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Legislative Update: Statutory Issues and How to Address Them

Prior to World War II, the population of the United States had demonstrated periods of substantial growth. However, when the fighting men and women of the United States Armed Forces returned home from World War II, a period of population growth began which changed the face of America. The post-war era, variously measured from 1945-1955 or 1945-1960, became known as "The Baby Boom" because of the population explosion it entailed. The United States population began top experience dramatic, exponential growth during this period, but remained economically prosperous, due, in part, to the increased manufacturing capacity resulting from capital investment made during the war effort.[1]

For many parts of the country, the post-war prosperity lasted well into the 1960's. For many other areas, especially urban neighborhoods, prosperity for the many meant poverty for a growing underclass. As more affluent populations began to migrate to suburban areas which became known as "suburbs", capital investment lagged in inner city areas of the nation. As suburban growth led to development of new neighborhoods, racial division

[1] See *Politics in America*, Thomas R. Dye and L. Tucker Gibson, Jr., Prentice Hall, Englewood Cliffs, New Jersey, 1996, pp. 21-43.

and inequality in housing and job opportunities led to an America becoming more divisively segregated. During the 1960's, socio-economic studies began to demonstrate what many had long known: that poverty in America was real, and that it affected racial minorities and rural whites in disproportionate ways.2

As part of Lyndon B. Johnson′s Great Society legislative package, many measures were meant to address the issue of poverty among the states. Included in that bundle of measures was the United States Department of Housing and Urban Development Act of 1965, which created The U.S. Department of H.U.D. as a cabinet level agency. The U.S. Department of H.U.D. was charged with development of programs to provide safe and affordable housing, and to foster development which would, in turn, result in such housing. Thus the modern era of "affordable housing" was born. The primary means of new development of housing, as addressed by H.U.D., has included programs for insuring private mortgage loans, thus resulting in markedly lower interest rates than the market otherwise dictated.

While neither the presentation nor these written materials are intended to be a sociological study of the issues surrounding affordable housing, some historical background is helpful in understanding the blend of policy motivations behind any housing initiative. The politics of affordable housing, like the politics of any other perceived single topic, actually represents a myriad of interrelated issues, including fundamental issues of economic opportunity and fairness, racial discrimination, and

2 *Ibid.* pp. 44-52

urban decay. However, while theoretical and policy based arguments may extend to these lofty points of debate, most individuals involved in affordable housing understand a much more fundamental reality: the United States has a critical shortage of affordable housing, and we, as a responsible nation, must do all we can to create affordable housing units now.

In 1986, when the Tax Reform Act of 1986 was enacted, Low Income Housing Tax Credits (LIHTC) became the primary means of federal subsidy of new affordable housing development. Although H.U.D. mortgage insurance programs remain in force, credit subsidy availability issues have limited the numbers of loans to a mere fraction of the LIHTC program.

The Low-Income Housing Tax Credit Program is the primary means of directing private capital towards the creation of affordable rental housing. Developers of low-income rental housing use the tax credit to offset a portion of their federal tax liability in exchange for the production of affordable rental housing. To qualify for the credit, either twenty percent (20%) or more of the project's units must be rent-restricted and occupied by individuals whose income is fifty percent (50%) or less of the area median family income; or forty percent (40%) or more of the units must be rent-restricted and occupied by individuals whose income is sixty percent (60%) or less of the area median family income.3

H.U.D. created the designation of the Community Housing Development

3 See Sec. 42, Internal Revenue Code of 1986, as amended (Title 26 U.S.C.)

Organization, commonly referred to as the "CHDO". This classification, first created through regulatory action, and later codified at 42 U.S.C. 12704, was intended as a means of qualification for certain federal housing funds, known as HOME funds, which are distributed at the state, county or regional, and city levels. The HOME Investment Partnerships Program (HOME) provides grants and loans to help local governments, nonprofit agencies, for-profit entities, and public housing agencies provide safe, decent, affordable housing to extremely low-, very low- and low-income families. HOME allocates funds through four basic activities: Homebuyer Assistance, Rental Housing Development, Owner-Occupied Housing Assistance, and Tenant-Based Rental Assistance. The program has a fifteen percent (15%) set aside for community housing development organizations and a ten percent (10%) set-aside for special needs, including the homeless, the elderly, persons with disabilities, and person with AIDS.4

Although the designation of CHDO is defined and authorized by federal statute, curiously, the certification of the status is delegated to state and local housing agencies. An organization which meets the standards for qualification may be certified as a CHDO at the state level, the county or regional level, or the city level, or any combination thereof. The certifications qualify the organization for distinct funding opportunities. An organization certified as a state level CHDO, for example, is eligible for HOME funds distributed at the state level, while local certification is required for receipt of HOME funds distributed by the city or county level certifying agency.

4 See 24 C.F.R. 92.500, *et seq*.

As the statutory definition provides, a Community Housing Development Organization is a nonprofit organization which meets several standards. To qualify as a CHDO, a nonprofit organization must:

1) be organized under state or local law;

2) have no part of its net earnings inure to the benefit of any individual;

3) comply with accounting standards set by the Secretary of H.U.D.

4) have among its purposes significant activities related to provision of decent housing to low-income and moderate income persons

5) maintain at least one-third of the governing board's membership for residents of low-income neighborhoods, other low- income residents, or elected representatives of low-income neighborhood organizations;

6) have a demonstrated capacity for carrying out activities assisted under HOME programs;

7) have a history of serving the local community within which housing assisted under the HOME programs is located or is to be located.[5]

While all of the foregoing are conditions precedent to qualification and certification as a CHDO, some items are frankly more difficult to comply with than others. The primary barrier to CHDO certification is the maintenance of one-third of the governing board as residents of low-income neighborhoods, other low-income residents, or elected representatives of low-income neighborhood organizations. From a policy perspective, this provision is a wonderful way to maintain a nexus between the target population and

5 See 42 U.S.C. 12704(5)-(6)

the service provider. In practice, it can be problematic when the low-income resident board members continue to be transient tenants. How then, can one meet the statutory requirements, fulfill the policy initiative of communication between the CHDO and the community it serves, and likewise maintain the order necessary for continuous business-like management of the enterprise?

