



Lawyers Alliance  
*for* New York

*Connecting lawyers, nonprofits, and communities*

# Joint Ventures for Housing Organizations

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## **Introduction**

This is the first of three publications that Lawyers Alliance for New York will issue on the topic of joint ventures for housing organizations. This issue covers the question of when an organization should consider entering into a joint venture and what the legal issues are when a nonprofit enters into a joint venture with a business entity.

### ***What is a joint venture?***

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A joint venture is an arrangement between two or more parties who invest in a single business or property.

### ***When should a nonprofit consider entering into a joint venture?***

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A nonprofit housing organization might consider entering into a joint venture in any of the following situations:

- A nonprofit may want to get a project started but may not be able to secure the financing necessary to complete the project.
- An organization may have other projects in the pipeline and may lack the staff to dedicate to a new project.
- An organization might want to respond to a request for proposals but is unable to meet all of the requirements for the proposal, and another team member is needed to satisfy all of the requirements.
- An organization lacks the resources to acquire a site and you need a partner that can make the cash outlay to purchase a development site.
- A developer has approached an organization with a project and the developer wants to partner with the organization.

No matter what the circumstance, the first step in the process of deciding whether or not to enter into a joint venture is to assess what your organization expects to get from the joint venture, what your organization has to offer to the joint venture, and what your organization's capacity is to participate in the joint venture.<sup>1</sup> At this juncture it is also advisable to check the purpose clause in your organization's certificate of incorporation and confirm that it includes the development of low-income housing. If it does not, you should consult an attorney for advice on amending your certificate of incorporation.<sup>2</sup> The New York State Attorney General's office has a useful brochure available online entitled "Procedures for Forming and Changing a New York Not-for-Profit Corporation". The address of

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<sup>1</sup> For a list of questions to ask about the venture, see MELANIE L. HERMAN, NONPROFITS' INSURANCE ALLIANCE OF CALIFORNIA AND ALLIANCE OF NONPROFITS FOR INSURANCE, MANAGING COLLABORATION RISKS: PARTNERING WITH CONFIDENCE AND SUCCESS 6 (2002).

<sup>2</sup> Contact Lawyers Alliance for New York for assistance with reviewing and amending your certificate of incorporation.

the website for the New York State Attorney General's office where the brochure can be found is [www.oag.state.ny.us/charities](http://www.oag.state.ny.us/charities).

***What is in it for your organization?***

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If you cannot answer this question, you might want to reconsider moving ahead. There are two primary motivations: (1) advancement of the organization's mission and (2) the potential financial rewards. At a minimum, the project should be furthering your organization's mission and therefore allow you to serve a greater number of clients. Perhaps your organization will earn a portion of the developer's fee allocated to the project. Or perhaps you are going to manage the property and receive an income stream through management fees. Even if the potential financial benefits are significant, you need to make sure the project is true to your mission.

***What can your organization contribute to the joint venture?***

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In order to negotiate a successful joint venture agreement you need to have a full understanding of your organization's strengths. Start by making a list of what you feel your organization has to offer the joint venture. Below is an example of attributes or assets that you might take into account:

- Site control to a development site
- Community contacts
- Cash
- Development experience
- Project management expertise
- Experienced staff
- Good reputation in the community
- Successful track record

There are resources available to guide you when examining your organization's attractiveness as a partner. After assessing your organization, if you did not have a sense beforehand, you should now have a sense of what you need your joint venture partner to have and be ready to start the search for a partner.

### ***How to Locate a Joint Venture Partner***

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If your organization has been developing housing, you may already have a network of contacts to approach in your search for a partner. You may even have a partner in mind. One caveat: if you have already identified a site but you do not have site control, you need to be careful not to reveal too much information to a player that may end up being your competitor instead of your partner.

If you are new to housing development, you have a lot more work to do to locate and assess a potential partner. You can start by reaching out to established housing organizations for information. There are also organizations that sponsor events, workshops, and conferences that provide networking opportunities such as the New York State Association for Affordable Housing (NYSFAFH), the New York Housing Conference, the Citizens Housing and Planning Council, and the Supportive Housing Network of New York.

