

J. LOW-INCOME HOUSING UPDATE

by

Lynn Kawecki and Marvin Friedlander

1. Introduction

This article supplements the discussion of low-income housing in the 1992 CPE text in the context of public comments, both formal and informal, on Notice 93-1, Safe Harbor Guideline for Low-Income Housing, 1993-1 I.R.B. 172. Although it is not the function of this article to provide an official response to the public comments, it will discuss some major concerns raised in the comments in the context of Service positions.

2. Safe Harbor Guideline

A. Background

The Service has long held that providing affordable, low-income housing is not, in and of itself, a charitable purpose under IRC 501(c)(3) or Reg. 1.501(c)(3)-1(d)(2). A housing organization must provide housing in a charitable manner to qualify for exemption. This can be done by serving charitable purposes including relief of the poor and distressed, lessening the burdens of government, lessening neighborhood tensions, elimination of discrimination, combatting community deterioration and providing specialized housing for the elderly or the handicapped. See the 1992 CPE text for a thorough discussion of these grounds.

To obtain recognition of exemption, an organization providing low-income housing has been required to demonstrate, through the facts and circumstances of its operations, that it served charitable purposes as defined in Reg. 1.501(c)(3)-1(d)(2). On October 16, 1992, the Service published the Safe Harbor Guideline for Low Income Housing (guideline or safe harbor) in IRM 7664.34 to provide a "bright-line" standard to simplify the process for low-income housing organizations that clearly relieve the poor and distressed within the meaning of Reg. 1.501(c)(3)-1(d)(2). To assure public notification and to request public comment, the Service reprinted the guideline in Notice 93-1, 1993-1 I.R.B. 172.

Generally, an organization will meet the safe harbor guideline if it establishes that at least 75 percent of the units for a given project will be made available for families earning 60 percent or less of the area's median income, as

adjusted for family size. Of the remaining 25 percent of the units, if any, the organization must adopt a general policy that states the remaining units will be made available to persons on the lower end of the economic spectrum, yet who may not necessarily be members of a charitable class.

Many housing organizations that apply for exemption based on relief of the poor and distressed find that the clear standard of the guideline eases and expedites their task of establishing their qualification for exemption. These are generally organizations that are substantially subsidized through grants, contributions, or government rental subsidies. Because the subsidies relieve them of the reliance on rental receipts, these organizations tend to provide benefits to the maximum number of tenants meeting the guideline's income standard.

The safe harbor is merely an alternative method of demonstrating qualification for exemption under IRC 501(c)(3). Inability to meet the safe harbor provision for low income housing may never be used to deny exemption to an organization. Rather, failure to meet the safe harbor merely requires application of the facts and circumstances test to determine if the organization is relieving the poor and distressed or is otherwise serving charitable purposes.

B. Comments

Notice 93-1 has generated public comments, both formal and informal. Some comments have complained that the guideline is too restrictive and leaves too many organizations to face the uncertainties of the facts and circumstances test. This concern was expressed on behalf of organizations that are not heavily subsidized. Because they have insufficient subsidies, yet must meet operating expenses and service long-term debt, they rely on rental income from units leased at or near market rates to subsidize the below market rate units leased to poor and distressed tenants. They cannot remain economically feasible within the percentages set out in the safe harbor guideline.

The Service appreciates the concern and is studying methods to make it more flexible. However, the purpose of the guideline is to allow the Service to take a cursory look at the occupancy requirements of an organization's project and, quickly but confidently, determine if the composition of the residents is such that the organization is clearly relieving the poor and distressed. Accordingly, the guideline set income requirements at a level that allows the Service to conclude, without knowing anything else about the residents, that they qualify as poor and distressed. Whether the guideline can be relaxed without sacrificing Service

confidence in determinations has yet to be decided.