A standard format has emerged which allows these various requirements to be fulfilled, and which also can be helpful as a strategy for nonprofits to follow as they expand the size and number of communities they serve. Currently, it is rare for an organization to seek qualification as a CHDO in a vacuum; rather the certification is most often sought in preparation for a particular transaction. Give this background, most proposed CHDO certifications contemplate a particular multifamily community as the target population. Moreover, the level of due diligence required for closing any multifamily transaction dictates that significant information be amassed regarding historical lease data, rent rolls, income certifications, and management information. Many of our clients find a helpful way to approach formulation (or re-formulation, as the case may be) of their governing board is to name a resident as one of the low-income representatives.

An issue which should be addressed at this stage of analysis is that of SPE formation. As you may be aware, many, if not all lenders and bond issuers require SPE (Single Purpose Entity) formation for transactional purposes. Lenders reason that requiring a new entity to be formed solely for the purpose of borrowing the money loaned, and for owning the asset creates a remoteness from bankruptcy which provides some added security against the vagaries of financial problems which may otherwise affect the

borrower's parent or related entities. As a matter of course, these SPE's take the form of limited liability companies. The primary reason for use of this organization form is that the Treasury Regulations provide that in cases of limited liability companies with a single owner, the LLC is disregarded for federal tax purposes, and the tax exempt status of the single owner will reflect through the LLC6. Of course, if the nonprofit has the luxury of a group exemption, use of the LLC organizational form is not required, as subsequently formed subsidiary corporations can avail themselves of the tax exempt status of the parent. Group exemptions in this area, however, are about as rare as hen's teeth, and use of the limited liability company is the prevalent organizational form you will encounter. More detailed consideration of the applicability of tax exemptions to LLC's will be included in a later section.

Although the specifics will be addressed at a later point in both this article, the amendments to Tax Code 11.182 embodied in HB 3383 also create the opportunity for the use of a limited partnership organizational form for CHDO transactional purposes. Those opportunities are limited to certain types of bond and tax credit transactions, and will be analyzed in greater detail *infra*.

At this point, many might wonder, if the CHDO certification requires fulfillment of the standards already listed, does it also require fulfillment of other standards as well? The simple answer is "yes". One fact we have glossed over thus far is the description of nonprofit organization included in 42 U.S.C. 12704. Although the statute does not explicitly address the issue, all state and local certifying agencies have taken the position

6 See Treasury Regulations, at '301.7701-3(b)

that the only way to ensure that a nonprofit has no part of its net earnings inuring to any private benefit is to require that the nonprofit be determined to be tax exempt under Sec 501(3) of the Internal Revenue Code of 1986, as amended. From this point forward, while less than rigorous in its correct application, we perhaps should equate the term "nonprofit" with the term "tax exempt organization" for our discussion.

The reason that the additional requirement of being a tax exempt entity is important, is that tax exempt organizations must, by their very definition, comply with certain rules and guidelines of operation and formation which do not, by definition, apply to all nonprofit organizations. In other words, a separate and distinct level of scrutiny exists for tax exempt entities which does not exist for other nonprofit organizations. The most specific area in which this item is important is that of low-income housing. The Internal Revenue Service has determined that providing housing is not a charitable goal, in and of itself, sufficient to warrant tax exempt status. Consequently, the Service has established guidelines, in the form of Revenue Procedures, to create so-called "safe harbors" within which a tax exempt organization is safe to operate. The most important parameter of this type is Revenue Procedure 96-32, which provides that in order to maintain "safe harbor" status, a tax exempt organization seeking to provide housing as its charitable mission, must provide at least seventy five percent (75%) of all its housing units to persons with no greater than eighty (80%) of area median income (AMI). Further, as an additional condition, the organization must set aside either: 1) twenty percent (20%) of units to be leased to persons with no greater than fifty percent (50%) of AMI, or 2) sixty percent of

the units to persons with no greater than sixty percent (60%) of AMI.7 Fifty percent of AMI is defined as very low income and sixty percent of AMI is defined as low income by H.U.D.

This means that any organization seeking certification as a CHDO must first meet I.R.S. requirement for determination as a tax exempt organization, and further, must continue to operate within the safe harbors established by the Service, or risk both loss of its tax exempt status, and the concomitant taxes, interest, and penalties which accrue upon such loss. In January, 2001, Jason Kall, Texas and Louisiana Exempt Organizations Group Manager for the I.R.S., publicly noted that property acquisition utilizing tax exempt bonds was a priority item for the Fiscal Year 2001 Workplan Examination Program. In simple terms, the I.R.S. was giving fair warning that tax exempt bond-financed transactions were audit targets. Given this fact, together with the heightened scrutiny placed upon CHDO applicants by the Texas Department of Housing and Community Affairs, it appears that oversight of CHDO transactions is becoming more and stricter. In short, anyone who believes that CHDO transactions are not scrutinized, or who fears or claims that "fake" CHDO's are (or will be) running rampant is simply unaware of the reality of the regulatory environment within which CHDO's must operate. Now we must get to the crux of the matter, why should any nonprofit organization become a CHDO? The answer depends upon to whom the question is posed. H.U.D. officials will tell you that the only reason for the existence of CHDO certification is for allocation and receipt of HOME funds as contemplated by the HOME Program requirements set

7 See Exhibit Rev. Proc. 96-32

forth in the Code of Federal Regulations.[8] While the utilization of HOME funds is certainly not an insignificant part of affordable housing policy, in practical terms, it is a small fraction of the financial resources necessary for completion of contemporary affordable housing transactions in today's market. While HOME funds can be an important piece of a transaction, they rarely define a transaction. What other reasons, then, are there to become certified as a CHDO? The real reason that almost all CHDO's seek certification is because of legislation originally enacted in the 75th Legislature in 1997, and which became effective January 1, 1998. That legislative initiative, which was embodied in Texas Tax Code 11.182, provided for certain property tax exemptions for CHDO's.

