



Forming the Affordable Housing Nonprofit Developer

By Brent C. Shaffer

Given the desire of many to increase the production of simple, decent housing at low cost, it is ironic that the more affordable the housing, the more elaborate and complex is the task to build it. This truism holds for setting up the affordable housing developer itself. The affordable housing development entity can never be considered as something that can be easily established “off the shelf.” Every affordable housing development entity needs to be thought out very carefully before any type of formation document is drafted, any document is filed with the IRS, or any individuals are promised board or officer positions.

This article discusses issues that should be considered in drafting the affordable housing entity’s organizational documents, applying for tax-exempt status, and setting up its board and control structure. It assumes that the corporation is to be set up as a nonprofit corporation, with a true charitable purpose and not a profit motive, for the purpose of creating or enhancing affordable housing, either for sale or for rent. The corporation will need to qualify as tax-exempt under the Internal Revenue Code in order to attract the maximum amount

of equity contributions. In the nonprofit context, corporations provide the advantages of liability protection to members, officers, and directors without the countervailing consideration that argues against using for-profit corporations in real estate projects: the taxation of both corporate-level income and personal income (on distributions to the members or shareholders) and capital gains at the corporate-level on appreciated real estate owned by the corporation.

The developer in a tax credit deal must be a for-profit entity that can pass through the income tax credits awarded to tax credit investors, which will themselves be for-profit entities that can make use of the tax credits. For these reasons, the tax credit project development entity needs to be a limited partnership or limited liability company that meets numerous requirements of both the IRS and tax credit investors. See Stephanie M. M. Smith, *Partnership Agreements in Tax Credit Projects*, Prob. & Prop., Jan./Feb. 2007, at 61.

The formation of a development entity that uses either low-income housing tax credits (LIHTC) or historic tax credits is outside the scope of this article.

Organizational Documents

As a practical matter, in most jurisdictions the formation of the nonprofit affordable housing development corporation is mechanically accomplished like any other corporation, through the familiar process using three primary documents.

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A formation document is filed by an “incorporator” (usually the attorney who has prepared the document) with the proper state office. Written bylaws are prepared, setting forth more detail about the corporation’s books, management, and daily operations. An organizational action is then undertaken by the incorporator (or by the board of directors, if the initial board of directors is named in the formation document) to adopt the bylaws and elect the corporation’s initial officers, see, e.g., Del. Code Ann. tit. 8, § 108(a), and the action needs to be memorialized in corporate minutes or in a written action by unanimous consent.

Preparing these three documents and satisfying these straightforward mechanical basics are surprisingly difficult for an affordable housing developer. The documents cannot be finalized without consideration of several issues, which can be categorized into four primary areas of concern. First, the corporation’s structure must allow the nonprofit affordable housing corporation to obtain the maximum number of loans and grants it seeks. All of these funding sources will have their own requirements for structure and documentation. Second, the organization’s documents must be crafted, and the corporation must operate, in a way that enables the corporation to obtain, and later maintain, its tax-exempt status in the eyes of the IRS. Third, the documents must ensure that the entity operates within the primary philanthropic purpose of the corporation, as marketed to the project’s donors and other sponsors. Finally, the corporation’s structure must satisfactorily address control issues, such as maintaining the power of a “sponsor” that is the primary driver or source of funds in setting up the nonprofit corporation or addressing the concerns of various stakeholders in the philanthropic purpose of the corporation, such as the community in which the housing will be developed.

