E. COLLEGE HOUSING

by
Debra Cowen, Debra Kawecki and Gerry Sack

1. Introduction

Recently, the Service has received a number of applications and ruling requests from organizations that want to provide up-to-date student housing facilities on or near college campuses. The organizations plan to construct or purchase, own, and operate the dormitories or apartment facilities. The projects will be financed through the issuance of tax-exempt bonds. Although each applicant's proposal is different and must be considered on its merits, there are a number of common threads that raise concerns. This article addresses those concerns.

2. Common Fact Pattern

Although no two organizations or transactions are identical, it is helpful to discuss exempt organization issues in context. The following example is representative:

X is organized and operated to provide reasonably priced student housing for colleges and universities that lack adequate student housing and is considering projects at several colleges across the country. X plans to construct, renovate, own, and operate the student housing facilities and may also provide additional services such as cafeteria facilities. X represents that any project will be built in response to the college's decision that it needs additional student housing and will be compatible with the college phone system and Internet technology allowing a direct link to the campus network. X plans to finance the facility through the issuance of tax-exempt bonds.

X may lease land for the facility at a nominal fee from the college, or may purchase property adjacent to or near the campus. X plans to develop and operate the student housing in conjunction with the respective colleges. The charges to students are to be sufficient to pay the operating expenses of the facility and retire debt. Once the facility is built, X will contract with a third-party management company to manage the facility. X will retain an administrative fee for its development, financing, and oversight. At the end of the lease term or on payment of the bonds in full, X plans to transfer ownership of the facility to the college.

Upon completion of the purchase or construction, the facility will be made available to students consistent with the guidelines and policies of the college. Vacant apartments may also be made available to faculty and staff. When the college is not in session, rooms may be made available to participants in college-sponsored interim programs, participants in non-college sponsored educational activities near campus, and students from other colleges studying or pursuing internships in the area, as well as to the general public.

X plans to look for similar opportunities at other educational institutions across the country. Where new construction is not needed, X will either lease or acquire existing facilities for renovation and operation. Depending on the needs of the institution, X will also develop, own and operate student food service facilities in conjunction with the student housing facility. Both construction and renovation will be financed by tax exempt bonds.

3. Current Law

A. Serving a Charitable Class

Providing housing for students, absent special facts and circumstances, is a trade or business that is not charitable. An organization providing student housing may, however, qualify for exemption under IRC 501(c)(3) if certain facts and circumstances are present. It may qualify for exemption by serving a class of students recognized as a charitable class. For example, Rev. Rul. 64-274, 1964-2 C.B. 141, describes an organization that provides free housing, scholarships, and books, to students who could not otherwise attend college because of a lack of funds. The Service ruled that this organization was exempt because it was advancing education by relieving the poverty of the students. It was serving a charitable class. Similarly, the Service recognized an organization making low-interest, unsecured loans for educational purposes to students needing financial assistance as exempt under IRC 501(c)(3) in Rev. Rul. 63-220, 1963-2 C.B. 208.

B. College and Community Control

The organizations described in Rev. Ruls. 67-217, 1967-2 C.B. 181, and 76-336, 1976-2 C.B. 143, rely for exemption primarily on the element of control by or on behalf of an exempt organization.

The organization described in Rev. Rul. 67-217, was formed to provide housing and food service exclusively for students and faculty at a specific university, which lacked adequate facilities. The facility was constructed near the university and was managed by a commercial firm in accordance with the university's rules. The facility was made available to students at rates comparable to those charged by the university for similar facilities. Support services were provided to supplement university activities. Income came from rents and food service charges and funds were expended for operating expenses and debt retirement. Any surplus was donated to the university. The university had an option to purchase the facility at any time for an amount equal to the outstanding indebtedness.

The organization described in Rev. Rul. 76-336, 1976-2 C.B. 143, was formed by community leaders to provide housing for students of a particular college in response to studies by staff members of the college showing that the college lacked suitable housing to meet the need. The college itself provided no housing because it was financially unable to do so. Many students, however, lived so far away that daily commuting was unreasonable. The housing facility was built adjacent to the college campus and available to students first-come, first-served. The college and the organization consulted and cooperated to ensure the needs of the college and its students were served by the operation of the housing facility. Income came from rentals and contributions. Disbursements were for operating expenses and debt retirement. Under these circumstances, the Service determined that the organization was advancing education by assisting the college, which was unable to provide adequate student housing, to fulfill its educational purposes, and aiding the students to attain an education.