The exemption extended to both improved and unimproved real property, and abates any *ad valorem* taxes otherwise due. Exemptions of personalty utilized by the nonprofit could also be obtained, although such exemptions were governed by another Tax Code section to be addressed *infra*. Provided a nonprofit was organized as a CHDO and owned property for building or repair of same for sale without profit to persons satisfying the organization's eligibility requirements (or rents such property without profit to the same class of person), the exemption attaches. One reason that the Texas CHDO tax exemption is attractive is that it mandates the exemption; once the criteria for exemption are met, it is a matter of right, and not one of discretion.[9]

8 See 24 C.F.R. 92.500, *et seq.*

9 See Texas Tax Code ' 11.182

Some of the language in the existing statute reveals a less than exacting use of the English language, and even less artful statutory draftsmanship. In particular, the statute provides that A>community housing development organization′ has the meaning assigned to that term by 42 U.S.C. Section 12704.10 While it certainly makes sense that this most basic term be defined as a part of the applicable exemption statute, query whether it was also necessary to include the requirement that the organization comply with the prohibition against inurement of private benefit and be charged with use of its assets in performing its charitable functions, when those requirements are, by statutory definition, subsumed under the very term "community housing development organization".11

Irrespective of this author′s criticism of draftsmanship, the statute had a predictable and laudable result: a significant increase in the number of units of affordable housing created and maintained in the State of Texas. However, as recently as May, 2023, it was determined that Texas had a shortage of 864,338 affordable and available units for households living at or below 50% AMI.12 Similarly, Virginia While great need for thousands of units of affordable housing still exists, market participants recognized the opportunity for CHDO's to create and acquire affordable housing, and as always throughout human history, the unfathomable mechanism of the free market answered the call. The tax exemption has allowed CHDO′s to do what they needed to do to effect their shared goal: compete with for profit developers for market opportunities. By gaining an exemption from *ad valorem* taxes, transaction which otherwise would require tens of

10 Tax Code '11.182(e)
11 Tax Code '11.182(c), Sec. 11.43(a) and (b)
12 Affordable Housing News, Affordable Housing Studies, Newsletter, May 2023

thousands, if not millions of dollars of private equity contributions could now be underwritten with 100% financing. Nonprofits could now be the masters of their own fate; dealing effectively in the marketplace for opportunities for acquisition and development which otherwise would simply not exist. This is important for two reasons; first, because it allows nonprofits to set their own development and acquisition strategies without reliance upon for profit partners and developers, and second, because housing units obtained by a CHDO are no longer available to be simple market rate units. The converse of this truth is perhaps more telling; housing units retained by for profit owners are unavailable as affordable housing units.

Certain parties identifying themselves as supportive of the exemption have publicly expressed dismay that "for profit" developers and "fake" CHDO's have manipulated the exemption for personal economic gain. While anyone genuinely concerned about the state of affordable housing in Texas must take seriously any abuses within the financing system, this fear is unfounded. In order to apply for CHDO certification, an organization must already possess a 501(c)(3) determination letter from the I.R.S. In order to obtain a determination letter, or in the case of an organization which has existed less than twenty four months, an advance determination letter, an organization, by and through its officers, must complete and submit an I.R.S. Form 1023 Application for Recognition of Exemption. As with all federal tax forms, any materially false statements contained in the application make the applicant amenable to federal felony charges. Further, once the determination is obtained, the organization must be operated so as to comply with all applicable federal and state limitations on operation of

a nonprofit organization. Finally, even with this continued, aggressive oversight[13], the organization must submit its application for certification to the Texas Department of Housing and Community Affairs, or to a county or city level housing agency for approval. Anyone who has submitted an application to any of these entities within the past year knows all too well that these applications undergo a level of scrutiny which is substantial. One of the motivating forces behind the effort to amend Section 11.182 of the Tax Code was the effort to thwart perceived abuses of the system. This author likens this type of policy approach to that of a portion of the lobby supporting more restrictive gun laws. If a criminal already knows it is illegal to possess the firearm, why in the world would any reasonable person believe that adding another statutory prohibition against his possession would deter him if existing laws failed to do so? Likewise, if an individual already is willing to risk federal felony prosecution and civil lawsuits, penalties and seizures by the I.R.S. by perpetrating tax fraud via manipulation of a tax exempt entity, why in the world would that individual be deterred by another limitation of the CHDO tax exemption? One must especially harbor this wonder after considering the amateurish level of draftsmanship exhibited by the author and its subsequent amendments.[14]

Before continuing with analysis of the new amendments to the Tax Code, further examination of the 1998 statute is worthwhile. Again, the aspect of SPE′s is important. As previously noted, the prevalent organizational form of actual fee ownership entities is that of the limited liability company (LLC). One initial question should cause some level

13 See statements of I.R.S. Group Manager Jason Kall, *supra.*
14 See Exhibits HB 3383, Original Text, and HB 3383, Enrolled Version

of discomfort among most practitioners: If a CHDO creates an LLC as the SPE to own an asset, does the CHDO tax exemption embodied in Tax Code Section 11.182 flow through to the LLC? The quick answer is "not really", but that is neither appropriately informative nor helpful in these circumstances. In reality, after practicing in many of the most populous counties of the state in CHDO transactions, and after speaking with other lawyers involved in housing practice around the state, I have been unable to identify a single appraisal district which has denied a Tax Code Sec. 11.182 CHDO ad valorem tax exemption based upon the fact that the owner entity is an LLC owned by the CHDO and not a CHDO itself. Until the fall of 2000, one had little choice but to take solace in the fact that no one had been called on the carpet for the statutory discrepancy, and roll the tax exemption application dice.

