



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

1/24/04
Beck

Date:

NOV 25 2003

[Redacted]

Contact Person:

[Redacted]

Contact Number:

[Redacted]

Employer Identification Number: [Redacted]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

FACTS

You were incorporated on [Redacted], 2002 and filed an application for exempt status shortly thereafter. You plan to purchase buildings to operate as low-income housing in a number of medium-sized cities. Tax-exempt bonds, taxable bonds, purchase money indebtedness issued to the seller of the facility, interest earned on unexpended bond proceeds and state or federal governmental housing programs will provide the financing. You state that you will operate the facilities in compliance with Rev. Proc. 96-32.

Your long range goal, described in Attachment II.2 is "to assemble a major, national chain of affordable housing facilities, which will enable it to provide housing to moderate and low income tenants in many market areas...." You will "acquire projects as quickly as they can be prudently identified and financing arranged," probably no more than 1 or 2 projects per year, "given the complexity of such financings." You will locate facilities "anywhere in the continental United States that such projects are available to be acquired."

Your CEO and board members will identify facilities to purchase "through their contacts with brokers, underwriters and other sources." Your CEO will "make a preliminary evaluation for quality, price and financiability (sic)." The board will commission an MAI or HUD appraisal, and other evaluations of engineering and environmental issues.

You do not expect to hire any employees. The Board of Directors will conduct the activity, "through arrangements with experts and other providers of the services necessary." [Redacted] "anticipates operating its facilities under management contracts with

[REDACTED]

professional managers of such facilities, which may in some instances be the seller of the facility." Your "officers and directors will maintain close contact with the managers," meeting at least 10 times per year, usually by telephone conference. You plan to have each board member visit one facility each year, and your full board will visit one facility each year.

A hypothetical budget shows that you plan to do little renovation. You hope to acquire projects that do not need extensive renovation "so as to minimize risk to potential bondholders."

A management agreement shows nearly complete control given to the manager. There is no charitable purpose clause, although the agreement is made "subject to all of the terms and conditions of the Bond Documents." The manager provides a management plan including rental rates which will ensure compliance with the Rev. Proc. 96-32," but is also authorized to establish and revise rents, subject to owner's written approval. The owner has a right to terminate due to default on any material provision of the agreement, after notice and opportunity to cure. It may also terminate if the manager causes a breach of default under the bond documents, or if the manager fails to implement any recommendation of a management consultant retained pursuant to the bond documents. The management fee, which is in addition to reimbursement for expenses, is set forth as "\$___ plus ___% of monthly gross receipts in excess of \$___ but not to exceed \$___."

Your [REDACTED]-person Board of Directors includes [REDACTED], and all of the directors also are directors of a group of nursing and rehabilitation facilities called [REDACTED]. Apparently, these have all been financed with tax-exempt bonds also. The board members reside in four different states. You intend to reimburse directors for board meetings and to pay "modest fees to the Board members, either for their service on the Board or for their service as officers of the Company at a rate on the order of \$ [REDACTED] per annum per facility up to an amount which would be comfortably within the guidelines set forth in Treasury Regulations." Your President & CEO will also receive "reimbursement for out-of-pocket expenses... and a salary on the order of \$ [REDACTED] per annum per facility...." Your by-laws do not provide for oversight of the reimbursement decisions by financially disinterested persons, nor do they include a conflict of interest provision. The law firm of your director, [REDACTED] serves as your counsel, to whom you pay "usual and customary fees for professional services rendered."

You believe that "having separate locations will further the Company's exempt purposes by enabling the Company to subsidize projects which are not performing well from the excess revenues of projects which are performing better than anticipated, thereby providing greater economic stability to the over-all enterprise." You believe that you will "need to generate an excess of revenues over expenses" to ensure compliance with Rev. Proc. 96-32.

LAW

Section 501(c)(3) of the Internal Revenue Code (the Code) recognizes 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 1.501(c)(3)-1(e) of the Income Tax Regulations (the regulations) provides that an organization may meet the requirements of section 501(c)(3) of the Code although it operates 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 purpose.

Section 1.501(c)(3)-1(c)(1) of the regulations states 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). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations states that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization had the burden of establishing that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Revenue Procedure 90-27, 1990-1 C.B. 514 explains that exempt status will be recognized in advance of operations if proposed operations can be described in sufficient detail to permit a conclusion that the organization will clearly meet the particular requirements of the section under which exemption is claimed. The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means for carrying out the activities, the anticipated sources of receipts, and the nature of contemplated expenditures.