The potential sources of debt and equity funds can be numerous, and nearly every affordable housing project will use more than one source. For example, projects involving new or

rehabilitated housing for sale or for rent may seek loans (or, in exceptional cases, grants) from the applicable state or local governmental administrator of housing development funds (HDF) or housing trust funds (HTFs) available in many states, see, e.g., N.Y. Priv. Hous. Fin. Law § 570 et seq.; loans or grants under HUD’s HOME Investment Partnerships program, 42 U.S.C. § 12741 et seq.; or grants or loans from financial institutions as a qualified “Community Development Corporation” under the U.S. Office of the Comptroller of the Currency’s regulations, 12 C.F.R. § 24.1 et seq., which count for purposes of the financial institution’s Community Reinvestment



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Act requirements. The developer also may seek loans from Fannie Mae Delegated Lenders such as the Enterprise Social Investment Corporation or from a sponsor bank under the Federal Home Loan Bank’s Affordable Housing Program. Rental multi-family housing projects on a large scale may seek multi-family bond financing from government issuers. Funds also may be available under HUD’s Community Development Block Grant Program (CDBG), which are allocated for use in blighted communities and administered by the local city, county, or state that receives the allocation. See 42 U.S.C. § 5301 et seq.

In some states such as Pennsylvania, a special, distinct entity type known as a “nonprofit corporation” can be created under the state corporation statutes. See 15 Pa. Cons. Stat. § 5101 et seq. This special entity type often enjoys certain filing and reporting requirement advantages at the state level when compared to a standard corporation, so it should be used if possible. In other states, the entity is simply a “corporation” formed under the state’s general corporation law. The “nonprofit” label in such states merely means that the corporation has received a favorable ruling on tax-exempt status from the IRS.

Certificate of Incorporation

As a starting point, the state in which the corporation is being formed will require filing with the appropriate state office of “articles of incorporation,” a “charter,” or a “certificate of incorporation” for the affordable housing developer. In most states this office will be the Secretary of State.

In most states the requirements for the certificate of incorporation are minimal. For example, under the Delaware statute, only six items are required to be contained in the certificate: the name of the corporation, street address of the corporation’s registered office in Delaware, name of the corporation’s resident agent, nature of the corporation’s business, number of stock shares to be issued (if any), incorporator’s name and address, and (if desired) name and mailing addresses of the initial directors. Del. Code Ann. tit. 8, § 102. These are all fairly easy to supply, except for the initial directors. As discussed below, the makeup of the board of directors of the affordable housing nonprofit is quite critical. Though often not done, including them in the initial certificate is advisable so that their powers are established immediately in place of the powers otherwise held by the incorporator. Id. § 108(a).

Most affordable housing developers will want to take advantage of any ability under the applicable jurisdiction’s corporate statutes to limit in the certificate the personal liability of

directors to the corporation itself or to its stockholders or members for monetary damages for breach of fiduciary duty as a director. See, e.g., *id.* § 102(b)(7). That limitation may be necessary to recruit directors. The certificate is also the appropriate document in which to provide for the corporation's indemnification of its officers and directors.

In setting forth the "nature of the corporation's business," the certificate should give a full-blown statement of the mission of the organization. Clarity of the developer's mission and purpose will be essential to almost everyone—the directors, officers, and volunteers who are advancing the affordable housing projects; the IRS (which needs to know that the corporation can be operated only for a charitable purpose, see, e.g., Rev. Rul. 2006-27, 2006-1 C.B. 915) and those institutions that will be providing grants and loans to the corporation. Because the mission statement is so important, it ought to be in the certificate as well as the bylaws because it is ordinarily more difficult to amend the certificate than the bylaws, and so that actions taken outside the approved scope of activities can be disavowed as *ultra vires*.

Describing the purpose or mission of the corporation in the certificate is truly a balancing act, based on the particular project and its expected sources of financing. To qualify for tax-exempt status under the federal tax code, it is essential to state that the corporation is organized "exclusively for religious, charitable, scientific or educational purposes within the meaning of section 501(c)(3) of the Internal Revenue Code of 1986 as amended or a corresponding section of any future federal tax code." If appropriate for the developer's mission, the purpose in the certificate also might be crafted even more narrowly so as to fall within the "safe harbor" that the IRS has established for a favorable determination of tax-exempt status discussed in more detail below. The safe harbor test requires, among other things, that at least 75% of the housing units developed by the