In Rev. Rul. 67-217, the college clearly controlled the activities of the organization. In the later revenue ruling, the tie was to both the community and the college. In the example above, X can not rely on either of these revenue rulings. Because X's purpose is to provide financing and housing services to a number of colleges and universities, it can not be controlled by any one educational institution or by any one community. Also, it will not restrict its services to a charitable class of students.

Although GCMs are not precedential, they contain a more detailed discussion of the facts and analysis applied in a particular situation than a published revenue ruling. GCM 36493 considers the organization described in Rev. Rul. 76-336 and is helpful to a discussion of the key factors to consider in analyzing whether an organization providing student housing is operated in a manner consistent with exemption under section 501(c)(3).

A fact that weighed heavily in the analysis of Rev. Rul. 76-336 was that the organization was created by community leaders after studies made by the President of the College and the community leaders showed insufficient affordable student housing. The organization was not controlled by the developers but by the community on behalf of the college. The college and the organization consulted and cooperated to serve the housing needs of the students.

The organization described in Rev. Rul. 76-336 also operated below cost. The housing site was provided by the city at a fraction of its market value and the city made substantial contributions of equipment and services. The housing was not bond-financed. The costs not covered by the affordable rents were offset by contributions from both individuals and the community.

There is no GCM elaborating on the facts stated in Rev. Rul. 67-217. However, a close reading reveals ongoing cooperation between the university and the organization regarding both the need for the facility and the operation of the facility so as to serve the needs of the university. The ruling indicates that the facility was made available to students at the same price as other university housing. The ruling is silent, however, whether the organization operated below cost by reducing its charges to students through the use of contributions or university subsidies.

The essential facts and circumstances in both Rev. Rul. 67-217 and 76-336 - community control, college involvement, and below cost operation - are significantly absent in the Common Fact Pattern. X, as noted above, is not controlled by any one exempt organization and, although it offers discounted administrative services, does not operate below cost. The facts that services are provided at cost and solely for exempt organizations are not sufficient to characterize the activity as charitable. Rev. Rul. 72-369, 1972-2 C.B. 245, discussed further in subsection D, denied exemption to an organization similar to X that provided consulting and management services to unrelated exempt organizations.

C. Feeder Provisions

IRC 502 is a good starting point for analyzing whether an organization engaged in a commercial type activity qualifies for exemption under IRC 501(c)(3). IRC 502 sets forth the general rule that an organization operated for the primary purpose of carrying on a trade or business for profit cannot establish exemption on the ground that all of its profits are payable to one or more exempt organizations. A subsidiary organization may be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, but an organization that provides services to organizations other than its parent (or its parent's subsidiaries) is engaged in a trade or business that would be considered an unrelated trade or business if conducted directly by the parent and will not qualify for exemption.

The example in the regulations is an organization furnishing electric power. The organization will be tax-exempt as long as it is operated for the sole purpose of furnishing electricity to its parent because its activities are integral to the operation of its parent. If, however, the organization is operated primarily to furnish electric power to consumers other than its parent, it will not qualify for exemption because it is engaged in a business that would be an unrelated trade or business if regularly carried on by the parent.

As an example of the operation of IRC 502, consider the organizations described in Rev. Ruls. 54-305, 1954- 2 C.B. 127 and 69-528, 1969-2 C.B. 127. Rev. Rul. 54-305 involves a purchasing agency formed by unrelated exempt hospitals to reduce hospital costs. It was denied exemption under IRC 501(c)(3). The agency was formed to purchase supplies and perform related services for several otherwise unrelated charitable organizations. The Service determined that these activities were not *per se* charitable but were business activities of the kind ordinarily carried on for profit. Because the activities would have been unrelated activities if carried on by any one of the tax-exempt organizations served, exemption was precluded by IRC 502.

In Rev. Rul. 69-528, investment services provided to unrelated entities were also considered ordinary commercial services that would be unrelated trade or business if carried on by any of the tax-exempt members of the organization. The malpractice insurance trust described in Rev. Rul. 78-41, 1978-1 C.B. 148, on the other hand, was able to establish exemption because it was considered an integral part of its parent hospital. The activities of the trust were ordinary insurance services available in the commercial marketplace. Because the services were offered solely to the hospital that created it, exemption was not precluded by IRC 502.