Having been nagged by the potential disaster of having an exemption denied post acquisition based on the CHDO/LLC distinction, I prodded T.D.H.C.A. for some assistance. While still serving as Director of Strategic Planning for T.D.H.C.A., John Garvin asked this author to draft a proposed policy for the agency, which would address both the concerns of those of us in the CHDO community, and the regulatory concerns of the agency. T.D.H.C.A. had long standing problems with reconciling the requirement that the CHDO applicant be a tax exempt entity and Treasury Regulations which provided that LLC's wholly owned by tax exempt entities would be disregarded and thus treated as tax exempt. In crafting a written policy for the agency, I believed that prior scrutiny was important to the regulatory scheme of T.D.H.C.A. Consequently, the policy I proposed in April, 2000, and which was ultimately adopted by the agency in October,

2000, was that a limited liability company could be certified as a CHDO if its sole member was not only a tax exempt entity, but was also an already certified state level CHDO. The newly promulgated CHDO application form adopted this policy and incorporates it as its own.[15]

For all transaction currently contemplated, it is highly recommended that not only the underlying nonprofit organization be certified as a CHDO, but that the actual ownership entity be certified as well. This certification will not only make application smoother, but will give rise to the option of filing an application for a writ of mandamus in the event that an otherwise properly qualified application for exemption is denied.

The subject of application for the exemption is more complicated than one might anticipate. Under the current form of the statute, compliance with two application provisions is required.[16] Those provisions are fairly straightforward; they simply require that the CHDO must file an application, and that the application must be filed annually.[17] While the applications provision itself does not address the issue of timing, CHDO′s should be aware of limitations for filing both their original application for exemption, and all subsequent applications. The Texas Tax Code specifically provides that a CHDO must file for its exemption within thirty days of the date of acquisition of the subject property.[18] The exemption opportunity will be lost for the year of acquisition if the exemption application is not made. On new construction projects, this poses a quandary

15 See Exhibit T.D.H.C.A. CHDO Application Form
16 Texas Tax Code '11.182(c)
17 Texas Tax Code '11.43(a)-(b)
18 Texas Tax Code '11.436(a)

of timing as well. In most cases, the CHDO will actually take fee title to the real property at the initial closing, even though nothing is yet built upon it. While some CHDO′s have successfully deferred application for the exemption until final closing (because of the ownership of improvements issue), the better practice may well be to file an initial application upon taking title to the real estate, and file a subsequent application within the appropriate time limits for final closing. CHDO′s should note that the former statute provided that they must file the initial application within thirty days of acquisition, and file subsequent applications after January 1 and before May 1 of each calendar year of ownership19. House Bill 1392, which was signed by the Governor on June 14, 2001, and which became effective immediately, obviates the necessity for annual filing, but implementation of the provisions of House Bill 3383, which will become effective January 1, 2002, largely negate the effect of HB 1392.20

The newly effective amendment to Tax Code 11.43(c) provides that the exemption, once allowed, need not be claimed in subsequent years.21 The tradeoff for the one time exemption application is the continuing duty to provide the chief appraiser of the relevant appraisal district with a list of properties acquired or sold, and the chief appraiser may require the CHDO to file new applications periodically by so demanding in writing.22

19 Texas Tax Code '11.43(d)
20 See Exhibit House Bill 1392, amending Texas Tax Code '11.43(c)
21 Texas Tax Code '11.43(c), as amended
22 *Ibid.*

The reason that this newly enacted and recently effective one time application provision may not be helpful is the enactment of HB 3383. This bill, which comprises several amendments to Tax Code 11.182, places new limitations on CHDO's. The new amendments treat new construction and existing housing in markedly different ways. It will become the law of the State on January 1, 2002, and CHDO's should be cognizant of its effects. Under the new version of 11.182, any multifamily property of thirty six or more units may not receive the ad valorem tax exemption for years subsequent to its initial allowance unless, in the preceding tax year, the CHDO spent an amount equal to at least forty percent (40%) of the total amount of taxes that would have been imposed on the property, on social, educational, or economic development services, capital improvement projects, or rent reduction. Properties acquired using tax exempt bond financing between January 1, 1997 and December 31, 2001 are exempted from this provision under a grandfather clause.23

The final form of the law varies considerably from its initial form, which was drafted, in part, by this author. The initial draft and new amendments go to great length to define "cash flow" for new construction transactions; why then does the enacted version completely omit any definitions of crucial terms such as Asocial, educational, or economic development services, capital improvement projects, or rent reduction@? Further, another provision in the amended version extends the CHDO *ad valorem* tax exemption to volume cap and LIHTC transactions in which a CHDO is the general partner. While this is a worthwhile notion, it appears that it may inure almost to the

23 Texas Tax Code '11.182(d), as amended

benefit of the for-profit developer and the purchaser of the tax credits, since the CHDO, by definition, cannot benefit from tax credits.

