Chapter 6
Tax-Exemption

Overview

Types of Federal Tax-Exempt Status. The Internal Revenue Code defines a number of types of tax-exempt status for which nonprofit corporations may qualify. CLTs that address the needs of low-income people and low-income communities normally qualify for the type of exemption defined under Section 501(c)(3) of the Code. This is the most advantageous status for a CLT because it means not only that the CLT will not have to pay federal income tax but that those making donations to the CLT will qualify for tax deductions (under current tax law). 501(c)(3) status therefore increases the likelihood of donations. It is also usually required if the organization is to receive direct grants from foundations or other charitable funding sources, and it may be a prerequisite for certain forms of state or local tax-exemption in your state.

Another type of tax-exempt status is defined under Section 501(c)(4) of the Code. A number of organizations that do not qualify for 501(c)(3) status are able to qualify for 501(c)(4) status. This status provides exemption from federal income tax, but it does not provide tax deductions for donors and does not meet the requirements of many funding sources. Most CLTs are recognized as 501(c)(3) organizations, and this chapter is primarily concerned with 501(c)(3) status.

Achieving Recognition of 501(c)(3) Status. In the final section of this chapter we will review the formal application process, but it is important to understand that the process involves more than filling out a form "correctly." In making a determination of your organization's status, the IRS will look at an extensive body of material, including articles of incorporation, bylaws, descriptions of present and projected activities, and past and projected revenue and expense. In many cases, the IRS responds to an initial application with a request for further detailed information regarding activities and policies. The process can be time-consuming, but it is not an unreasonable process given the nature of the distinctions that the IRS must make under the law. CLT organizers who have a basic understanding of these distinctions will find it easier to deal with the process of achieving 501(c)(3) status.

Basic criteria. An organization may qualify for exempt status under Section 501(c)(3):

- if it is "organized and operated exclusively" for specifically permitted purposes, including "charitable, religious, educational, or scientific purposes;"
- if no part of its net earnings "inures to the benefit of any private individual" and if, upon its dissolution, no part of its net assets can be passed on to anyone other than a government agency or 501(c)(3) organization;
- if "no substantial part" of its activities consists of "carrying on propaganda or otherwise attempting to influence legislation;" and
- if it "does not participate in, or intervene in, any political campaign on behalf of any candidate for public office."

The Organizational and Operational Tests. The requirement that a 501(c)(3) organization be both "organized and operated" for certain purposes gives rise to what are commonly called the "organizational" and "operational" tests, both of which must be met by an applicant organization.

*Organizational test***.** The organizational test is applied to a corporation's organizing documents, with the primary concern being the articles of incorporation. The primary requirement of the test is the inclusion of certain language in the articles of incorporation, limiting the purposes of the corporation to those defined as exempt under Section 501(c)(3), and explicitly prohibiting activities prohibited under Section 501(c)(3). The sample articles of incorporation presented elsewhere in this guide include the language normally required to pass the organizational test.

The IRS will also look closely at any corporate purposes enumerated in the articles of incorporation to determine whether all of them do in fact qualify as exempt. Even though your articles state that the corporation is organized exclusively for 501(c)(3) purposes, the IRS may claim that one of your specified purposes is not recognized as exempt under 501(c)(3). In such cases, the IRS may suggest that the articles be amended to delete or adjust the offending statement. Complying with such suggestions will not necessarily limit the activities of the organization if the intended activities can be justified under another purpose that is recognized as exempt. For instance, if a CLT's articles state that one purpose of the organization is to remove land from the speculative market, the IRS may object that removing land from the speculative market is not an exempt purpose in and of itself. But this does not mean that the activity of removing land from the speculative market is impermissible if, as an element of the CLT's program, it serves another purpose that is recognized as exempt – as, for most CLTs, it does.

Operational test. The operational test concerns the question of whether an organization is actually operated for the exempt purposes stated in its organizing documents. In applying the operational test, the IRS reviews the organization's activities and determines whether they serve exempt purposes and whether any activities violate the special restrictions and prohibitions imposed by Section 501(c)(3). The more difficult issues involved in achieving 501(c)(3) status will come up in connection with the operational test, though the question of what is and is not an exempt purpose remains central to these issues.

It should be noted that the IRS sometimes refers to "exempt activities" as though certain activities are exempt in and of themselves. This usage clearly reflects the assumption that in some circumstances certain activities necessarily serve exempt purposes and cannot reasonably be understood to serve any other purposes. Providing affordable housing directly to poor people will normally be viewed as an "exempt activity" in this sense. However, providing assistance to a business that will offer jobs to poor people will normally not be viewed as an exempt activity in and of itself, though in some circumstances it may be recognized as a means of achieving a charitable purpose.

As noted above, 501(c)(3) organizations must be organized and operated *exclusively* for exempt purposes. In other words, although the organization must necessarily engage in some activities, such as administrative activities, that are not exempt in themselves, all *programmatic* activities should qualify as exempt. Different programmatic activities need not all qualify on the same basis, but each must serve one or another exempt purpose.

Revenue Rulings, Revenue Procedures. In determining whether an applicant organization's activities are exempt (serve exempt purposes), IRS personnel are guided not only by the Tax Code, Tax Regulations, and court cases, but by a body of "Revenue Rulings" issued by the IRS in response to requests for advice regarding the exempt or non-exempt nature of particular organizations. Revenue Rulings are published twice each year in the Internal Revenue Service Cumulative Bulletin. The IRS also develops and publishes "Revenue Procedures," which are statements of policy on issues of concern for IRS personnel and others.

What Is "Charitable"?