<b><i>List of websites for organizations that provide networking opportunities:</i></b>
<i>New York State Association for Affordable Housing:</i> <a href="http://www.nysafah.org">www.nysafah.org</a>
<i>New York Housing Conference:</i> <a href="http://www.thenyhcn.org">www.thenyhcn.org</a>
<i>The Citizens Housing and Planning Council:</i> <a href="http://www.chpcny.org">www.chpcny.org</a>
<i>The Supportive Housing Network of New York:</i> <a href="http://www.shnny.org">www.shnny.org</a>

Once you have identified a potential partner, be sure to research the company and confirm their track record. At a minimum ask for and check references. There are many possible resources – other nonprofit organizations, lawyers, contractors, architects, contacts at title companies, developers, vendors – ask everyone you know whether they know your potential partner. You can also run searches online or consult organizations like the Better Business Bureau for information. Bear in mind that your potential partner will be looking for information about your organization as well. They will have the same resources available to them along with additional resources such as *Guidestar* (where they will have access to your organization's 990s) and the Charities Bureau at the New York State Attorney General's office. A checklist to use in researching your joint venture partner is included as Schedule A.

### ***The Joint Venture Relationship***

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After assessing and selecting a partner or partners, you and your partner(s) will need to determine the breakdown of tasks between the parties and to agree upon each parties' rights and responsibilities. You will also need to have an understanding of the partners' goals and how long each will stay in the venture. Negotiating these issues can be a time consuming process but reaching agreement is a major step in establishing the joint venture.

In almost all instances the partners will form a new entity, usually a limited liability company or a limited partnership, to carry out the joint venture and own the project. Before you form the entity that will own the project, you might consider entering into a preliminary agreement that will enumerate the parties' rights, responsibilities, and their roles with respect to the project. Such an agreement might be called a letter of intent or a memorandum of understanding. This lays the groundwork for the details to be memorialized in the organizational documents for the entity that will own the project. A lawyer should represent each party when negotiating the terms of any joint venture agreement, including the initial stages when the letter of intent or memorandum of understanding is prepared.<sup>3</sup>

Some attorneys and developers believe that entering into a letter of intent or memorandum of understanding is a waste of time and money (spent on legal fees) since the terms will have to be renegotiated in detail when the final agreement between the parties is prepared. Whether or not the parties decide to enter into a preliminary agreement will depend on the circumstances of each transaction. If a long time will pass between the partners first coming together and the closing of the transaction, entering into a letter of intent or memorandum of understanding may be prudent. It memorializes the parties' understanding but avoids the expense of forming the limited liability company or limited partnership in case things do not work out between the parties or with respect to the transaction. While a preliminary agreement may not guarantee that the venture will be implemented, it helps concretize the parties' plans. However, while we would advise that it is preferable to have an agreement, if your partner does not want to sign one, it is not likely to get done.

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<sup>3</sup> In our next issue we will discuss the letter of intent or memorandum of understanding and the joint venture agreement in more detail.

While there are no prescribed terms, such a preliminary agreement might cover the purpose of the joint venture, the proposed equity contributions, exclusivity conditions, confidentiality, location of the project, a description of the project including project size, the population served, any amenities, how the development team will be selected, the term, the tasks each partner will perform, the dispute resolution mechanism and any other terms that might be relevant to your particular transaction.

### ***Restrictions on Nonprofits entering into Joint Ventures***

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When a nonprofit enters into a joint venture agreement with a for profit entity, there are issues under New York State law and federal law that the nonprofit must take into consideration to avoid jeopardizing its exempt status.

### ***New York State Law Restrictions***

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Not-for-profit corporations in New York are formed under and governed by the Not-for-Profit Corporation Law (“N-PCL”). The N-PCL states that no not-for-profit corporation may be formed for “pecuniary profit or financial gain”<sup>4</sup> and may not engage in such activity unless the activity supports their other lawful activities.<sup>5</sup> The N-PCL permits a not-for-profit corporation “to be an incorporator of other corporations”<sup>6</sup> but it does not explicitly state that a not-for-profit corporation has the authority to serve as a partner in a limited partnership or as a member in a limited liability company. This is in contrast to a corresponding provision in the New York State Business Corporation Law, which expressly states that business corporations have the power to serve as partners or members in “other business enterprises or ventures.”<sup>7</sup> Because of this ambiguity, practitioners have developed the practice of forming a business entity that is wholly owned and controlled by the not-for-profit corporation to serve in any joint venture with a for-profit. The Internal Revenue Service has clarified under what circumstances a nonprofit may participate in a joint venture without jeopardizing its tax-exempt status.