Some public comment on the guideline has come from organizations concerned that it is, or will become, a substantive rule that will adversely affect their qualification for exempt status. Some indicate that it has become an audit standard used to determine continuing qualification of organizations recognized as exempt under a facts and circumstances approach. Some have stated that they have been told by Service personnel that the safe harbor guideline is the exclusive method to determine the IRC 501(c)(3) qualification of low-income housing organizations, or that organizations must first demonstrate an inability to meet the safe harbor before being allowed to establish another basis for exemption. The guideline should only be used as a procedural tool to allow the Service to easily identify organizations that clearly relieve the poor and distressed. The safe harbor is not an audit standard. It should be used as an alternative method of demonstrating a charitable purpose. Failure to meet the guideline merely requires that an organization's eligibility for exempt status be determined under the facts and circumstances test.

Some comments express concern that the guideline is inconsistent with other federal housing programs. They argue that its required percentage of low-income residents are higher than those required by other federal programs and thus serve to frustrate federal housing policy. Others suggest that the Service retain the safe harbor as a standard to demonstrate relief of the poor and distressed, but that it develop another safe harbor for organizations that operate in government programs that provide for housing with a wider "mix" of income levels among residents. These comments suggest that use restrictions and rent restrictions, in combination with operation under a government housing program, could be used to demonstrate that an organization was operating to produce a public benefit.

These comments must be considered in light of long standing Service position that "poor and distressed," as used in Reg. 1.501(c)(3)-1(d)(2) in defining whether persons are members of a charitable class, has been limited to persons who are unable to afford the basic necessities of life without undue hardship. Further, the Service has long held that eligibility for assistance under a federal housing program does not define the recipient as a member of a charitable class. See, Rev. Rul. 70-585, 1970-2 C.B. 115. However, the points in these comments are well taken and will be given serious consideration in light of federal housing policies.

3. Facts and Circumstances

A. Organizations Relieving the Poor and Distressed

As emphasized above, an organization does not need to meet the safe harbor guideline to demonstrate that it relieves the poor and distressed within the meaning of Reg. 1.501(c)(3)-1(d)(2). The guideline specifically states that "[e]xemption is not precluded for organizations that provide housing but do not satisfy the safe harbor. For these organizations, consideration will be given to all the facts and circumstances of the particular case (e.g. the percentage of poor residents; an actual showing that the persons aided could not otherwise secure housing; retention of residents who initially were poor notwithstanding an increase in income consistent with federal, state or local housing programs; and any other special circumstance for not satisfying the safe harbor)."

One method of assuring continued viability of the facts and circumstances test is to provide additional factors for satisfying that test. Often times persons who are somewhat above 60 percent of median income may have the same or even less to spend on necessities because of their particular circumstances. For example, unusually high medical costs that are paid out of pocket may cause a family with an income greater than 60 percent of median to be in a worse condition with respect to other necessities, including housing. In these circumstances, the persons could qualify as poor and distressed.

Local conditions may result in a high housing cost area where incomes have not kept pace with costs. This would be a significant factor. Also, an area may be a high cost area for necessities other than housing so that when the costs of all necessities are considered, a situation may exist in which the general cost of living may prevent those in need of housing from having sufficient income to afford safe and decent housing.

We do not suggest that these factors are the only ones available to demonstrate that persons are poor and distressed. Other factors could be considered.

B. Organizations Serving Other Charitable Purposes

Even if a low-income housing organization's assistance is not limited to the poor and distressed, it is not necessarily disqualified from exemption under IRC 501(c)(3). The facts and circumstances may show that it serves another charitable

purpose listed in Reg. 1.501(c)(3)-1(d)(2). This is especially applicable to organizations operating under federal or state housing programs, as they may be found to be lessening the burdens of government, lessening neighborhood tensions, eliminating discrimination, combatting community deterioration, or providing specialized housing for the elderly or the handicapped.

As a direct result of the publication of the guideline there has been an increased reliance on combatting community deterioration by organizations that cannot satisfy the safe harbor and which are uncertain about the use of facts and circumstances to demonstrate relief of poor and distressed. Many times combatting community deterioration will provide an organization with a clear alternate method of demonstrating a charitable purpose.

Combatting community deterioration often applies to low-income housing organizations because many low-income housing projects are located in deteriorated areas. The importance of this approach is that the economic composition of the occupants of a low-income housing project is generally not crucial to exemption. This should be of considerable interest to many housing organizations which are funded from programs that require economic mixes that do not meet the safe harbor.