Some CLTs may have specific programs designed to serve educational purposes, and a few may have programs with scientific purposes (e.g. ecological or agricultural research), but it is unlikely that any CLT will qualify for 501(c)(3) status solely as an educational or scientific organization. Most CLTs will qualify as charitable organizations. The definition of the term "charitable" is therefore crucial.

Basic definition. Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations defines charitable purposes as including:

> "relief of the poor and distressed or of the underprivileged; ...advancement of education; ...lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes or... to lessen neighborhood tensions; ...to eliminate prejudice and discrimination; ...to defend human and civil rights secured by law; ...or to combat community deterioration and juvenile delinquency."

Significantly, this definition includes both purposes addressing the problems of individuals who are "poor," "distressed," or "underprivileged," and purposes addressing community problems involving "neighborhood tensions," "prejudice and discrimination," and potential "community deterioration and juvenile delinquency." As a practical matter, most CLT activities – and housing-related activities in particular – will qualify as charitable on the basis that they relieve the poor and distressed and/or on the basis that they "combat community deterioration," or, in some cases, "lessen the burdens of government."

One of the most frequently cited bases for determinations of the charitable or non-charitable nature of housing-related programs is a Revenue Ruling dating from 1970 (Rev. Rul. 70-585). An introductory paragraph of this ruling states:

> "It is held generally that where an organization is formed for charitable purposes and accomplishes its charitable purposes through a program of providing housing for low and, in certain circumstances, moderate income families, it is entitled to exemption under Section 501(c)(3) of the Code. The fact that an organization receives public funds under State or Federal programs for housing is not determinative; qualification is based on whether or not the organization is charitable within the meaning of Section 501(c)(3)."

The ruling then describes four differing situations as "illustrative of the foregoing principle." We will refer to these situations in the paragraphs that follow.

Low income households. In "Situation 1," Rev. Rul. 70-585 describes an organization with "a program for new home construction and the renovation of existing homes for sale to low income families on long-term, low-payment plans....throughout the city in which it is located." The conclusion is as follows:

> "By providing homes for low income families who otherwise could not afford them, the organization is relieving the poor and distressed. Thus it is held that this organization is organized and operated exclusively for charitable purposes, and it is exempt from Federal income tax under section 501(c)(3) of the Code. The determination of what constitutes low income is a factual question based on all of the surrounding circumstances."

In this and other rulings, the term "low income" is treated as synonymous with the term "poor," or "poor and distressed." Prior to 1993, the IRS offered no specific quantitative definition of "low income" – either in the Tax Code, the Tax Regulations, the Revenue

Rulings, or other publications. Providing housing or other benefits to low-income people was accepted as charitable if your definition of "low-income" was considered reasonable in relation to the "surrounding circumstances." In applying for recognition of 501(c)(3) status, housing organizations usually defined "low income households" as the term was defined by government housing programs in which they participated – most often as households with incomes below 80% of area median income. The IRS tended to accept these definitions as reasonable, while continuing to make it clear (1) that no one definition was automatically acceptable in all circumstances, and (2) that participation in a government housing program was not in and of itself grounds for recognition as charitable.

Beginning in 1993, however, the IRS modified its approach to the matter of definition. In the course of establishing so-called "safe harbor" guidelines for charitable housing organizations, the IRS adopted the specific quantitative definitions of "low income" and "very low income" used in federal housing programs. The safe harbor guidelines define a set of conditions which, if met by a housing program, assure IRS recognition of the program as "relieving the poor and distressed." These guidelines (and related policies), which are reviewed in detail below, now have a major effect on the way the IRS processes 501(c)(3) applications from housing organizations. However, they do not change the underlying principles set forth in the earlier Revenue Rulings.

Moderate income households. It should be emphasized that providing affordable housing for "moderate income" households is not recognized as a charitable activity, in and of itself, even if housing is not otherwise affordable for these households. Revenue Ruling 70-585, in its description of "Situation 4," is clear on this point:

> "An organization was formed to build new housing facilities for the purpose of helping families to secure decent, safe, and sanitary housing at prices they can afford. Its membership is composed of community organizations that are concerned with the growing housing shortage in the community. A study of the area shows that because of the high cost of land, increased interest rates, and the growing population, there is a shortage of housing for moderate income families in the community. The organization plans to erect housing that is to be rented at cost to moderate income families. The organization is financed by mortgage money obtained under Federal and State programs and by contributions from the general public.
>
> "Since the organization's program is not designed to provide relief to the poor or to carry out any other charitable purpose within the meaning of the regulations applicable to section 501(c)(3) of the Code, it is held that it is not entitled to exemption from Federal income tax under section 501(c)(3) of the Code."

A combination of low and moderate income households is permitted by the safe harbor guidelines (though the term "moderate income" is not used in that context). A program may also provide housing to a mix of low and moderate income households on the basis that the program serves a charitable purpose other than that of "relieving the poor and distressed" – e.g., the purpose of "combating community deterioration." However, the moderate income households in these cases may not be seen as qualifying for charitable benefits. In other words, they may receive housing from a charitable organization but the IRS may not recognize a basis for subsidizing the cost. Within certain limits, however, non-poor individuals may receive charitable benefits if they qualify as "distressed" on other than economic grounds – e.g., as aged or handicapped individuals. They may also receive charitable benefits through programs that qualify as charitable on the basis that they "lessen the burdens of government," as discussed below.

"Safe Harbor" and Related Guidelines

The IRS first set forth a "safe harbor" for organizations serving the housing needs of the "poor and distressed" in 1993 (93-1, 1993-1 C.B. 290). A more complete set of guidelines, incorporating public comments on the earlier notice, was proposed in 1995 and was then issued in 1996 as Revenue Procedure 96-32. This document describes both the "safe harbor" guidelines, by which an organization can be assured that its projects qualify as charitable, and the "facts and circumstances test" by which an organization that does not satisfy the safe harbor requirements may still qualify as "relieving the poor and distressed." It also notes other purposes (other than "relieving the poor and distressed") on the basis of which housing organizations may qualify as charitable.