Congress has legislated two exceptions to IRC 502 to accommodate cooperative organizations whose purposes are to provide certain support services at cost to unrelated exempt members. IRC 501(e) provides exemption for hospital service corporations performing specific enumerated services on a cooperative basis for its members that are tax-exempt hospitals. IRC 501(f) provides exemption to cooperative service organizations, organized and controlled by schools and certain state and municipal colleges and universities, for the collective investment of their funds in stocks and securities. A thorough discussion of IRC 501(e) and 501(f) is outside the scope of this article. (For further discussion of these sections see Cooperative Hospital Service Organizations, 1979 CPE 268, 1980 CPE 77, 1981 CPE 29, 1982 CPE 3, and 1999 CPE 86, Feeder Organizations, 1983 CPE 83, and Cooperative Service Organizations, 1986 CPE 80.) These exceptions, however, are clear and unambiguous. Both sections have been strictly construed. Although the organizations described in Rev. Ruls. 54-305 and 69-528 may now qualify for exemption under these legislative exceptions, the rationale on which the rulings were based remains valid.

D. Integral Part and/or Substantially Below Cost

An organization may avoid IRC 502 by providing essential services to a related entity as discussed in subsection C, or by providing services at substantially below cost. The

Service first published this position in Rev. Rul. 71-529, 1971-2 C.B. 234. This ruling describes an organization assisting unrelated educational organizations manage endowment and investment funds in a manner similar to Rev. Rul. 69-528. However, this organization's operating expenses were paid by grants from independent non-member charitable organizations. The member organizations paid only a nominal fee for the services. The revenue ruling states that fees represented less than 15 percent of the total costs of operation. The ruling concludes that the organization qualifies for exemption because it is performing an essential function for exempt organizations, and that by performing this function for a charge substantially below cost it is performing a charitable activity. The importance of the donative element was affirmed in Rev. Rul. 72-369, 1972-2 C.B. 245, which describes an organization formed to improve exempt organizations' charitable programs by providing managerial and consulting services. The services were offered at cost. The Service ruled that this organization did not qualify for exemption because providing administrative services on a regular basis for a fee is a trade or business ordinarily carried on for profit. Without the donative element of below-cost operation, the organization lacked a charitable purpose. This ruling is a reaffirmation of the longstanding general rule stated in IRC 502.

Courts have upheld the position taken by the Service in the above revenue rulings. Unless a court views the services provided by the organization as essential and the class of recipients as related, it has not found the integral part test satisfied.

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the Court held that an organization providing consulting services to non-profit organizations at not less than the organization's cost was not operated exclusively for exempt purposes. The consulting services were directed at basic and applied research for the organization's non-profit clients. In sustaining the Service's determination that the organization was operated for a substantial non-exempt commercial purpose, the Court found that petitioner's sole activity, selling consulting services to exempt and other non-profit organizations, was the conduct of a business which ordinarily is conducted by commercial ventures for profit. The organization's only role was that of a conduit linking individual researchers with the interested organizations seeking a substitute to full-time staffing, a role not inherently charitable, educational, or scientific.

In Chart, Inc. v. U.S.A, 491 F. Supp. 10 (Dist. D.C. 1979), rev'd 652 F.2d 195 (D.C. Cir. 1981), the plaintiff provided shared electronic data processing to tax-exempt, non-profit member hospitals. The organization was held exempt because the services were found to be an integral part of the hospitals' activities and were highly specialized services for which there was no commercial counterpart.

In Council for Bibliographic and Information Technologies v. Commissioner, 1992 T.C. Memo 364 (1992), the petitioner was an outgrowth of an existing organization, Ohionet, which was exempt under IRC 501(c)(3). One project of Ohionet was TLM. Ohionet was controlled by its members who were IRC 501(c)(3) organizations. Ohionet asked those members using TLM to form a new organization to use TLM. The Court described TLM as follows:

> TLM is an on-site computerized library system. TLM uses a computer that is owned and operated by petitioner's members. TLM is a transaction system which a library and its patrons may use for its circulation and cataloging. Users of TLM include terminal operators who charge or discharge books at circulation desks, technical processing staff members who label materials and create inventory records, acquisition staff members who prepare orders, and patrons or reference libraries who conduct on-line searches.

The following paragraph provides a summation of the Court's analysis.

> In our opinion, petitioners activities...are necessary and indispensable to the operations of petitioner's members. In order for a library to function, materials must be ordered, added to the catalogue system, shelved, located by patrons or staff, checked out, checked in, reshelved, and eventually removed from the catalogue system. Such activities are the essence of running a library. Accordingly, since we conclude that petitioner's activities bear a close and intimate relationship to the functioning of its tax exempt members, we hold that the petitioner is entitled to tax exemption as an educational institution under section 501(c)(3).

