

Public Finance Advisory: Exempt Status Denied to Student Housing Nonprofit

8/26/2008

On August 15, 2008, the Internal Revenue Service ("Service") publicly released a redacted final adverse determination letter (PLR 200833022 (May 21, 2008)) denying Section 501(c)(3) status to a nonprofit organization ("M") created to provide student housing for colleges and universities through the issuance of tax-exempt bonds. The Service's denial of exempt status to M was based on the failure of M to establish that its operations furthered a charitable purpose and not a commercial trade or business. The Service stated in its letter that "[p]roviding services at cost and solely for exempt organizations is not sufficient to characterize the activity as charitable." The Service suggested that the result of the letter would have been different had the housing been provided free or below cost to low-income students, or had M been controlled by the colleges, universities, or communities it served.

Under the facts of the letter, "Q," an existing Section 501(c)(3) organization formed to lessen the burdens of government, desired to help colleges and universities develop student housing. To accomplish its goal, Q formed M, and M submitted an application for exempt status under Section 501(c)(3) to the Service. In its application, M described to the Service that it planned to form limited liability companies ("LLCs") to separately own and operate student housing for each participating college or university. Each LLC would charge rent sufficient to cover operating expenses and debt service with any excess donated to the college, university, or related community, or used to fund housing grants to low-income students. Each LLC was to have a five-member board including one member from a college or university, two community members, and two members selected by Q. A support agreement would be entered into describing both the obligations of the educational institution and the LLC. An unrelated property management company would operate the student housing. Despite the detailed requirements of the support agreement, the IRS found no evidence that the institution or community board members would have any significant role in the actual operations of an LLC. Hence, the Service concluded that through the overall structure, M was conducting a trade or business and not a charitable activity.

A negative letter may have been averted by structuring the board of M with a majority consisting of participating colleges or universities and community members or, alternatively, by having M exclusively serve a single college or university rather than multiple educational institutions through LLCs. Until this letter was publicly released, concerns over the charitable purpose of student housing appeared to have abated since late 2002 when the Service closed an examination of the exempt status of the Collegiate Housing Foundation. To end the audit without jeopardizing its Section 501(c)(3) status, the Collegiate Housing Foundation amended its articles of incorporation and bylaws so that it would be governed by member colleges and universities. Here, unlike the Collegiate Housing situation, the board of Q has authority to appoint all of M's directors.

What Is the Significance of This Letter?

This final adverse determination letter states the Service's position on specific facts and cannot be relied upon as precedent by others seeking determination letters. Quite surprisingly, the letter was not appealed within the Service or to a court through a declaratory judgment procedure, which would have yielded further guidance. Nevertheless, the letter provides valuable insight into the Service's concerns when student housing is provided by nonprofit organizations supporting multiple educational institutions. Those nonprofit organizations who may be currently operating under a structure similar to that described in the letter should discuss its implications with counsel.

If you wish to discuss the contents of this advisory, or for assistance with issues raised by the legal development that is the subject of this advisory, please contact any of the members of Mintz Levin's Public Finance Section listed below.

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