Income guidelines. The safe harbor guidelines are a constructive response to a widely recognized need for clearer, more specific, and more standardized criteria for determining whether housing organizations qualify as charitable, particularly with regard to the specific income levels served. The guidelines are also a constructive response to the need for a clearer statement of how federal tax-exemption policies relate to federal housing policies, particularly with regard to housing policies supporting mixed-income projects that are not limited to low-income residents.

The first and most specific requirement for qualification within the safe harbor is that:

> "The organization establishes for each project that (a) at least 75 percent of the units are occupied by residents that qualify as low-income and (b) either at least 20 percent of the units are occupied by residents that also meet the very low income limit for the area or 40 percent of the units are occupied by residents that also do not exceed 120 percent of the area's very low income limit. Up to 25 percent of the units may be provided at market rates to persons who have incomes in excess of the low income limit."

The terms "low income" and "very low income" are defined specifically as in the Housing Act of 1937, with low income households being those with incomes below 80% of area median income and very low income households being those with incomes below 50% of area median income as calculated, adjusted and published by HUD.

Homeownership and the facts and circumstances test. The safe harbor guidelines require that, "If the project consists of multiple buildings, they must share the same grounds." It is thus clear that the guidelines are intended to be applied on a project-by-project basis, not a program-by-program basis. And, although they are not explicitly limited to rental projects, there are a number of points where it appears to be assumed that the projects in question are rental projects (or possibly coop or condominium projects). It is therefore generally better to present CLT homeownership programs in terms of the "facts and circumstances test" – and necessary to do so in the case of scattered-site single-family programs where buildings do not "share the same grounds."

The Revenue Procedure introduces the facts and circumstances test as follows.

> "If the safe harbor… is not satisfied an organization may demonstrate that it relieves the poor and distressed by reference to all the surrounding facts and circumstances. Facts and circumstances that demonstrate relief of the poor may include, but are not limited to, the following:
>
> (1) a substantially greater percentage of residents than required by the safe harbor with incomes up to the 120 percent of the area's very low income limit.
>
> (2) Limited degree of deviation from the safe harbor.
>
> (3) Limitation of rents to ensure that they are affordable to low-income and very low-income residents.

(4) Participation in a government housing program designed to provide affordable housing.
(5) Operation through a community-based board of directors, particularly if the selection process demonstrates that community groups have input into the organization's operations.
(6) The provision of additional social services affordable to the poor residents.
(7) Relationship with an existing 501(c)(3) organization active in affordable housing for at least five years if the existing organization demonstrates control.
(8) Acceptance of residents who, when considered individually, have unusual burdens such as extremely high medical costs which cause them to be in a condition similar to persons within the qualifying income limits in spite of their higher incomes.
(9) Participation in a homeownership program designed to provide homeownership opportunities for families that cannot otherwise afford to purchase safe and decent housing.
(10) Existence of affordability covenants or restrictions running with the property."

Among the listed factors, numbers 5, 9, and 10 are likely to be important for CLTs and should be emphasized – along with any other items that may apply – in describing the particular CLT program seeking recognition of charitable status.

"Organization R." Having listed possible facts and circumstances, the Revenue Procedure then presents briefly described examples of housing organizations that illustrate the application of the facts and circumstances test. Among these examples, the following is especially important for organizations that provide or plan to provide homeownership opportunities.

> "Organization R provides homeownership opportunities to purchasers determined to be low income under a federal housing program. Beneficiaries under the program cannot afford to purchase housing without assistance and they cannot qualify for conventional financing. R's residents will have the following composition: 40 percent will not exceed 140 percent of the very low income limit for the area, 25 percent will not exceed the low income limit, and 35 percent will exceed the low-income limit but will not exceed 115 percent of the area's median income. R does not satisfy the safe harbor. However, the facts and circumstances demonstrate that R relieves the poor and distressed."

It is important to note not only that Organization R provides for a higher range of incomes than the safe harbor permits, but also that the range is applied to the total number of "R's residents," rather than to the residents of a single project on a single parcel of land. Thus it appears to accommodate a mix of incomes within a CLT's overall homeownership program, regardless of how many sites are involved. It should also be noted that whereas the safe harbor guidelines put all non-low-income persons in a single "market rate" category regardless of any need for assistance, all of R's residents have incomes below 115 percent of AMI, and it is not stated that residents between 80 percent and 115 percent of AMI pay market rate prices for their homes.

A number of CLTs have made very specific use of the example of "Organization R" in describing their homeownership programs within their applications for recognition of 501(c)(3) status. These CLTs have generally adopted policies that specify the safe harbor income limits for rental projects, and the Organization-R income limits for homeownership programs. In some cases IRS personnel who reviewed applications from these CLTs objected that the income policy for the homeownership program did not meet the safe harbor guidelines, but were then satisfied when it was pointed out that the mix of incomes is

what is described for Organization R in Revenue Procedure 96-32.

Combating Community Deterioration

Many housing and community development programs are recognized as charitable not on the basis (or not solely on the basis) that they provide benefits to "poor" households but on the basis that they "combat community deterioration." Rev. Rul. 70-585, in "Situation 3," describes a community development organization that is held to be charitable on these grounds.