The next subject of analysis must be what qualifies as social, educational, or economic development services, capital improvement projects, or rent reduction within the meaning of the statute. Inasmuch as none of these terms is defined in the pertinent Code provision, rules of statutory construction dictate that we look to other codified meanings, then to common meaning of the words. A preliminary review has determined that the terms "educational services" has at least 130 different definitions within the Texas Black Statutes; this mean that a consensus of definition within statutory confines is unavailable. Therefore, the real compliance issue becomes twofold: what qualifies as a mandatory expenditure under the amendments, and what constitutes sufficient reporting of same? In reviewing the language regarding compliance reporting, we are sadly left with little true direction:

> To receive an exemption under Subsection (b) or (f), an organization must annually have an audit prepared by an independent auditor. The audit must include a detailed report on the organization's sources and uses of funds. A copy of the audit must be delivered to the Texas Department of Housing and Community Affairs and to the chief appraiser of the appraisal district in which the property subject to the exemption is located.24

While at first blush, this appears to be verbiage of the standard statutory variety, consider that no rights of hearing or appeal exist, and while no right of denial is afforded either to T.D.H.C.A. or to the chief appraiser, it is only a matter of time before some

24 Texas Tax Code '11.182(g)

appraisal district denies an exemption on a perceived failure to comply with this provision. In the event of such denial, do standard exemption denial rules control?

How then, should a CHDO go about complying with these new provisions? In most tax instances, an ethical tax professional will present alternatives, all supported by legal positions, but with varying degrees of aggressiveness. A similar approach is probably warranted here. Obviously the least aggressive approach would be to document actual out of pocket expenditures of forty percent (40%) of annual *ad valorem* tax savings. The problem with this approach is that virtually all financing vehicles will provide less than forty percent (40%) of the tax savings as Net Operating Income (NOI) on any given project. In other words, even if the CHDO spends 100% of its available cash, it will, in almost all instances, be significantly less than the required minimum expenditure mandated by the statute. This was a major reason for opposition to the statute, which was simply not understood by many of the legislators involved in its passage. If a CHDO is insistent upon the least aggressive approach to compliance, then the simple truth is, acquisition of existing properties is probably not an option for them.

Because the term "capital improvement projects" is not defined in this section, but is defined as including capital improvement and replacement reserve funds in the new construction provisions of the statute, one may well wish to include the budgeted cost of capital replacement reserves as a part of the minimum forty percent (40%) expenditure target. A more aggressive approach would be to calculate the proportion of actual expenditures at the subject property attributable to low-income and very low-income housing. A suggested approach would be to determine the actual number of set aside

units (whether low-income or very low-income), and calculate that number as a percentage of total units. Utilizing that number, one then multiplies the percentage by the actual cost of principal plus interest paid over the year for the property to obtain a pro rata cost of providing affordable housing. CHDO may want to consider using the percentage of units leased with profit to individual earning no more than eighty percent (80%) of AMI as the multiplier, as the eighty percent (80%) AMI is the threshold definition of "affordable housing" for most federal programs. The rationale behind this strategy for compliance is that providing affordable housing is, in and of itself, both a social service, and an economic development service to the community, and the CHDO should receive credit for those expenditures toward this arguably arbitrary expenditure standard. Moreover, the statute allows amounts spent for "rent reduction" as qualifying expenditures. One can easily argue that the amounts spent on principal and interest for those set aside units qualify as "rent reduction" expenditures in fulfillment of the mandated minimum expenditure amounts.

Finally, the most aggressive approach would be to place a value on the in-kind services provided by both the owner CHDO and any other nonprofit organizations with which the CHDO has memoranda of understanding regarding provision of social services. This approach is probably least defensible because of the language that the CHDO, Aspect...an amount equal to at least 40 percent of the total amount of taxes that would have been imposed on the property.25

25 Texas Tax Code '11.182(d)

The new construction provisions are much less problematic than those provisions dealing with acquisition of existing properties. For new construction beginning after January 1, 2002, a CHDO must spend ninety percent (90%) of its cash flow on the same social, educational, or economic development services, capital improvement projects, or rent reduction required by 11.182(d). One might wonder why an apparently onerous requirement of ninety percent of cash flow is not more concerning. The reason is that the definition of cash flow is so limiting, that few, if any projects will have any cash flow as it is defined in the statute, and paying even ninety percent (90%) of zero is not a problem. For new development, cash flow is defined as the amount remaining after the following disbursements: 1) standard property maintenance; 2) debt service; 3) employee compensation; 4) fees required by government agencies; 5) expenses incurred in satisfaction of requirements of lenders, including reserve requirements; 6) insurance; and 7) other justifiable expenses related to the operation and maintenance of the project.26

Two provisions in the latter part of the amendments have significant impact as well. Here, the CHDO *ad valorem* exemption is extended to private activity bond transactions, volume cap transactions, and LIHTC transactions. As previously noted, this will primarily benefit the for-profit developers and tax credit purchasers involved, but will clearly improve the economics of otherwise marginal transactions to the extent that a deluge of new financing applications utilizing CHDO′s as general partners should be anticipated for 2002. The final provision to examine is one which may negate a good deal of what we have discussed thus far. In an almost anticlimax to the drafting issues

26 Texas Tax Code '11.182(a)(1)

surrounding the amendments, a wholesale exception clause has been inserted. The statute provides that Subsections (d) and (e)(3) do not apply to property owned by a CHDO if the entity that provided the financing for the acquisition or construction of the property either 1) requires the CHDO to make payment in lieu of taxes to the school district in which the property is located, or 2) restricts the amount of rent the organization may charge for dwelling units on the property, or 3) the CHDO has entered into PILOT* agreement for 100% of the taxes that would have been paid.27

While one would certainly have to question the rationale of anyone who would bother with having a PILOT agreement for 100% of the taxes otherwise due, the first two provisions are very important. Some local bond issuers around the state have adopted the policy that in order to obtain a final bond resolution for financing, the CHDO must enter into a PILOT agreement for pay at least school taxes, if not a greater share of the otherwise imposed tax burden. This provision would exempt those CHDO's from compliance with the mandatory minimum expenditure provisions. Perhaps the most important part of whole statute, however is this exception in 11.182 (h)(1)(B). This exception provides that the CHDO is exempted from the mandatory minimum expenditure provisions of 11.182(d) if the entity providing financing "restricts the amount of rent the organization may charge for dwelling units on the property." 28 As previously noted, all CHDO's must, by definition, be organizations exempt from taxation under I.R.C.'501(c)(3). As also noted, all 501(c)(3) organizations providing housing must