corporation are to be occupied by residents that qualify as low-income under HUD guidelines. Depending on how much is known at the time about the type of housing the corporation will be developing and where it will be developing such housing, often that "purpose" should be limited in the certificate to activities in certain geographic areas, such as the development of land and property in a specified neighborhood of a state—or other areas targeted for redevelopment by local, state, or federal governments that are located within a slightly broader area—for "housing and other uses that enhance the physical, social, cultural, economic or educational condition of such areas." Developers vying for CDBG funds should limit such locations to the distressed communities, typically identified by census tracts as designated by the U.S. Census Bureau, for which the funds have been allocated, and should make it clear that their activities benefit low- and moderate-income people. 42 U.S.C. § 5301(c).

If the corporation is to seek certain special allocation of funds under the Home Investment Partnership Act, 42 U.S.C. § 12741 et seq., or is to serve as the managing general partner in a LIHTC project seeking to qualify for credits under the nonprofit set-aside, then it needs to qualify as a Community Housing Development Organization (CHDO). 42 U.S.C. § 12704. CHDOs are nonprofits that have as their central purpose "the provision of decent housing that is affordable to low-income and moderate-income persons," *id.* § 12704(6)(A), and such purpose should be stated in the certificate.

State and local funding sources have their own requirements for corporate purpose. For example, the certificates of organizations receiving New York HDF financing must contain four specific statements, including one to the effect that, if the corporation receives temporary HDF loans or advances, the HDF supervising agency may appoint a majority of new members to the corporation's board if the loan or advance is in

jeopardy of not being repaid or the project is in jeopardy of not being constructed. N.Y. Priv. Hous. Fin. Law § 573(3)(d).

Bylaws

Because the bylaws are the working document for day-to-day operations of the affordable housing nonprofit corporation, bylaw provisions need to be readable and practical, as well as meet the requirements of the sponsors, the IRS, and the financing sources. It is often helpful to repeat the same specific purpose and mission statement in the bylaws as is set forth in the certificate. In many state loan programs this can in fact be a requirement. For CDHOs it is also advisable to state the purpose of developing decent affordable housing for low-to-moderate income people in the bylaws. Rochelle E. Lento, *Federal Sources of Financing*, in *Legal Guide to Affordable Housing Development* 215, 234 n.98 (Tim Iglesias & Rochelle E. Lento eds., 2006). The bylaws should also deal in a very specific way with the number of directors and how they are selected. In some states, the corporation must have members or stockholders separate and distinct from the directors and the members or stockholders must elect the directors. E.g., Del. Code Ann. tit. 8, § 215. In these states, a good drafting technique is to form the corporation as a membership corporation and state that the members of the corporation consist of all of the directors of the corporation. This plan allows maximum control over the makeup of the corporation's board. An alternative is to establish "members" by some sort of formal registry, which may or may not involve the payment of dues. Though the independent membership registry technique may at first seem more democratic and appealing, often in practice such rosters are not properly kept up-to-date, members may become impossible to locate, quorums may be difficult to meet, and significant donors and supporters may object to having the same number of votes as those of non-active persons with relatively

insignificant contributions.

The bylaws need to establish the number of board members and ought to set up at least two classes of directors so that their terms of incumbency can be staggered. Most nonprofits also find it extremely helpful to establish term limits for directors and officers as a method of continuously interjecting new ideas (as well as new sources of donations). The bylaws are the place in which to set forth the qualifications of board members, such as mandating that a certain number of seats are to be held by members of the community in which the affordable housing is being developed, requiring a certain number of board members who have backgrounds in various disciplines, or requiring that a certain number of members also be directors of parent or affiliated organizations, as discussed below in this article.

To assist in a favorable tax-exempt determination by the IRS, it is also good practice to insert in the bylaws a provision that employees shall receive no more than reasonable compensation for services rendered.