Generally, organizations seeking to qualify by combatting community deterioration are asked to supply information that the area in which they operate is designated by an appropriate governmental agency as blighted. If the organization cleans up or rehabilitates existing structures, or constructs new buildings in this designated blighted area, it will generally be regarded as combatting community deterioration. While this approach is consistent with charity law, it is not the sole method of demonstrating that an organization combats community deterioration. Combatting community deterioration may be demonstrated by reference to all the surrounding facts and circumstances, not merely designation of blight.

Various revenue rulings address combatting community deterioration. These indicate that the Service is willing to conclude that an organization combats community deterioration without a designation from a governmental agency that the area is blighted, although, the designation adds a degree of comfort. For example, if an organization applies for an exemption involving a single project, and it can demonstrate that the area has indicia of deterioration, we may have little difficulty concluding that the area is deteriorated for purposes of combatting community deterioration. However, if an organization intends to engage in projects throughout the city or state, we might not be able to conclude that the

organization combats community deterioration without representations that the rehabilitation or construction activities will be confined to areas designated as blighted by an appropriate government agency.

The suggestion that deterioration can be demonstrated by facts and circumstances begs the question as to what factors are important. This is a factual analysis, which means that any fact that tends to demonstrate that an area is deteriorated will be considered. For example, Rev. Rul. 70-585, supra., relies, in part, on studies that demonstrate that the area is old and badly deteriorated as well as having a lower median income than the rest of the city.

However, the facts do not have to be limited to those that demonstrate that the area is already deteriorated. In Rev. Rul. 68-17, 1968-1 C.B. 247, an organization combats community deterioration in deteriorating neighborhoods. Accordingly, the facts, in addition to demonstrating actual deterioration, may include those that demonstrate the process of deterioration. Similarly, in Rev. Rul. 68-655, 1968-2 C.B. 213, the activities of the organization do not demonstrate actual deterioration. In this ruling, the organization's activities that stabilize the neighborhoods combats the potential for community deterioration.

Some factors we have relied on in some recent applications that demonstrated deterioration as well as potential deterioration include:

1. Income level of the area residents. This is relevant to owner-occupied as well as tenant-occupied buildings. A homeowner of low-income is often unable to afford necessary repairs. If tenant-occupied, the cash flow may not support reserves necessary for repairs.
2. Age of the housing stock. This is particularly relevant when viewed in combination with the income level of the residents.
3. Unemployment in the area. This factor indicates that less money is available to make repairs. It also indicates a generally poorer economic base.
4. Location in relationship to parks or other areas for diversion. Limited recreational facilities place heavy pressures on the infrastructure of a neighborhood and may accelerate decline.

5. Comparative housing cost. Declining housing costs helps identify an area in decline.
6. Percentage of abandoned, boarded up or permanently vacant structures. And the size, age, and length of time structures have been boarded up.
7. The amount of crime in an area as compared to the rest of the city.
8. The level of drug trafficking.
9. The presence and amount of graffiti.
10. The percentage of homes below city code standards.

This list could be greatly expanded. However, in many cases, the determination that the neighborhood is deteriorating will be established by its designation as "blighted." Many areas that are in need of assistance have already been designated as blighted, or as an economic development zone, or designated as eligible for some governmental subsidy.

In some recent discussions, organizations or their representatives suggested that cities do not want the designation as blighted because such a designation may inhibit investment and growth. The designations are usually made in conjunction with or pursuant to some overall planning, development or grant program. Even if a city regards the designation of having blighted areas as onerous, it will not, generally, pass up a real opportunity to receive outside capital to help redevelop depressed areas.

Because the purposes for designations made by different agencies may differ, a designation from one agency may more effectively demonstrate deterioration than a designation from another. If an organization does choose to use a designation of blight as a factor to demonstrate deterioration, it should also show that the reasons for the designation demonstrate deterioration.

4. Conclusion

Those responding to Notice 93-1 have provided many valuable suggestions and incisive criticisms which have been helpful in our current considerations

about the need for making adjustments to the guideline. As decisions are made about the need for adjustments to the Guideline, we will provide notice to the public.