Revenue Procedure 96-32, 1996-20 I.R.B. 14 defines some circumstances under which organizations providing housing will be considered charitable within the purview of section 501(c)(3) because they relieve the poor and distressed. The circumstances described constitute a "safe harbor," which the Service has said in advance it will recognize as a charitable purpose. An organization must establish that at least (a) 75 percent of its units are occupied by low-income families, and (b) either 20 percent of the units are also occupied by very low income residents or 40 percent of the units are occupied by residents whose incomes do not exceed 120 percent of the area's very low income limit. In addition, the housing must be affordable, a requirement that may be satisfied by use of government-imposed restrictions. The organization may not further the private interests of individuals with a financial stake in the project resulting from real property sales, development fees or management contracts.

Federation Pharmacy Services, Inc. v. Commissioner, TC Memo 1986-348, holds that although the activity of the organization promoted health, which could be a charitable purpose, it operated in a commercial manner. The opinion notes that the organization relies upon the sale of drugs to the public and competes with commercial pharmacies. The slight discount offered, which does not reduce prices below cost, did not amount to a charitable purpose.

[REDACTED]

In *Living Faith, Inc. v. Commissioner*, TCM 1990-484, the court holds that the operation of a restaurant and health food shop is not exempt under section 501(c)(3) of the Code. Although the establishments carried out religious rules about food, they were operated in a commercial manner. The court pointed out that they were in competition with commercial restaurants, and set prices, hours, and other characteristics to compete with those commercial restaurants.

In *Airlie Foundation v. IRS*, 2003 TNT 188-69, the court holds that a foundation operating a conference center that derives substantial income from special events and private persons and competes with commercial entities is operated for a substantial non-exempt purpose and is not entitled to recognition under section 501(c)(3).

ANALYSIS

You have not demonstrated that you will be organized and operated exclusively for exempt purposes. Because you have applied for exempt status in advance of operations, you have the burden of describing your proposed operations in sufficient detail to show that you will clearly meet the criteria. Revenue Procedure 90-27, *supra*. The information that you have submitted will not allow the Service to conclude that you are organized for exempt purposes rather than for the benefit of private interests. Furthermore, the information that you have submitted will not allow the Service to conclude that your activities will be operated exclusively for exempt purposes rather than commercial purposes.

Your application raises questions that it does not answer about possible private benefit in several areas. The first is your relationship to the seller of the facilities. You indicate that you will, in some cases, take back a purchase-money mortgage from the seller of a facility and you may hire the seller to manage a facility. In addition you intend to use bond financing, both tax-exempt and taxable, but have not specifically answered many of the questions related to bonds because you have not begun operations. The relationships to the seller and with the parties to a bond issue, create the risk of private benefit. Allowing the board to make decisions about its own compensation will, at a minimum, prevent you from taking advantage of the rebuttable presumption that compensation is reasonable.

Organizations that wish to be exempt from income taxation must operate exclusively for exempt purposes. Many activities can be carried out either as exempt or as commercial activities. For example, a pharmacy that sells to the public, competes with commercial pharmacies, and offers only slight discounts was held by the Tax Court to be operating in a commercial manner. See *Federation Pharmacy Services, supra*. Similarly, the Tax Court found a restaurant that carried out religious rules about food, but competed with commercial restaurants, setting prices, hours, and advertising to compete with them was not operating in an exempt manner. See, *Living Faith, Inc., supra*. Recently, the U.S. District Court for the District of Columbia analyzed the operation of a conference center by a foundation by using the commerciality doctrine. The Court found that the facts that 30-40% of the patrons were private or corporate, that it discounted some fees but provided few services below cost, competed directly with a number of commercial operations, and maintained a commercial website and

[REDACTED]

paid for significant advertising and promotion all indicated that it was operated for a significant non-exempt commercial purpose.

Developing and managing housing for low-income residents can be accomplished either as a commercial venture or as an exempt activity. Many of the features of your anticipated operation appear to be commercial. You plan to generate an excess of revenue over expenses, you pay your board and president significant sums without any oversight by financially disinterested persons. Your board is a small one, related by family and past business ties. It lacks community representation from either the geographic locations in which you intend to operate, the low-income persons you plan to serve, or anyone with knowledge of or interest in housing for low-income persons. You plan to establish a national chain as quickly as possible, the expansion dependent upon obtaining funding. You intend to finance your operations through taxable and tax-exempt bonds, rather than grants, government subsidies, or donations. Your board will identify facilities for purchase that your president will evaluate for quality, price, and ability to finance, rather than on the basis of identified need in a particular community. You plan to acquire projects that do not need renovation or rehabilitation to minimize risk to bondholders. You have failed to describe your proposed activities sufficiently to allow the Service to conclude that you will operate exclusively for exempt purposes.

You have failed to establish that your proposed activities will be in furtherance of section 501(c)(3) purposes, therefore you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service,

[REDACTED]

TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
[REDACTED]
1111 Constitution Ave, N.W.
Washington, D.C. 20224

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

Sincerely,

[REDACTED]
[REDACTED]
Manager, Exempt Organizations
[REDACTED]

Originated By

Reviewed By

[REDACTED]
[REDACTED]
[REDACTED]