> "An organization was formed to formulate plans for the renewal and rehabilitation of a particular area in a city as a residential community. Studies of the area showed that the median income level in the area is lower than in other sections of the city and the housing located in the area is generally old and badly deteriorated.
> . . . It sponsors a renewal project in which the residents themselves take the initiative.... As part of the renewal project, it purchased an apartment house that it plans to rehabilitate and rent at cost to low and moderate income families with the preference given to residents of the area. . . .
> Since the organization's purposes and activities combat community deterioration by assisting in the rehabilitation of an old and run-down residential area, they are charitable within the meaning of section 501(c)(3) of the Code."

This ruling (and most other rulings in which "combating community deterioration" is held to be a basis for the charitable nature of an organization's program) is clearly limited to a geographical area where housing is already deteriorated and where median income is "lower than in other sections of the city." Applicant organizations that claim to "combat community deterioration" may be asked to demonstrate that at least one of these conditions applies in the area where it will operate, or that specific areas characterized by these conditions will be targeted for the program in question. However, the demonstration need not be elaborate; it is often sufficient to show that the specified area has been targeted by a public agency for the use of CDBG funds or for other programs designed to aid poor or deteriorated communities.

Programs that do not limit their activities to poor or deteriorated areas will find it more difficult to gain recognition of exemption on the basis that they combat community deterioration (though they may be recognized as exempt on the basis that they serve other charitable purposes). Revenue Ruling 76-147 does recognize as exempt an organization "formed to improve conditions in an area of a city where the income level is higher and housing better than in other areas of the city." However, the activities of this organization are limited to urging residents to clean and repair their property, providing information on home maintenance and repair, sponsoring clean-up campaigns, conducting surveys, etc. It should not be assumed that CLT activities involving active production or provision of housing in such an area would be recognized as charitable on this basis.

Eliminating Prejudice and Discrimination

It can be said that eliminating prejudice and discrimination is an important goal of most CLTs, and an important effect of many CLT programs. In providing access to land and housing, CLTs remove traditional barriers raised by racial and ethnic prejudice as well as by economic factors. However, for many CLTs, it will be either difficult or unnecessary to argue that specific activities (not qualifying as charitable on other grounds) should qualify as charitable on the grounds that they serve the purpose of eliminating prejudice and discrimination.

Revenue Ruling 70-585, in "Situation 2," recognizes as charitable an organization

which:

> "constructs new housing that is available to members of minority groups with low and moderate income who are unable to obtain adequate housing because of local discrimination. These housing units are so located as to help reduce racial and ethnic imbalances in the community. . . . Preference is given to families previously located in ghetto areas. . . ."

What is important in this ruling is that it recognizes as charitable a certain kind of housing program that serves moderate as well as low income households and that operates in an area that is not characterized as poor or deteriorated. Some CLTs may have similar programs that will qualify on the same basis as the organization described here and that will not qualify on any other basis. Presumably, it will be necessary to demonstrate that these programs – and in particular their resident-selection criteria and procedures – give preference to "families previously located in ghetto areas," or that the programs are otherwise specifically designed to eliminate prejudice and discrimination. However, many CLTs, including many serving minority communities, will find it easier to demonstrate that their programs are designed to aid low-income households and combat community deterioration than to demonstrate that certain programs are designed specifically to eliminate prejudice and discrimination.

Lessening the Burdens of Government

In recent years, as a growing number of CLTs have assumed clearly defined roles as instruments of municipal or state affordable housing policies, some of them have sought and attained recognition of charitable status on the basis that their programs "lessen the burdens of government." This possible basis for charitable status can be critically important in the case of programs that are designed specifically to address the housing needs of moderate income households and that do not qualify as charitable on the basis that they combat community deterioration or eliminate prejudice and discrimination.

In the past some CLTs argued unsuccessfully that they served this charitable purpose simply on the grounds that they reduced social problems and thereby lessened government's responsibility for dealing with these problems. However, the IRS defines "burden of government" more narrowly. On this matter, Revenue Ruling 85-2 is commonly cited with regard to a variety of nonprofit organizations. The Ruling states:

> "To determine whether an activity is a burden of government, the question to be answered is whether there is an objective manifestation by the government that it considers such an activity to be a part of its burden. The fact that an organization is engaged in an activity that is sometimes undertaken by the government is insufficient to establish a burden of government."

To determine whether an organization's activities do lessen an acknowledged governmental burden, we are told, "all of the relevant facts and circumstances must be considered." In the particular case addressed by this Ruling, one kind of circumstance – the relationship between the organization and the government entity – is emphasized.

> "A favorable working relationship between the government and the organization is strong evidence that the organization is actually lessening the burdens of government."

What does this mean for a housing organization seeking recognition of charitable status for a program serving moderate income households? Clearly it will be necessary to present objective evidence (1) that a government entity considers efforts to provide affordable housing (or affordable homeownership opportunities) for households above 80% of AMI to be "a part of its burden," and (2) that the government entity has entered into some

form of relationship with the housing organization to further these efforts and thereby lessen this burden. Potential objective evidence of such a relationship might include:

- government action to support the creation and/or operation of the organization specifically as a means of implementing the government's efforts to make affordable housing available to moderate income households..
- legislative action to fund or otherwise support specific activities of the organization that implement or support such efforts;
- a contract with the government entity, under which the organization carries out activities intended to implement or support such efforts;
- A written statement by a government official that the government has asked the organization to carry out certain activities to implement or support such efforts.

(Note that evidence of a relationship formed in an effort to make affordable housing available to moderate income households can stand as evidence not only that the organization is lessening the burdens of government but also that the government does in fact consider such efforts to be a part of its burden.)