27 Texas Tax Code 11.182(h)(1)-(2)
28 Texas Tax Code 11.182(h)(1)(B)
* Payment In Lieu Of Taxes

comply with the safe harbor low-income or very low-income set asides to maintain their exempt status. A division exists within the tax counsel community as to whether the units merely need to be leased to persons with the appropriate percentage of AMI, or whether the rents on the units themselves must also be affordable. The prevailing position is that the rents themselves must be limited to between 30% and 35% of the income of the low-income and very low-income residents. This means that in most CHDO transactions, the rents on *some* dwelling units are, by the very terms of the transaction, restricted. The emphasis on the word *some* is not insignificant. After an initial palpitation or two, many in the affordable housing community began to dismiss the entire set of amendments to 11.182 because of this exception in 11.182(h)(1)(B). This kind of cursory review and consequent relief is probably not justified. The provision in question provides relief for CHDO's with restrictions on "the amount of rent the organization may charge for dwelling units on the property".29 A simple reading of the statute would lead this reader to the conclusion that rent on *all* units must be restricted to avail oneself of this exception. This issue can, however, be successfully addressed at various stages in the transaction. Insofar as in most case, no more than twenty five percent (25%) of units will be leased at "market" or otherwise unrestricted rates, the CHDO may then insert into the loan documents a restriction that it will lease all otherwise unrestricted units to no greater than ninety five (95%) percent of the market rental rate. Simple formulae for definition and determination of market rents are readily created. By utilizing this approach, all dwelling

29Texas Tax Code 11.182(h)(1)(B)

units would qualify as "rent restricted" within the meaning of the statute, and compliance with mandatory expenditures would no longer be an issue.

This rent restriction issue may also be the salvation of CHDO's detrimentally affected by the limited grandfather clause included in the amended statute. As previously noted, the grandfather clause exempts only those properties acquired by means of tax exempt bond financing during the period from January 1, 1997 through December 31, 2001. Some Texas CHDO's have closed transactions during that period utilizing financing forms other than tax exempt bonds, and hence, are placed in an unenviable position. For many of these projects, equity partners (typically commercial bank Community Development Corporations (CDC's) are paid out of cash flow after debt service of the senior purchase money loan. Consequently, just as the case of most tax exempt bond financed properties, the NOI is insufficient to pay the minimum mandatory expenditures for social, educational and economic development services, capital improvement projects and rent reduction. Although certain legislators agreed that this provision should be amended because of this specific problem, it was inexplicably left in the final version, which was stealthily ushered through the Senate during the final days of the session. While compliance strategies previously addressed may provide a solution for these unfortunate CHDO's, another post-closing strategy may work even better. By executing a loan addendum making it an event of default to exceed agreed upon rent levels (ala the suggested 95% of market rental rate for otherwise unrestricted units), a rent restriction is created which exempts the entire transaction from compliance.

One pragmatic concern in this area is what issuers will be willing to agree upon, in terms of documentation. After all, the issuer is technically the entity providing the financing, so the issuer is the one with whom an agreement regarding rent restrictions must be made. Some observers have opined that the exemption provision will simply be a negotiating tool used by issuers to obtain a PILOT agreement as a quid pro quo for agreement to preferred levels of rent restrictions. Although this view appears overly cynical, no issuers have publicly addressed this topic as of the date of this article.

In any event, this issue certainly saw new activity in the 78th Legislature in 2003; and only the activism of those in the affordable housing community who have a firm grasp of the subject aided those in power from doing more harm than good. The result was HB 3446, which ultimately was enacted as Texas Tax Code 11.1825. . I was deeply involved in and drafted the original legislation first introduced by Rep. Debbie Riddle, and later substituted by Rep. Peggy Hamric, which created Tax Code Section 11.1825. I have been asked by both the Texas House Local Ways and Means Committee and the Texas Senate Finance Committee to testify as to the meaning and implementation of these statutes, and I have served as an expert witness for Tarrant County with respect to the exemption and its use in development and acquisition of properties.

It is important to differentiate between the statutory requirements of the full exemption provisions of Tax Code Sec. 11.182, and the fifty percent (50%) exemption requirements of Tax Code Sec. 11.1825. Specifically, the board membership requirements are starkly different between the two statutes. In both cases, the majority of the board is not required to be of any particular income level or to live in any particular area or type of neighborhood, although each statute is often misread or misunderstood to have such a

requirement..

In the case of the full exemption statute, Tax Code Sec. 11.182(b) requires only that "An organization is entitled to an exemption from taxation of improved or unimproved real property it owns if the organization: (1) is organized as a community housing development organization". No mention of the board or the board's income is directly included in the statute. However, Tax Code Sec. 11.182(2) also provides that "'(c)ommunity housing development organization' has the meaning assigned by 42 U.S.C. Section 12704". Thus, we must look to the requirements of the only statutory reference to determine what specific income requirements, if any, are imposed upon a community housing organization which otherwise qualifies for the statute.

42 USC 12704 (6) provides as follows:

"(6) The term ``community housing development organization'' means a nonprofit organization as defined in paragraph (5), that--

(A) has among its purposes the provision of decent housing that is affordable to low-income and moderate-income persons;

(B) maintains, through significant representation on the organization's governing board and otherwise, accountability to low-income community residents and, to the extent practicable, low-income beneficiaries with regard to decisions on the design, siting, development, and management of affordable housing;

(C) has a demonstrated capacity for carrying out activities assisted under this Act; and

(D) has a history of serving the local community or communities within which housing to be assisted under this Act is to be located."

