocates to participate in the debate.

The safe harbor guideline defines the class of "poor" that must be served for the housing development to be deemed charitable. It states that an organization will qualify for tax ex-

emption if it establishes that at least 75 percent of the units for a given housing project will be made available for families earning 60 percent or less of the area's median income, as adjusted for family size; the remaining 25 percent of the units are to be made available to persons on the "lower end of the economic spectrum." These persons need not be members of the charitable class. The *Internal Revenue Manual* notes that exemption is not precluded for organizations that do not satisfy the safe harbor guideline, but that in such cases a review of all of the facts and circumstances will be necessary.²

Whether or not they fall within the safe harbor, these organizations must be able to demonstrate that their activities serve public, rather than private, interests. A community-based board of directors would be a significant factor supporting a charitable purpose. Relationships with private persons, such as developers or managers, will be subject to special scrutiny.

Critique of IRS Standard

For administrative ease, the IRS has shifted to using fixed-income guidelines as the basis of the charitable tax exemption, a shift that is troubling to affordable housing developers. Although the training manual notes that "poor," "distressed," and "low-income" are not defined in the Internal Revenue Code or Treasury Regulations, it proceeds to cite the standards under the low-income housing tax credit program (50 and 60 percent of median income), and the Housing Act of 1937 and section 8 program (50 percent of median income) as illustrative of the income limits that should be applied by "charitable" low-income housing organizations. The safe harbor guideline clearly adopts this view. The implication is that the myriad current housing programs serving 100 percent, or even 80 percent, of area median income, and mixed-income programs, may be suspect as not truly "charitable."

Oddly, neither the training manual nor the safe harbor guideline makes any mention of the newly enacted Cranston-Gonzalez Act, which looks to much higher income limits for the targeting of HUD funds. The guideline cites only standards used in rental housing programs, which are generally able to assist lower-income persons, rather than any of the homeownership programs that exist. For example, even the mortgage revenue bond program under section 143 of the Internal Revenue Code, an affordable housing program for homebuyers who have not owned homes in three years, reaches persons at 115 percent of area median income.

In practice, it is likely that the exemption applications of organizations not satisfying the safe harbor guideline will be subject to in-depth review, thereby requiring additional processing time. A housing organization that does not meet this strict numerical test will need to prove to the IRS that its housing program is in fact charitable, relying on the facts and circumstances test. A more practical approach would be for the IRS to adopt income guidelines consistent with those utilized by federal housing programs so as to facilitate rather than hinder the use of those programs.

Where the "relief of the poor" standard is not satisfied by homeownership or mixed-income developments, the alternative test of "promotion of social welfare" is even more important. Under the safe harbor guideline, an applicant for exemption can make its case even if the housing development does not serve the "poor" as defined by the IRS. It must demonstrate that it promotes social welfare. However, the IRS must re-interpret

"promotion of social welfare" in light of today's housing needs and programs.

One way of promoting social welfare is for the housing development to combat community deterioration. However, more and more housing organizations are challenging traditional notions of housing projects and exclusionary zoning laws by mov-

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ing into suburbs with scattered-site housing. These developments do not combat directly "municipal squalor" as conceived in earlier revenue rulings, nor can they produce the types of evidence of deterioration that the training manual indicates is necessary for a charitable determination.³ Rather, these developments promote a balance among cities and suburbs that contributes to the overall stability of a region. Although the IRS has granted exemptions to housing organizations that combat "potential" community deterioration, it has not recognized a broader regional theory that would be consistent with the type of affordable housing that meets this need.

The IRS must also re-evaluate its criteria for eliminating prejudice and discrimination and lessening neighborhood tensions, the other components of promoting social welfare. The training manual indicates that the organization must show how the present racial and ethnic mix has or will give rise to neighborhood tensions, and how the affordable housing program will alleviate such tensions. Again, historic notions of neighborhood tensions may be anachronistic today, and the IRS should be more open to the benefits of affordable homeownership and rental development in suburban contexts that ultimately lead to societal integration, even absent direct evidence of racial tensions.

Conclusion

Affordable housing nonprofit organizations seeking tax exemption should understand the criteria that are currently applied in evaluating exemption applications. Those organizations with favorable section 501(c)(3) determination letters from the IRS should review the representations made in their applications and ensure continuing compliance with those representations in light of the standards set forth in the 1991 training manual. For example, if an organization's status was granted on the basis of combating community deterioration and that group now does exclusively suburban development, the IRS may attempt to revoke the exemption unless the organization can demonstrate the means by which it achieves that goal.

Increasingly, our federal affordable housing policy has moved away from governmentally owned projects and toward developments sponsored by private housing nonprofits. It is ironic that as HUD increases its reliance on the nonprofit community, the IRS has made it more difficult for those very organizations to obtain section 501(c)(3) charitable tax exemptions, which would enable them to qualify for tax-exempt bond financing or other forms of public financing to construct affordable housing.