In recent years, at lest one CLT initiated by a municipal government (Irvine, CA) as a means of developing and preserving affordable housing has sought and received 501(c)(3) status *solely* on the basis that it lessens the burdens of government – without reference to the question of what income levels would receive the housing. It is also possible, however, for a CLT to gain recognition of the charitable nature of part of its overall program on the basis that it serves low-income people while gaining recognition of another part of its overall program on the basis that it lessens the burdens of government. For example, a California CLT originally created to preserve the affordability of homes built by Habitat for Humanity for very low income people was later asked by the local municipality to play a similar role in preserving the affordability of moderate income housing made affordable through the municipality's inclusionary zoning program. Having originally sought and received recognition of 501(c)(3) status on the basis that it relieved the poor and distressed, the CLT then contacted the IRS and asked that its stewardship of moderate income homes be recognized as charitable on the basis that it lessened the burdens of government, as evidenced by a letter from a municipal official explaining its request that the CLT perform this function. The request was approved.

Although "a favorable working relationship between the government and the organization" is important as evidence that the organization is lessening the burdens of government, we should be aware that not all relationships with government that can be characterized as "favorable" will assure recognition of charitable status. Any such relationship is likely to be treated as a relevant fact or circumstance but not as fully "determinative." We should also emphasize that "participation in a government housing program designed to provide affordable housing" (see facts and circumstances listed in Revenue Procedure 96-32 above) will not necessarily be seen as indicating "a favorable working relationship" with the government. As noted above, Rev. Rul 70-585, explicitly states: "The fact that an organization receives public funds under State or Federal programs for housing is not determinative." For purposes of determining charitable status, any set of "facts and circumstances" is likely to involve grey areas where interpretations can vary, but it is safe to say that the more distinctive an organization's relationship with government – the more it is unlike the relationships of other organizations with that government – the more likely it is that it will be seen as relieving the burdens of that government. Being one of many organizations participating in a government housing program probably will not be sufficient evidence, whereas being *the* organization designated by a government to carry out a specific function probably will be sufficient.

Other Issues Related to Charitable Status

Environmental conservation. Protecting the natural environment and promoting the ecologically sound use of land and natural resources is generally a goal of the CLT model, and is generally recognized as a charitable purpose. For CLTs primarily concerned with providing affordable housing, conservation purposes may be expressed through energy-saving housing designs or through land use restrictions written into a residential ground lease, prohibiting practices that would have a harmful effect on the environment, that would waste or contaminate resources, or that would be otherwise ecologically detrimental. Such measures are not likely to have a significant effect on the CLT's tax-exempt status. They are consistent with charitable purposes, but they are not sufficient grounds for recognizing an otherwise non-charitable housing program as charitable. However, for CLTs that acquire some amount of undeveloped land with the intention of holding it in a more or less undeveloped state, environmental conservation purposes can be important.

The country's many "conservation land trusts" are recognized as tax-exempt under section 501(c)(3) on the basis that they preserve and protect the natural environment for the benefit of the public. Revenue Ruling 76-204 describes such an organization, whose activities consist primarily of acquiring "ecologically significant undeveloped land" and preserving this land with only limited use for educational or scientific purposes (or turning it over to a government agency). The organization is found to be exempt under 501(c)(3). Similar activities carried out by a CLT should be recognized as exempt as well.

The preservation of productive land (agricultural land or land used for production of forest products) raises more complicated issues, at least if the land will continue to be used for those purposes by people who are not members of a "charitable class." Revenue Ruling 78-384 finds that a certain nonprofit organization that holds farm land is not exempt, in that the farm land is not "ecologically significant" and the activity does not yield significant public benefit. Nonetheless there are 501(c)(3) conservation land trusts that do own farms and do lease them to farmers through long-term ground leases that are quite similar to CLT ground leases. The charitable purposes stated by these land trusts in these stewardship roles normally include conservation purposes that have been explicitly recognized as exempt, but they normally do not include assistance to farmers as a purpose in and of itself. CLTs with an interest in acquiring and stewarding farms or other productive land should contact established conservation or agricultural land trusts for information regarding recent experience with tax-exemption issues.

A Note on 501(c)(2) Organizations. Section 501(c)(2) of the Code provides tax-exempt status for organizations defined as "title holding corporations." To qualify for 501(c)(2) status, such an organization must be controlled by a 501(c)(3) organization, and its purposes must be limited to holding title to property, collecting income from this property, and turning the income over to the controlling 501(c)(3) corporation. A few regional land trusts with 501(c)(3) status by virtue of conservation purposes and activities have established title holding corporations to hold title to parcels of land that are leased to farmers or other individuals. This may be an appropriate and practical arrangement for these organizations as a way of managing such lands, but the arrangement does not allow the 501(c)(2) organization to carry out activities that would not be permissible for the 501(c)(3) organization itself. For instance, the 501(c)(2) organization could not charge a less-than-market-rate lease fees or otherwise subsidize the farmer's operation. It should also be said that, since a local organization cannot achieve tax-exempt status as a title holding corporation unless it is controlled by another corporation, it cannot operate as an autonomous, member-controlled "classic" CLT.

Non-charitable CLT leaseholder situations. In concluding this discussion of charitable purposes and activities, it is useful to note the range of situations in which a "charitable" CLT (as well as a 501(c)(2) organization controlled by a charitable CLT) may lease land to lessees who are not themselves members of a "charitable class" – i.e., who are not demonstrably "poor" or otherwise "distressed."

As already noted, "moderate income" households may be among those who receive benefits from activities that can be shown to "combat community deterioration" or "lessen the burdens of government" or accomplish other charitable purposes. And up to 25% of the units in a mixed-income residential project may be rented at market rates to households whose incomes are above 80% of median (whether moderate or more than moderate). Apart from these situations, though the circumstances differ, a CLT should still not assume that it cannot enter into lease arrangements with people who are not members of a charitable class. With any such arrangements, the CLT must be able to show that the lessee is not an improper beneficiary of a charitable program, which means, for one thing, that the lessee should pay a market rate lease fee to the CLT. It should be remembered, however, that the market value of property subject to use and resale restrictions can be much lower than the market value of unrestricted but otherwise comparable properties.