So, to be technically correct, the only requirement of any kind whatever regarding the makeup of the board of the community housing development organization is set forth at 42 USC 12704(6)(B), which provides as follows: maintains, ***through significant representation on the organization's governing board and otherwise, accountability to low-income community residents and, to the extent practicable, low-income beneficiaries with regard to decisions on the design, siting, development, and management of affordable housing*** (*Emphasis mine*).

So, the only requirement is that the board have "significant representation", which is an undefined term, and thus subject to interpretation, which is accountable to low-income community residents and beneficiaries of the group's projects. It is completely conceivable that a group and its board could be accountable to low-income community residents and beneficiaries without any particular low-income directors at all, if a sufficient formal policy was in place requiring input from the low income community.

The requirement of one-third of the board being low-income directors is a requirement of 24 CFR Part 92.2, and is used only for certification as a community housing development organization ("CHDO") for HOME Funds purposes, not for State tax exemption purposes. In fact, the only Court of Appeals which has ever addressed the issue has held that if an organization is "organized" as a CHDO, certification as a CHDO is absolutely not required in order to qualify for a Tax Code Sec. 11.182 exemption. *See Orange County Appraisal Dist. v. Agape Neighborhood Improvement, Inc.,* 57 S.W.3d 597, 602 (Tex.App.--Beaumont 2001, pet. denied). In short, there is no legal requirement

that any specific number of directors or members of the managing board of AOH be lowincome or reside in low-income neighborhoods. Despite that fact, more than one board member does qualify as either a low-income director or a director living in a low-income neighborhood.

When the Legislature created Tax Code Sec. 11.1825 to supersede Tax Code Sec. 11.182, it did create a specific board membership requirement, since the former statute had no such requirement. The intent of the legislature, as expressed during formal hearings regarding the pending legislation, was to make the new law stricter, and to impose requirements which did not previously exist.

Texas Tax Code Sec. 11.1825(b)(3) provides as follows: "(3) at least two of the positions on the board of directors of the organization must be reserved for and held by: (A) an individual of low income as defined by Section 2306.004, Government Code, whose principal place of residence is located in this state; B) an individual whose residence is located in an economically disadvantaged census tract as defined by Section 783.009(b), Government Code, in this state; or (C) a representative appointed by a neighborhood organization in this state that represents low-income households;

Section 2306.004 of the Texas Government Code provides:

"Individuals and families of low income" means individuals and families earning not more than 80 percent of the area median income or applicable federal poverty line, as determined under Section 2306.123 or Section 2306.1231.

(In other words, anyone who earns at or below 80% of AMI qualifies as low-income for purposes of the statute).

Section 783.009(b) of the Texas Government Code provides:

(b) In this section, "economically disadvantaged census tract" means a census tract delineated by the U.S. Bureau of the Census in the most recent decennial census in which the median family income is reported by the U.S. Bureau of the Census to be less than 80 percent of the area median family income.

Put simply, if the census tract is at or below 80% of AMI, it qualifies as low-income for purposes of the statute, the same standard as for individuals (which is also the same standard used by virtually every state and federal government entity in defining "low income"). It absolutely does not require that any board member live in a Qualified Census Tract. Under Section 42(d)(5)(C) of the Internal Revenue Code of 1986, as amended by the Community Renewal Tax Relief Act of 2000,a Qualified Census Tract is any census tract in which at least fifty percent (50%) of the households have an income less than sixty percent (60%) of the Area Median Gross Income (AMGI), or where the poverty rate is at least twenty five percent (25%) and where the census tract is designated as a Qualified Census Tract ("QCT"). The significant difference in the standard is obvious, and attempts to require that anyone, whether a resident or a board member, live in a QCT are not supported by any legitimate legal theory or by the statute itself. No Central Appraisal District is entitled to expand statutory definitions, as that is the sole province of the Legislature.

Additionally, Tax Code Sec. 11.182 provides that one way of qualifying as a director is if the director has his residence "located in an economically disadvantaged census tract". There is no requirement that the director own the property which is his residence, or that the residence be designated as that person's homestead. In fact, there is no legal

requirement at all that any person file for a homestead exemption for his principal place of residence; that is merely an exemption available under state law, and which many people fail to utilize. For purposes of the statute, a simple certification by the director that a particular address is their residence is sufficient, but not legally necessary, as the representation that an address is a director's residence constitutes a part of the application, which is signed and submitted under penalty of perjury.

MEMORANDUM

TO: **VIRGINIA HOUSING COMMISSION**
LANDLORD/TENANT, REAL ESTATE LAW AND AFFORDABLE HOUSING SOLUTIONS WORKGROUP
FROM: **MICHAEL W. EATON, PH.D.**

RE: Statutory Requirements for Affordable Housing Property Tax Exemptions

The original Texas statute that created an affordable housing tax exemption was Tax Code Sec. 11.182. This statute created a 100% property tax exemption for, "improved or unimproved real property it owns if the organization: (1) is organized as a community housing development organization".

I have often been asked to respond to inquiries regarding the income standards for non-profit board members and the neighborhoods in which they reside in the relevant statutes, as well as other issues related to the exemption, including underlying rationales for such statutes. Wed strongly believe that enactment of such a statute would enhance and increase the amount of affordable housing developed and made available in the Commonwealth of Virginia. . I was deeply involved in, and actually drafted the original Texas legislation first introduced by Rep. Debbie Riddle, and later substituted by Rep. Peggy Hamric, which created Tax Code Section 11.1825. I have been asked by both the Texas House Local Ways and Means Committee and the Texas Senate Finance Committee to testify as to the meaning and implementation of these statutes, and I have served as an expert witness for multiple Texas counties with respect to the exemption and its use in development and acquisition of properties.