Form 1023 Application for Recognition of Exemption

Most affordable housing organizations will seek to be recognized as exempt from federal income taxation under Code § 501(c)(3) as an organization organized and operated for a charitable purpose. There are many reasons to do this, beyond the basic function of eliminating taxation at the corporate level and allowing contributors to list itemized deductions for donations to the housing developer in their own income tax returns. Code § 170. For example, many state and local HTFs that use investment income to provide housing subsidies specifically allocate proceeds to technical assistance and capacity building for “nonprofit” housing development organizations. E.g., Tex. Gov’t Code Ann. § 2306.202(a). Certain land disposition programs are made available only to community-based nonprofits. The development organization must be a nonprofit in certain areas to take

advantage of exemptions from local governmental fees such as those charged in connection with the issuance of building permits. See, e.g., Salt Lake City, Utah, Code § 18.20.220, available at <http://66.113.195.234/UT/Salt%20Lake%20City/index.htm>.

The entity will need to apply to the IRS for the exemption by filing a Form 1023 Application for Recognition of Exemption, containing great detail regarding the proposed housing development, as described in the accompanying checklist on page 34, including a pro-forma budget for the proposed housing development and information regarding how the homes will be offered, marketed, restricted, and priced. The IRS can and will ask for information such as descriptions of the nature of the areas in which the housing will be developed, state or local documentation establishing areas as blighted or distressed, steps taken to involve the surrounding community or its residents in the project, details regarding payments to officers or directors providing goods or services, payment of brokerage commissions, and copies of documents such as leases, contracts, agreements, grant proposals, brochures, pamphlets, and newsletters regarding the developer applicant.

The income tax regulations define the term “charitable” as including the relief of the poor and distressed. 26 C.F.R. § 1.501(c)(3)-1(d)(2). Though several helpful revenue rulings have applied the 501(c)(3) exemption to housing providers over the years, as further discussed below, a revenue procedure issued in 1996 establishes a safe harbor in the low-income housing arena. Rev. Proc. 96-32, 1996-1 C.B. 717. To fall within the safe harbor, the developer must satisfy three fundamental requirements: (1) at least 75% of the housing units are occupied by residents who qualify under HUD guidelines as low-income and either at least 20% of the units must be occupied by residents who also meet the very low-income limit or 40% of the units are occupied by residents who also do not exceed 120% of the very low-income limit; (2) the project must

actually be occupied by poor and distressed residents (if not yet completed, a reasonable transition period is allowed to place the project in service); and (3) the housing must be affordable to charitable beneficiaries (in the case of rental housing, this means the rents charged must be limited so that they are affordable to low-income and very low-income residents; in the case of sales, mortgages must comply with government-imposed mortgage limitations).

If the safe harbor test is not satisfied, the developer will need to establish that its activities are truly “charitable.” The IRS has determined that an organization that offers downpayment assistance to low-income homebuyers, but receives funding for such assistance from sellers and other parties interested in the sale of homes on a non-anonymous basis, is not operated exclusively for a charitable purpose. Rev. Rul. 2006-27, 2006-1 C.B. 915. Because the seller paid the organization only if its sale closed, the organization was really a straw party for a purchase price rebate. But if, instead, the same organization was funded by broad-based fund-raising unrelated to sales, it could qualify as tax-exempt. *Id.* Similarly, an organization that leased homes at cost to a city for families displaced by fire was not “charitable” because, although the residents themselves stayed in the homes for free, the city paid the organization for this privilege. Thus, the city was the party providing the charity, not the developer. Rev. Rul. 77-3, 1977-1 C.B. 140. The IRS will look for, among other things, operation through a community-based board of directors, particularly if the selection process demonstrates that community groups have input into the organization’s operations; the provision of additional social services affordable to the poor residents; a relationship with an existing 501(c)(3) organization active in low-income housing for at least five years, if the existing organization demonstrates control; and the existence of affordability covenants or restrictions running with the property.