Lease fees from non-charitable lease situations may not qualify as program-related income, and net income derived from these fees may be taxable. Check with you accountant regarding any such situations.

Public Charity Status

Public Charity vs. Private Foundation status. Once a CLT meets the criteria for 501(c)(3) status, there is another distinction to be noted. Every 501(c)(3) organization is designated as either a "public charity" or a "private foundation." This distinction is based *not* on the nature of the organization's purpose and programmatic activities but on the nature and sources of its financial support (or on its ties with other organizations). The distinction was introduced by the Tax Reform Act of 1969, which created Section 509 of the tax code to deal with certain abuses of tax-exempt status by nonprofit entities supported entirely by one or a few wealthy parties. Section 509 imposes limits on the tax-deductibility of donations to 501(c)(3) organizations classified as private foundations and subjects these organizations to other special requirements and restrictions. There are no advantages to status as a private foundation rather than a public charity, and the disadvantages are significant.

To qualify as a public charity, a 501(c)(3) organization (other than certain kinds of institutions such as churches, schools and hospitals) must show that it meets one of several sets of tests relating to the sources of its support or show that it qualifies on the basis of its relationship to another public charity. The several ways of qualifying are stated in three separate sections of the Code: 509(a)(1), 509(a)(2), or 509(a)(3). In completing Form 1023 an organization seeking recognition as a public charity must indicate which of these sections it expects to qualify under – unless it is uncertain of whether it will qualify under Section 509(a)(1) or Section 509(a)(2), in which case it may ask the IRS to decide the proper category. Most applicant organizations should take advantage of this option and therefore may not need to concern themselves with the details of the tests described in 509(a)(1) and 509(a)(2). The following review of these sections is included for those organizations that, for one reason or another, are not sure of whether they can in fact qualify as public charities.

Section 509(a)(1) organizations. The most common basis for public charity status is that described in Section 509(a)(1) of the Code. Most CLTs should qualify on this basis.

Section 509(a)(1) allows organizations to qualify by passing either of two tests: the "one-third support test," or the "facts and circumstances test."

An organization meets the one-third support test if it normally receives at least one third of its total support from government sources and/or contributions made directly or indirectly by the general public. In applying this test, "program-related" income is excluded from total support. CLTs can assume that all income generated by their "charitable" housing programs will be treated as "program-related" income. The one third test will therefore be applied only to support from other sources, which means that CLTs with a reasonably broad base of support from dues, donations and government grants should meet the test. However, the test does involve a number of specific definitions and rules that may prevent some organizations from meeting the test. One of these is the "2% rule" described below in the quotation from IRS Publication 557. This publication can be consulted for a comprehensive review of all the relevant rules and definitions.

Organizations that do not meet the one-third test may still qualify under Section 509(a)(1) if they meet the facts and circumstances test. To meet this test, an organization must receive at least 10% of its total support from public or government sources and must maintain a program designed to attract support from such sources on a continuous basis. In applying this test, the IRS takes a number of factors into consideration (see Publication 557), and gives some consideration to the special fundraising circumstances of new organizations.

Regarding both the one-third support test and the ten-percent-of support-requirement, the following passage in Publication 557, page 32 (as of 2008) should be noted.

> "Support from the general public. In determining whether the one-third support test or the ten-percent-of-support requirement are met, include in your computation support from direct or indirect contributions from the general public. This includes contributions from an individual, trust, or corporation but only to the extent that total contributions from such individual, trust, or corporation, during the four-year period immediately preceding the current tax year (or substituted computation period), are not more than 2% of the organization's total support for the same period."

For some organizations – particularly younger organizations dependent on a limited number of private funding sources – it may be a problem that no more than 2% of the total contributions from any one private source during the four-year period may be treated as public support (while the full amount of such contributions is included in total support). However, fundraising activities can be carried out that should allow most CLTs to meet the ten-percent-of support requirement, if not the one-third support test.

Section 509(a)(2) organizations. Organizations that do not meet either of the tests provided under 509(a)(l) may be able to qualify as public charities under 509(a)(2), which describes two tests, both of which must be met. The first of these is a variation of the one-third support test. In this case, gross receipts from program-related activities are *included* in both the numerator and denominator of the fraction (as part of both public support and total support), rather than being *excluded* from both as under 509(a)(1). A CLT with substantial receipts from its charitable activities (e.g., lease fees), may be able to meet this version of the one-third support test even if it cannot meet the tests under 509(a)(1). (It should be noted that the numerator of the fraction may include, from any one person in one year, no more than the greater of $5000 or 1% of total support.)

The second test under 509(a)(2) is the "not-more-than-one-third support test," which is met if the organization normally receives no more than one third of its support from gross investment income and unrelated business income. Gross investment income is defined as

including "interest, dividends, payments with respect to securities loans, rents, and royalties...." However, rents and fees received by a CLT for facilities or services provided in carrying out a charitable program should be treated as program-related income rather than as investment income. Most CLTs should meet the "not-more-than-one-third support test."

Section 509(a)(3) organizations. Section 509(a)(3) allows an organization to qualify as a public charity not on the basis of the sources of its support but on the basis of its relationship to another 501(c)(3) public charity. 509(a)(3) Organizations (described by the IRS as "supporting organizations") must be organized and operated to benefit or carry out the purposes of another publicly supported organization and must be supervised or controlled by or in connection with that organization. Since most CLTs are organized as independent corporations and can qualify as public charities under 509(a)(1) or 509(a)(2), they need not concern themselves with section 509(a)(3). However, anyone considering creating a CLT as an organization controlled to some degree by an existing corporation can explore, with a knowledgeable attorney, the advisability of creating a corporate structure that would qualify for public charity status as a "supporting organization."