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<sup>4</sup> New York Not-for-Profit Corp. Law (“N-PCL”) §102(a)(5).

<sup>5</sup> N-PCL § 204.

<sup>6</sup> N-PCL § 202(a)(15).

<sup>7</sup> New York Bus. Corp. Law (“BCL”) § 202(a)(15).

***Federal Restrictions: Maintaining Tax-Exempt Status as a Party to a Joint Venture***

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To be tax-exempt under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (“IRC”), an organization must be “organized and operated exclusively” for exempt purposes, including charitable purposes, such as relief of the poor and distressed.<sup>8</sup> While the courts have not interpreted this requirement literally, the presence of a single non-exempt purpose, if substantial in nature, will render the organization ineligible for exemption, regardless of the number or importance of truly exempt purposes.<sup>9</sup> Therefore, in drafting the joint venture agreement it is important to state clearly that the purpose of the venture is to develop low-income housing. The IRS applies a two-part test in determining whether a nonprofit’s participation in a joint venture endangers its exempt status:

- (1) participation in the joint venture must further the organization’s exempt purposes,<sup>10</sup> *and*
- (2) the arrangement must not be “organized or operated for the benefit of private interests, such as designated individuals ...”<sup>11</sup>

When applied to housing joint ventures, the test is expanded, as described below, to insure that the venture is formed to develop low-income housing.

***Application of the Two-Part Test to Housing Joint Ventures:***

***Part One of the Test – Furtherance of Charitable Purposes***

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In order to satisfy part one of the test, an exempt organization must demonstrate that participating in the joint venture is furthering its exempt purposes. To the extent that an organization was formed to sponsor or develop low-income housing,

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<sup>8</sup> IRC §501(c)(3), Treas. Reg. § 1.501(c)(3)-1.

<sup>9</sup> *Better Business Bureau v. United States*, 326 U.S. 279, 283 (1945).

<sup>10</sup> See the discussion below regarding application of the test to housing ventures and compliance with the safe harbor guidelines.

<sup>11</sup> Gen. Couns. Mem. 39,005 (June 28, 1983).

it can satisfy the first prong of the two-part test by demonstrating that the project falls within the safe harbor guidelines established by the IRS in 1996.<sup>12</sup> An organization will fall within the safe harbor guidelines and demonstrate it provides relief to the poor and distressed, and is therefore considered charitable, if the following conditions are met:

- (i) Persons earning no more than 80% of the area median income as established by the federal government for a particular community ("AMI") occupy 75% of the units;
- (ii) *Either* 20% of the units are occupied by residents earning no more than 50% of AMI, *or*; 40% of the units are occupied by residents earning no more than 60% of AMI;
- (iii) The units must actually be occupied by poor and distressed residents; and
- (iv) The housing must be affordable to low-income persons.

For organizations that do not fall within the safe harbor guidelines, the IRS may apply a “facts and circumstances test” to determine whether the organization provides relief to the poor and distressed. Facts and circumstances relevant to this analysis include the degree to which there is deviation from the safe harbor percentages described above, whether the organization provides affordable social services at the premises, the existence of affordability restrictions running with the property and whether the residents, “when considered individually, have unusual burdens such as extremely high medical costs.”<sup>13</sup>

Relief of the poor and distressed is not the only exempt purpose that an organization may have. Housing organizations with projects that do not meet the specific unit breakdown and income guidelines described in paragraphs (i) and (ii) above, may also satisfy part one of the test by establishing that they further exempt purposes which may include, but are not limited to: (i) combating community

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<sup>12</sup> Rev. Proc. 96-32, 1996-1 C.B. 717.

<sup>13</sup> *Id.* at 10.

deterioration, (ii) lessening the burdens of government, (iii) lessening neighborhood tensions and (iv) relief of the distressed or physically handicapped.<sup>14</sup>

***Part Two of the Test – Nonprofit Assets at Risk v. Benefit to For-Profit***

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In determining whether the second part of the test is satisfied, the IRS examines the joint venture to make sure that the assets of the exempt organization are not placed at unnecessary risk for the benefit of the for-profit and that the for-profit does not receive more than an incidental benefit from participating in the joint venture. Very often housing joint ventures are structured as limited partnerships.<sup>15</sup> A limited partner's investment in a housing limited partnership carries a certain degree of risk. Accordingly, the limited partner may impose obligations on the general partner to minimize this inherent risk. The general partner must insulate itself from obligations that promote private financial interests at the expense of the organization's charitable goals.<sup>16</sup> Accordingly, the IRS looks unfavorably upon circumstances in which the exempt organization provides excessive guarantees or indemnifications, such as a pledge to investors of all of the organization's right to receive distributions, allocations or fees.<sup>17</sup> Additionally, contributions or distributions that disproportionately favor the for-profit are discouraged.