Even if an organization furthers a

charitable purpose such as relieving the poor and distressed, it nevertheless may fail to qualify for exemption because private interests of individuals with a financial stake in the project are furthered. In addition, no part of the organization's net earnings should inure, directly or indirectly, to the benefit of any private shareholder or individual. If the affordable housing developer contracts with others, such arrangements must be scrutinized carefully to ensure the absence of impermissible private benefits resulting from real property sales, development fees, or management contracts. Rev. Proc. 96-32, § 7, 1996-1 C.B. 717. "Related transactions" with sponsors or supporters for work on construction of facilities/homes should be entered into only in the context of a competitive bid process. These must be disclosed in Form 1023, will be strictly scrutinized, and should amount to the equivalent of "arm's length" transactions.

If services are going to be provided to the residents (for example, a housing organization provides specially designated housing to elderly persons), using net earnings to improve the specialized services and facilities provided or to expand the facility when the needs of the community warrant such expansions are acceptable, provided that the organization subsidizes any resident unable to continue making his or her monthly payments. Rev. Rul. 79-19, 1979-1 C.B. 195.

A low-rent housing association that distributes its profits to members, or that is allowed to distribute a portion of its earnings to investors, is not exempt, even if the corporation is organized under a state law governing nonprofit organizations and makes very little profit. *Amalgamated Hous. Corp. v. Comm'r*, 337 B.T.A. 817 (1938), aff'd per curiam, 108 F.2d 1010 (2d Cir. 1940); *Indus. Addition Ass'n v. Comm'r*, 1 T.C. 378 (1942), aff'd, 149 F.2d 294 (6th Cir. 1945). But when a housing corporation's dividends on its preferred stock are in the nature of interest on its stockholders' investment in the corporation, and not a distribution of the corporation's profits, the corporation may qualify as exempt. *Garden Homes Co. v.*

Comm'r, 64 F.2d 593 (7th Cir. 1933).

Because most affordable housing development entities are newly formed when the IRS issues its favorable determination of tax-exempt status, this initial determination is not final—instead, the organization first operates as a nonprofit during an "advance ruling period" through the



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end of its fourth tax year. At that point, an additional filing must be made with the IRS to detail actual sources of funding, and the IRS issues its final determination.

Board of Directors

The board of directors of the affordable housing developer should be large enough so that sufficient areas of expertise and key constituencies are represented and quorum requirements are met, but small enough so that it can, without too many voices, effectively conduct meetings and operate efficiently. Again, sources of funds may determine the board's makeup. If the corporation needs to qualify as a CHDO, it must maintain "through significant representation on the organization's governing board and otherwise, accountability to low-income community residents and, to the extent practicable, low-income beneficiaries with regard to decisions on the design, siting, development, and management of affordable housing." 42

U.S.C. § 12704(6)(B). Regardless of whether the developer needs to be considered a CHDO, there is a strong movement to make affordable housing more community-based, and the IRS certainly views operation through a community-based board of directors as persuasive in evaluating whether the required charitable purpose has been satisfied for the purposes of tax-exempt status.

If the corporation is to be considered a "community-development corporation" by the U.S. Office of the Comptroller of the Currency, the community served should be "well-represented on the board of directors."

Bank-Sponsored Community Development Corporations: A Private Sector Initiative, Off. Comptroller Currency Q.J., Dec. 1982, at 1, 6, available at 1982 WL 184473. In addition, a majority of the board should not be officers or directors of a bank viewed as "establishing" the corporation. Interpretive letter from Roberta Walsh Boylan, Off. Comptroller Currency, to Confidential (July 14, 1978) (on file with author).

A sponsoring parent, especially one that will be gifting or otherwise transferring monies or properties to the nonprofit developer, may wish to require that it appoint a certain number of directors or, preferably, that the qualifications of a certain number of directors include concurrent incumbency on the sponsor's own board.