The Application Process

Fees and forms. The Revenue Act of 1987 requires payment of "user fees" with applications for recognition of exempt status ("exempt organization determination letter requests"). As of January, 2010, the basic fee is $850. The fee is reduced to $400 for an organization with annual gross receipts less than $10,000 during its first three, four, or five (or more) taxable years depending on whether it has been in existence less than one tax year, at least one tax year, or five tax years. (A CLT that expects to employ staff and launch a housing program in its early years must normally expect that its gross receipts will exceed $10,000.) The fee for all 1023 applications using Cyber Assistant software when it becomes available (expected in 2011) will be reduced to $200.

Form 1023 is required for the application for recognition of 501(c)(3) status. Form 1023 requires an applicant to have applied for and received an Employer Identification Number (EIN) *before* submitting Form 1023. You can apply for an EIN on line or by submitting IRS Form SS-4.

If the application is to be signed by an attorney or agent other than an officer of the corporation, you will need Form 2848: "Power of Attorney and Declaration of Representative." (The once-separate User Fee form is now incorporated in Form 1023.) Copies of the necessary forms can be downloaded from www.irs.gov/forms_pubs. You should also download the instructions for Form 1023 and "Publication 557 Tax-Exempt Status for Your Organization."

Don't be discouraged by the apparent length of Form 1023. Many of the pages consist of specialized "Schedules." Of these, you will need to complete only Schedule F. You will also need to complete and attach the checklist that appears at the very end of Form 1023.

When to apply; late applications. New organizations should apply within 15 months of the end of the month in which they were incorporated. Those that do not apply within 15 months may still qualify for an "automatic 12-month extension" if they apply within 27 months of the end of the month in which they were incorporated. For those who apply within this period and are recognized as exempt under 501(c)(3), the exemption will be retroactive to the date of incorporation. (For possible exceptions to these application requirements, see Form 1023, Part III.)

Most CLTs will want to apply as soon after incorporation as possible, and should immediately acquire a copy of IRS Form 1023 and familiarize themselves with the

questions that must be answered in completing the application. A number of these questions cannot be answered until a board of directors has been organized and has adopted basic program plans, budgets, and fundraising plans.

If more than 27 months have passed and your organization does not qualify for an exception or further extension of the time limit, you may still apply for exemption under 501(c)(3), but exemption can be recognized only from the date of the application (not retroactively from the date of incorporation).

Any organization that has passed the 27-month limit should, before applying, determine the possible consequences of not receiving retroactive exempt status. If an organization has not had taxable net income and if there have been no donors or grantors who would be affected by the organization's lack of 501(c)(3) exempt status for the period in which donations or grants were made, then the organization can simply apply for recognition of exemption from the date of the application.

If it is determined that donors or grantors could be significantly affected by the lack of 501(c)(3) exempt status prior to the date of application, then the organization should explore a possible further extension of the limit as noted above. If, however, it is determined that donors or grantors would not be affected but that the not-yet-exempt organization does have an income tax liability for the period prior to the date of application, then another course of action is possible. Such organizations may apply simultaneously for exemption under sections 501(c)(3) and 501(c)(4). Exemption under Section 501(c)(4) is always retroactive to the date the organization was formed. Any organization that qualifies for exemption under 501(c)(3) can also qualify under 501(c)(4), and can thereby achieve exemption from income taxes for the period prior to the date of application. (Donations to 501(c)(4) organizations are not tax-deductible.) The application for exemption under 501(c)(4) (Form 1024) is very similar to the application for exemption under 501(c)(3), so little additional work is required to complete the second application.

Notes on Form 1023

Form 1023 has been revised periodically. A number of changes have been made in the organization and numbering of questions, but the basic concerns of the IRS, as reflected in the questions, have not changed greatly. The most important of these concerns are discussed here.

Documents to be attached. Note that you must submit copies of both the articles of incorporation and the bylaws. The articles must be accompanied by evidence that the articles have been duly filed with the state. Any amendments filed with the state should also be submitted. The copy of the bylaws that is submitted should incorporate any duly adopted amendments.

Make sure that the corporate name appears in the bylaws (and in Form 1023) in exactly the same form as in the articles of incorporation. Any use of abbreviations in the corporate name and spellings of all words must be consistent from one document to another.

Narrative description of activities. This is an important part of the application and should be written carefully. For new organizations that are not yet in position to describe actual programmatic activities, it is important to be sure that the description of *planned* activities reflects plans that have in fact been developed and approved by the board of directors.

The "operational test," as described earlier, will be applied to this description of activities. For housing organizations, including CLTs, it will normally be applied with particular reference to the "safe harbor guidelines" and "facts and circumstances test" as described in Revenue Procedure 96-32 (discussed earlier). For programs that you expect

will be recognized as exempt on the basis that they "relieve the poor and distressed," your description should specify the mix of incomes that will be served, and should do so – as far as is consistent with board-adopted policy – in the terms used in the safe harbor guidelines (for rental projects) or in the description of "Organization R" (for homeownership projects).

To the extent that the programmatic activities do not conform to the safe harbor guidelines it is important either (1) to emphasize "facts and circumstances" that indicate the activities nonetheless "relieve the poor and distressed," or (2) to identify other charitable purposes served by the activities, such as "combating community deterioration" or "lessening the burdens of government." (Regarding methods of demonstrating that such other charitable purposes apply, see the earlier discussion of these topics.)