In determining whether there is a conflict of interest between the general partner's obligations and its exempt purposes, exempt organizations are guided by the following:

(i) An organization is likely to survive IRS scrutiny if it can demonstrate that the joint venture serves a primary motivation other than profit. Profit is usually not a motivating factor if the project is subject to government-imposed restrictions on

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<sup>14</sup> *Id.* at 14-16.

<sup>15</sup> As an example, in a low-income housing tax credit project that is owned by a limited partnership, the nonprofit organization or a wholly controlled affiliate of a nonprofit, forms a business entity to serve as the general partner. The interest in the business entity or the business entity's stock is owned 100% by the nonprofit or its affiliate. In the remainder of the discussion of "Part Two of the Test" references to the "general partner" are to an entity controlled by a nonprofit and the "limited partner" refers to a business entity and investor in the partnership.

<sup>16</sup> Gen. Couns. Mem. 39,005 at 11.

<sup>17</sup> Priv. Ltr. Rul. 9736039 (Sept. 5, 1997) at 9.

affordability of the housing units or if the joint venture places a limit on distributions that may be allocated to investors during any given year.

(ii) An exempt organization must retain sufficient control over management of the project's operations and the joint venture's ability to comply with applicable regulations. This authority cannot be limited to "ministerial and advisory functions."<sup>18</sup> Mechanisms by which an exempt organization may establish control include ownership of a controlling interest in the partnership (e.g., by holding a majority of the stock in the general partner), and by retaining control over the general partner's board of directors. Additionally, in the past, the IRS has looked favorably upon an organization's "right of first refusal" in any prospective sale of the project.<sup>19</sup>

(iii) The general partner's directors and officers should be independent of the limited partner. Transactions among the exempt organization, the joint venture and third parties must be at arm's length. Exempt organizations are, however, entitled to reasonable compensation in the form of management fees and developer fees that is directly related to services rendered. Although such payments by the partnership to the exempt organization are related party transactions that are commercial in nature, the IRS has determined that "a reasonable percentage compensation" is appropriate.<sup>20</sup> While there is no exact guidance on allowable percentages, payments directly related to the services rendered have been found to be reasonable.<sup>21</sup>

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<sup>18</sup> *Id.*

<sup>19</sup> Gen. Couns. Mem. 39,005 at 12.

<sup>20</sup> *Id.* at 13.

<sup>21</sup> *Ibid.*

***Conclusion***

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While there are federal and State law issues to be concerned about when entering into a joint venture, nonprofits should not be deterred from entering into joint ventures but rather nonprofits should seek the advice of counsel knowledgeable about the issues. With careful planning and attention to the details of the arrangement between the parties and, ultimately, the joint venture agreement, a nonprofit can benefit from such partnerships and, as a result, potentially thrive in a market that has become increasingly competitive.

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*Our next issue will cover what should go into a letter of intent or memorandum of understanding and the key terms in the joint venture agreement.*

*Schedule A*

*Due Diligence Checklist for Researching a Joint Venture Partner<sup>22</sup>*

A. Information relating to the Company

- Confirm exact name, address and where it is formed
- Confirm the principals in the company
- Request bios or resumes of the principals
- Confirm how long they have been in operation
- Ask for references, including, if possible, from other partners, contractors and architects, lawyers, title companies, brokers — anyone who may have worked with them
- Get a list of completed projects and projects in the pipeline
- Conduct an online search, including Lexis/Nexis, of the company and its principals
- Proposed structure chart

B. If the Company owns land or is buying land, information relating to the land, as follows:

- Plans and specifications for the development, if any
- Zoning analysis of the site
- Environmental survey
- Engineer's report
- Land survey
- Title search including copies of the deed, any leases and all documents recorded against the property
- Lender's checklist
- Consents required for closing
- Development and operating budgets, if any

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<sup>22</sup> This list is intended as a guideline to be used in looking at a potential partner. Each joint venture will present a unique set of circumstances to be taken into consideration when researching your partner.