Conclusion

The need to satisfy the IRS and the requirements under multiple loan and grant programs, and the need to address concerns of various contributors and sponsors, make formation of the affordable housing developer a complicated process. Though certainly "bare bones" documents can be drafted to bring the entity into existence, most likely they will need to be significantly amended later if such generic documents are used. Advance planning of the entire housing production and financing structure is required for the organizational documents and the application for nonprofit status to be finalized. ■



Information Needed for an Application for Recognition of Exemption for Affordable Housing Developer

1. Name, street address, and e-mail address to be used for the entity.
2. Description of the organization's activities and what charitable purposes the entity will serve (more detailed than the purpose of the corporation). This description should include a detailed explanation of the entity's planned activities, how such activities will further the entity's charitable purpose, and what proportion of the entity's resources will be dedicated to each such activity.
3. List of sources of financial support including individuals or entities who have provided or will provide start-up money (this list should include the general public to avoid the potential for private foundation status).
4. Description of any current and proposed fund-raising activities.
5. Annual compensation of the directors and officers (presumably, annual compensation will be zero—payment of compensation to directors or officers will not necessarily be fatal to exempt status but is not recommended).
6. Whether any board members are public officials.
7. Whether any board members are substantial (more than 5%) contributors to the organization.
8. Whether the entity is controlled by another exempt or non-exempt organization, and explanation of the relationship.
9. Description of activities conducted in conjunction with other tax-exempt entities, for example shared space, shared assets, joint fund-raising activities.
10. Description of the assets, if any, owned by the entity, for example buildings, office equipment, and similar items.
11. Whether the entity intends to apply for any tax-exempt bond financing during the next two years.
12. Copies of any management contracts or leases the entity has entered into.
13. Description of how members are admitted and any benefits associated with membership (presumably there will be none).
14. Annual dues or other charges to be a member and how such charges are determined.
15. Statement of revenues and expenses for the current year as well as proposed budgets for the next two years.
16. Current balance sheet.
17. Description of how the home sales prices are determined and whether they are above, below, or at cost, with explanation of how cost is determined.
18. Description of the area immediately surrounding the proposed housing projects and equipment or facilities available.
19. Whether the area has been declared distressed or blighted and, if so, the authority making such declaration, with copies of letters designating the area as distressed or blighted.
20. List of any steps taken to involve the community or the residents in the project.
21. If applicable, description of how the entity plans to comply with the safe harbor guidelines of Rev. Proc. 96-32, specifically addressing the following:
 - a. Whether developer will agree that for each housing project:
 - i. at least 75% of the units will be occupied by residents who qualify as low-income; and
 - ii. either at least 20% of the units will be occupied by residents that also meet the very low-income limit for the area or 40% of the units will be occupied by residents who also do not exceed 120% of the area's very low-income limit (up to 25% of the units may be provided at market rates to persons who have incomes in excess of the low-income limit).
 - b. Whether developer will agree that projects will actually be occupied by poor and distressed residents.
 - c. Whether developer will agree to provide housing that is affordable to charitable beneficiaries, with copy of a rental policy adopted that demonstrates affordable housing, if applicable.
 - d. Whether all units in the project share the same ground. If not, details of the facts and circumstances by which separate locations will be required and explanation of how the separate locations will further the exempt purpose.
 - e. Explanation of how the entity will ensure that the sale of homes furthers exempt purposes. Detailed description of the procedures the entity will follow in the sale of homes (for example, restriction of sales to individuals who would otherwise be unable to purchase a home, with sales prices in an amount they can afford).
22. Copies of any written agreements entered into by the organization. Copies of any grant proposals and indication of their status.
23. Copies of any pamphlets, brochures, newspaper articles, newsletters, and so on, concerning the organization.
24. Whether any members of the governing body receive payments from the organization, directly or indirectly, through financial interests in organizations with which the entity will do business.
25. Whether any officers or directors provide goods or services, directly or indirectly, to the facility and a detailed description of the goods or services that they will provide.