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Back-Up Support

Back-up support includes both direct consultation and advice to lawyers working with community development corporations, and acting as a resource center to provide information on significant developments in community development law. This support ranges from review and comment on difficult tax exemption applications to review and comment on low-income housing tax credit syndication documents. Any private lawyer providing pro bono assistance to a low-income community development organization can consult with Center lawyers.

The Center is creating a community development resource center with a documents bank containing sample agreements, forms, training material, and other documents prepared by Center, Legal Services, and private lawyers. The resource center will also include case studies and other information about community development organizations and their projects across the country, as well as information about funding and technical resources available to community development organizations. Submissions to the documents bank are always welcome.

Further information about the materials in the documents bank can be obtained by phoning or writing the Center, or by using Handsnet, an electronic forum. The Center is located in the "Legal Services" folder of the main menu. Select "Substantive Law" within that folder, then select the "Economic Development" folder. To contact the Center via electronic mail, use subscription code HN0186.

The Private Bar

Recognizing the need for private attorney assistance to the growing number of community development corporations, the Center in 1984 prepared a new manual to replace the outdated *Lawyer's Manual*. Entitled *Counseling Organizations in Community Economic Development*, the manual is a loose-leaf collection of Center articles, sample documents, training and practice outlines, and resource lists on matters of community development law. Newly prepared material is sent annually to each manual holder. Materials in the manual may be freely reproduced for use in private bar training.

Many cities now have organized programs to recruit private lawyers for volunteer assistance to community development corporations. The Center has made presentations in Chicago for the Community Economic Development Law Project and in Indianapolis for the Community Organizations Legal Assistance Project, and works closely with Public Counsel in Los Angeles, the Lawyers Committee in San Francisco, and other such clearinghouses. The Center is available to assist any community interested in forming a community development law project.

Academic Involvement

Also, a growing number of law schools have courses and clinical programs in community development law. The Center teaches a class at Hastings School of Law in San Francisco and has consulted with the organizers of courses at the University of Michigan, Stanford, and Yale, among others.

The Center has even worked with visiting professors on sabbatical, offering them a chance to work closely with community development organizations on major projects. One professor, for example, assisted a group of charitable corporations in the negotiation and acquisition of an office facility. Under pressure from increasing rents and decreasing available and affordable

space in their community, these corporations felt the need to own their office space. Individually, they were unable to do so, so they formed a new charitable corporation to be the owner-tenant to the member-tenants. Collectively, they were able to raise the money for acquisition and rehabilitation. There are relatively few examples of joint facilities purchased by community development organizations, but more are likely in the coming years.

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Because of the Center's national focus, it can provide perspective and a different insight to private lawyers new to the representation of community development organizations. As the Clinton Administration's community economic development program takes shape, the Center hopes to hear more from, and work more with, the private bar. □

COMMUNITY ORGANIZATIONS

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age and sustain the tireless work of these organizations and the individuals that drive them.

For further information about Enterprise's and LISC's activities and community-based development organizations in your area that might be looking for legal representation, contact Ellen Lazar, general counsel of Enterprise, at 410/964-1230, or Michael Levine, general counsel and secretary of LISC, at 212/455-9867. □

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Section 501(c)(3) status also enables housing organizations to attract tax deductible gifts and grants, as well as to satisfy eligibility requirements for other governmental programs that incentivize the construction of affordable housing.

The policies indicated by the safe harbor guideline and the training manual portend great difficulties for these nonprofits obtaining and preserving their charitable status. To the extent that section 501(c)(4) organizations may be eligible for subsidies through federal or other governmental housing programs, there may be less urgency to seek tax exemption under section 501(c)(3) and, therefore, no need to meet the safe harbor guideline. But at present, section 501(c)(3) status is generally desirable for most housing organizations.

The IRS misunderstands the nature of affordable housing development today. The IRS should be consulting with HUD and the movers behind the Cranston-Gonzalez Act to provide a consistent federal message to local affordable housing organizations. The housing community has a unique opportunity to raise these issues with the IRS during the comment period on the safe harbor guidelines. □

1. Notice 93-1, INTERNAL REVENUE BULLETIN 1993-1, 172. The comment period expires March 5, 1993, but as this article went to press a sixty-day extension had been sought by national nonprofit groups.

2. The *Manual* does note that exemption could be adversely affected for organizations that have a right to evict the elderly or handicapped for failure to pay rent. See Rev. Rul. 79-18 and 79-19.

3. The training manual recommends that an organization substantiate its claim of community deterioration with facts such as a designation by the local, state, or federal government that the area is blighted.