Compensation and relationships of officers, directors, employees and contractors. In these matters, the IRS is concerned with the possibility of earnings "inuring to the benefit of" a "private individual" through the individual's position within the organization or relationship to someone within the organization. This does not mean, however, that individuals cannot receive reasonable compensation for labor, goods or services provided to the organization. Since CLT directors and officers generally serve without compensation and since CLT staff salaries and payments to contractors rarely, if ever, exceed the "going rate" for the positions or services involved, these questions are not likely to present problems for CLTs.

Members and others receiving benefits. In answering questions regarding those who benefit from the organization's programs, most organizations that conform to the "classic" CLT model as membership corporations should make it clear that, although residents of CLT housing automatically become members, preexisting membership is not required to gain access to the benefits of CLT housing. Income requirements for the CLT's programs should be emphasized as the primary basis for determining eligibility.

Payments by recipients for benefits. CLTs should state that residents of CLT housing pay for that housing as tenants or homebuyers. The explanation can generally be framed within the basic principle that "recipients" pay the after-subsidy cost of the goods or services received, and that the extent to which costs are subsidized depends on the income level and special needs of the recipients. In the event that a CLT sells or rents property to a person in circumstances where the transaction does not serve a charitable purpose, it is then important to be able to show that the person pays a market rate price or rent.

Intervention in political campaigns. 501(c)(3) organizations are categorically prohibited from intervening in political campaigns. A CLT's articles of incorporation should normally proscribe such "intervention" (see Chapter 3, "Incorporation and Basic Structural Considerations"). CLT should answer no to this question.

Activities intended to influence legislation. 501(c)(3)organizations are prohibited from attempting to influence legislation *only* to the extent that such efforts constitute a "substantial part" of their activities. Though it is common for CLTs to attempt to influence legislation by local government relating to matters of affordable housing and community development, such efforts do not constitute a substantial part of the activities of most CLTs, and most CLTs, in completing Form 1023, can state categorically that efforts to influence legislation do not and will not constitute a substantial part of their activities.

If you are not sure whether such a statement is true, you should read the section of Publication 557 entitled "Lobbying Expenditures." If you expect substantial lobbying expenditures, you may consider filing Form 5768 (through which procedure a 501(c)(3) organization may be allowed to make up to 20% of its exempt purpose expenditures for the

purpose of influencing legislation), but it would be wise to consult an attorney who is knowledgeable on the matter before doing so.

Fundraising program. Anticipated fundraising activities will have a bearing on public charity status. For new organizations a simple description of planned fundraising efforts should suffice. Most new CLTs will not use professional fundraisers, and can say so. (Employees of the organization who carry out fundraising activities as a part of their jobs are not considered professional fundraisers in this context.)

Financial data. Note that the Statement of Revenue and Expense and the Balance Sheet must be completed for the current year (covering a period ending within 60 days of the date of application), and for each of three, four, or five (previous or projected) taxable years depending on whether the organization has been in existence less than one tax year, at least one tax year, or five or more tax years.

For organizations that have established accounting systems, the Statement of Revenue and Expense and Balance Sheet should be completed by someone familiar with the organization's books. If an accountant has assisted in setting up the books and/or performed an audit, he or she may complete these reports for the organization. Very new organizations with minimal revenue and expenses will find it relatively simple to report the necessary information on the appropriate lines. It is understood that budgets of new organizations may need to be changed as planning continues. The fact that changes in your proposed budgets can reasonably be anticipated should not be a cause for delaying your application. Generally, CLTs have submitted year-by-year *operating* budgets – not project-by-project capital budgets – and have attached a note explaining that the operating budget does not include amounts that are being or will be invested in acquiring and developing real estate.

Public charity vs. private foundation status. See the discussion of "Public Charity Status" above. Most CLTs can reasonably expect to be ruled public charities rather than private foundations. Unless you have reason to be sure that your organization cannot qualify as a public charity through any of the sets of tests discussed above, you should answer "no" to the question of whether you are a private foundation. Most CLTs will qualify as public charities under either section 509(a)(1) or section 509(a)(2), and can check the box indicating that they want the IRS to decide which of these sections will apply.

Follow through. After you have submitted your application to the appropriate IRS office, you will receive an acknowledgment, with an indication of when you can expect the application to be processed. The waiting period varies, depending on the number of applications waiting to be processed.

Once processing of your application begins, you may receive a request from the IRS for additional information. The request normally entails a list of questions – sometimes a rather long list. The questions may appear to overlap each other substantially or to ask for information already provided. Nonetheless, it is important to answer the questions, one at a time, thoroughly and precisely (and to do so within the time allowed). The answers should be prepared by the person who has prepared the original application, or, at least, by someone who is familiar with the original application and understands the distinctions on which 501(c)(3) status depends. Answers that are overly general may result in yet another set of questions from the IRS.

Once the office that initially processes the application believes that it has all of the necessary information, one of two things will happen. Usually the office will make a determination on your organization's status (and issue a "determination letter"), but if it still has questions about how to deal with your application it may refer it to the Washington,

D.C. office of the IRS. In the latter case, it is possible that the Washington office will ask for still more information before finally making a determination.

Most organizations achieve recognition of 501(c)(3) status relatively quickly and easily. For a few it proves to be a time-consuming process. The difference is due not only to differences among applications but to differences in the understanding and experience of IRS personnel. If the process is time-consuming for your organization, do not be discouraged. Do not be intimidated by the number of questions asked. Follow through. 501(c)(3) status will become increasingly important for your organization as it develops. If you do not follow through with your initial application, you will need to begin the process all over again in more complicated future circumstances.