I believe it is essential that the Commission examine both the original 100%exemption, and the successor statute, Sec. 11.1825. It is important to differentiate between the statutory requirements of the previous full exemption provisions of Tax Code Sec. 11.182, and the fifty percent (50%) exemption requirements of Tax Code Sec. 11.1825. Specifically, the board membership requirements are different in the two statutes. In both cases, the majority of the board is not required to be of any particular income level or to live in any particular area or type of neighborhood, although each statute is often misread or misunderstood to have such a requirement..

In the case of the full exemption statute, Tax Code Sec. 11.182(b) requires that "An organization is entitled to an exemption from taxation of improved or unimproved real property it owns if the organization: (1) is organized as a community housing development organization". No mention of the board or the board's income is directly included in the statute. However, Tax Code Sec. 11.182(2) also provides that "'(c)ommunity housing development organization' has the meaning assigned by 42 U.S.C. Section 12704". Thus, we must look to the requirements of the only statutory reference to determine what specific income requirements, if any, are imposed upon a community housing organization which otherwise qualifies for the statute.

42 USC 12704 (6) provides as follows:

(6) The term ``community housing development organization'' means a nonprofit organization as defined in paragraph (5), that--

(A) has among its purposes the provision of decent housing that is affordable to low-income and moderate-income persons;

(B) maintains, through significant representation on the organization's governing board and otherwise, accountability to low-income community residents and, to the extent practicable, low-income beneficiaries with regard to decisions on the design, siting, development, and management of affordable housing;

(C) has a demonstrated capacity for carrying out activities assisted under this Act; and

(D) has a history of serving the local community or communities within which housing to be assisted under this Act is to be located.

So, to be technically correct, the requirement regarding the makeup of the board of the community housing development organization is set forth at 42 USC 12704(6)(B), which provides as follows: maintains, ***through significant representation on the organization's governing board and otherwise, accountability to low-income community residents and, to the extent practicable, low-income beneficiaries with regard to decisions on the design, siting, development, and management of affordable housing*** (*Emphasis mine*).

So, the requirement is that the board have "*significant representation*", which is an undefined term, and thus subject to interpretation, which is accountable to low-income community residents and beneficiaries of the group's projects. It is completely conceivable that a group and its board could be accountable to low-income community residents and beneficiaries without any particular low-income directors at all, if a sufficient formal policy was in place requiring input from the low income community.

The requirement of one-third of the board being low-income directors is a requirement of 24 CFR Part 92.2, and is used for certification as a community housing development organization ("CHDO") for HOME Funds purposes. The only Court (Texas Court of Appeals) which has ever addressed the issue has held that if an organization is "organized" as a CHDO, certification as a CHDO is not an additional requirement in order to qualify for a Tax Code Sec. 11.182 exemption. *See Orange County Appraisal Dist. v. Agape Neighborhood Improvement, Inc.,* 57 S.W.3d 597, 602 (Tex.App.--Beaumont 2001, pet. denied). In short, in the original 100% exemption statute, there was no legal requirement that any specific number of directors or members of the managing board be low-income or reside in low-income neighborhoods. Despite that fact, more than one board member usually qualifies as either a low-income director or a director living in a low-income neighborhood – this apparent issue could be easily remedied through statutory language.

When the Legislature created Tax Code Sec. 11.1825 to supersede Tax Code Sec. 11.182, it did create a specific board membership requirement, since the former statute had no such requirement. The intent of the legislature, as expressed during formal hearings regarding the pending legislation, was to make the new law stricter, and to impose requirements which did not previously exist.

Texas Tax Code Sec. 11.1825(b)(3) provides as follows: (3) at least two of the positions on the board of directors of the organization must be reserved for and held by:

(A) an individual of low income as defined by Section 2306.004, Government Code, whose principal place of residence is located in this state; B) an individual whose residence is located in an economically disadvantaged census tract as defined by Section 783.009(b), Government Code, in this state; or (C) a representative appointed by a neighborhood organization in this state that represents low-income households;

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> *"Individuals and families of low income" means individuals and families earning not more than 80 percent of the area median income or applicable federal poverty line, as determined under Section 2306.123 or Section 2306.1231.*

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Put simply, if a census tract is at or below 80% of AMI, it qualifies as low-income for purposes of the statute, the same standard as for individuals (which is also the same standard used by virtually every state and federal government entity in defining "low income"). It absolutely does not require that any board member live in a Qualified Census Tract. Under Section 42(d)(5)(C) of the Internal Revenue Code of 1986, as amended by the Community Renewal Tax Relief Act of 2000,a Qualified Census Tract is any census tract in which at least fifty percent (50%) of the households have an income less than sixty percent (60%) of the Area Median Gross Income (AMGI), or where the poverty rate is at least twenty five percent (25%) and where the census tract is designated as a Qualified Census Tract ("QCT"). The significant difference in the standard is obvious, and attempts

to require that anyone, whether a resident or a board member, live in a QCT are not supported by any legitimate legal theory or by the statute itself. No Central Appraisal District is entitled to expand statutory definitions, as that is the sole province of the Legislature.

Additionally, Tax Code Sec. 11.1825 provides that one way of qualifying as a director is if the director has his residence "located in an economically disadvantaged census tract". There is no requirement that the director own the property which is his residence, or that the residence be designated as that person's homestead. In fact, there is no legal requirement at all that any person file for a homestead exemption for his principal place of residence; that is merely an exemption available under state law, and which many people fail to utilize. For purposes of the statute, a simple certification by the director that a particular address is their residence is sufficient, but not legally necessary, as the representation that an address is a director's residence constitutes a part of the application, which is signed and submitted under penalty of perjury.

Should you have any additional questions, please do not hesitate to contact me at your earliest convenience.

Michael W. Eaton, Ph.D.
(Pronouns: he, him, his)
Director of Real Estate Development

PIEDMONT HOUSING ALLIANCE

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