In Nonprofits' Inc. Alliance v. United States, 38 Fed. Cl. 288, (1994), the plaintiff was a group self-insurance risk pool with members consisting entirely of IRC 501(c)(3) organizations whose dues to the organization were fully paid up. The plaintiff, which qualified as tax-exempt under California law, maintained that by providing insurance at stable prices, it "directly advances the charitable purposes of nonprofit organizations..." Plaintiff conducted four basic activities: 1) providing liability insurance, 2) developing educational material and presentations, 3) providing loss control, and 4) serving as a resource

for insurance-related questions. Although plaintiff admitted that its services were similar to those provided by commercial entities, it claimed to be providing services at substantially below cost. It also claimed that its additional services, such as education and risk management distinguished it from a commercial insurance company. The plaintiff argued that it was providing services similar to those in Council for Bibliographic and Information Technologies, supra, and could rely on the shared hospital services cases as the Court had applied them to non-hospital situations. The court, however, determined that the services were not essential and that the members were not related so the integral part test was not satisfied.

4. Discussion

These precedents supply a framework for analyzing the Common Fact Pattern. X was not created in response to a student housing deficiency substantiated by the community and a specific college prior to its founding. It was not created by leaders of the community in which the housing units will be located, nor in conjunction with the colleges on whose campuses the units will be located. X is an independent organization that plans to canvas the country looking for opportunities to create and finance additional student housing. There is no evidence that members of the local community or directors of the college will have significant involvement, contribute to, or otherwise participate in the operations of X. X's role in the student housing projects is that of a developer. Its role is to market and design the projects and to act as a vehicle for financing the projects through the issuance of tax-exempt bonds. Its projects are designed to be self-supporting.

Although Congress has shown a willingness to consider special legislation for certain kinds of organizations [IRC 501(e) and 501(f)] providing specific commercial services to a particular sector of the Exempt Organizations community, X does not fit either of these exceptions. X is providing commercial development services with respect to the issuance of bond financing to unrelated exempt organizations for a fee. This is an activity normally conducted on a commercial basis and would be considered an unrelated trade or business if conducted by one exempt organization for other unrelated exempt organizations.

X is outside the scope of IRC 502 because it is not directly controlled by an exempt organization. However, the general rule in that section still applies. X cannot establish exemption on the grounds that all its profits are devoted to charitable purposes. X cannot establish that its operations benefit a charitable class. Nor can X demonstrate that it is operated for the exempt purpose of advancing education by assisting a particular college in fulfilling its educational purposes. X may establish exempt status by demonstrating that it

is providing essential services to a related group of organizations or it may establish that its commercial type services are offered to exempt organizations substantially below cost.

Under the facts and circumstances described in the Common Fact Pattern, it is unlikely that X can establish exemption as providing essential services or providing services at substantially below cost. X provides normal commercial services. These services are very similar to those provided by the organization in Nonprofit Inc. Alliance, supra. The entities that X will provide these services to are not related in any way. It is also highly unlikely that X is providing its services at substantially below cost. The Service and the courts have treated substantially below cost as 15% of cost with the rest of the organization's expenses made up from contributions. This is a very difficult test for an organization to meet. On the basis of this analysis, it is clear that an organization performing activities similar to those performed by X would not qualify for exemption under IRC 501(c)(3).

5. Other Issues

If an organization providing college housing in a manner similar to the organization described in Rev. Ruls. 67-217 and 76-336 is able to establish an exempt purpose, it is still necessary to examine its operations to assure they do not result in private benefit. The nature of the comprehensive service agreements between the developer and management company require detailed review. The organization must establish that it firmly controls the activities of the contracted companies, that the contracts were negotiated at arm's length, and that the terms of the contracts do not unfairly favor the contractors. These issues were addressed last year in Charter Schools (see the 2000 EO CPE Text, Topic J) but also apply in this context. Organizations issuing tax exempt bonds should also be aware of the inurement issues discussed in Identifying Abusive Transactions Involving Section 501(c)(3) Organizations and Tax-Exempt Bonds (see the 1999 EO CPE Text, Topic H).

Unrelated business income tax issues may also arise because of the very nature of college housing. Most students remain on campus for only 9 months. If space in the facility is made available during the summer or other interim periods, consideration must be given to whether that use is related to the organizations' exempt purposes (as opposed to the college's much broader exempt purposes) or is taxable as unrelated business income under IRC 511. Organizations should be aware that the housing organization cannot take advantage of the very broad mission of a college or university. One must keep in mind the limited exempt purpose of these organizations when making this determination. In this regard, it is likely that any rental activity other than to students enrolled in programs of the particular college being served will be considered unrelated to the organizations' exempt purposes and subject to tax.