

TOPICS

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NON-PROFIT <-> FOR-PROFIT COLLABORATION

As highlighted in prior issues of TOPICS, the share of new senior living properties being developed by for-profit sponsors has increased substantially. Many non-profits combine deep management capabilities, strong local reputations and land in highly attractive locations. Instead of competing, why not collaborate?

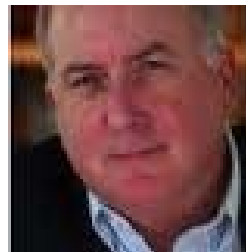
At the recent LeadingAge Washington annual meeting, Paul Gordon (Hanson Bridgett), Jay Woolford (Senior Housing Resource Group) and I hosted a discussion panel on this topic. This article is a very brief overview of our presentation ... and our presentation only “scratched the surface” of this subject.



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The Proposed For-Profit/Non-Profit Framework

Assuming a non-profit desires to keep their special tax benefits, interactions between for-profits¹ and non-profits can involve significant complexity. Non-profits have the *potential* to enjoy special tax treatment related to (i) income taxes, (ii) deductibility of donations, (iii) access to tax-exempt financing, and (iv) reduction or waiver of property

investment" payable to a resident must be capped by an inflation index or similar limitation.

Services: In the absence of tax-exempt bond financing,³ there is generally significant flexibility for non-profits to procure services from other firms. However, in the case of non-profits providing services to for-profits (or even other non-profits), it is likely that income from these services will be taxable.

... management by an exempt organization of an unrelated exempt organization's senior living property is not considered an exempt activity ...

Gordon

GORDON: Unrelated Business Income Tax ("UBIT") is triggered whenever a tax-exempt organization receives income from a trade or business that is unrelated to its charitable purposes. For example, management by an exempt organization of an unrelated exempt organization's senior living property is not considered an exempt activity of the manager, because it is the same business engaged in by many for-profit organizations. An exempt organization may engage in an "insubstantial" amount of unrelated business activity [about 10% of its expenditures or time] and simply pay the UBIT without jeopardizing the organization's tax exemption. However, if the activity is more than insubstantial, it should be conducted outside of the exempt organization, usually in a taxable subsidiary.

Financing: Many non-profit providers of senior housing and healthcare receive substantial capital from profit motivated investors or entities via tax-exempt bond proceeds⁴. Senior living non-profit 501c3's are afforded these borrowing privileges "as-of-right" and are not subject to private activity bond volume caps. For-profits can also borrow on a tax-exempt basis, but generally they need to comply with affordable income limitations.

Traditional tax-exempt investors are generally comfortable with start-up entry fee communities ... but are generally not as comfortable with the risk associated with start-up rental communities. Conversely, many for-profit investors are very comfortable with start-up rental communities ...

Another attribute of tax-exempt financing besides favorable capital cost is a difference in investor pools. Traditional tax-exempt investors are generally comfortable with start-up entry fee communities (subject to successful presale traction) but are generally not as comfortable with the risk associated with start-up rental communities. Conversely, many for-profit investors are very comfortable with start-up rental communities and not as comfortable with the risk of start-up entry communities.

With the elimination of new money under the HUD Section 202 program, the extra value available to non-profits under the major federal insurance programs is minor. In

fact, in the case of FHA insured loans, a non-profit may be better off electing to borrow on the same terms as for-profits, foregoing the slightly higher leverage in exchange for greater flexibility in the future use of funds.

An emerging capital source that falls in this category is the immigrant investor program, commonly referred to as EB-5. For qualifying development projects, EB-5 sourced funds can be loaned to non-profits as a low interest rate, taxable, unsecured bullet loan⁵. Accordingly, from the perspective of this proposed framework, EB-5 should be considered a type of financing (rather than a joint venture). Since investors are primarily motivated to gain U.S. citizenship, for appropriate projects, EB-5 can be a very attractively priced source of capital.



WOOLFORD: SHAG is currently evaluating the use of EB-5 funds as a source of capital for our new senior affordable housing developments. While we are relatively early in the exploration of this funding source, this source of low cost funding does appear promising for our specific project attributes and organizational objectives.

Investment: As stated earlier, transactions intended for one purpose, say as an investment, have the risk of being characterized as something else, such as a joint venture.

GORDON: An exempt organization may invest in stocks, real estate, and other assets without being taxed on income generated from the investment. An exempt organization's investment is considered passive if the organization is not providing services or otherwise engaging in the trade or business of its investment. For example, an exempt organization can lease its real estate to a company that is engaged in a taxable business, whether it is providing housing or selling tires, and the rental income will not be considered unrelated to the exempt organizations purposes or subject to UBIT. However, if the exempt organization leases its property to a for-profit housing provider and furnishes hospitality or social services, any income from the transaction is subject to UBIT. One exception to the passive investment rule is if rental income is generated by debt-financed real property, in which case it will be subject to UBIT.

... an exempt organization can lease its real estate to a company that is engaged in a taxable business ... and the rental income will not be considered unrelated to the exempt organizations purposes or subject to UBIT.

Gordon

Transaction: Admittedly a sale (or lease) transaction does not generally come to mind as a form of collaboration, and generally the parties have adverse interests (and should be appropriately represented by knowledgeable professionals), but a transaction might indeed be the best way for a non-profit to best leverage the

resources of for-profits. Given the extraordinarily high prices that for-profits are currently paying for senior living and healthcare assets, arguably this could be an opportune time for non-profits to dispose of some of their assets and focus on what they do best ... and/or where they can have the greatest social impact. In the more restrictive world of HUD/FHA, sales by non-profits to for-profits may be subject to limitations, but fortunately HUD has recently clarified the rights of non-profits to sell HUD 202 financed properties and retain the proceeds to meet other mission objectives.⁶

Joint Venture: By now, the reader may be thinking this is the least preferable category ... it certainly is the most restrictive. However, joint ventures provide an opportunity to creatively meet the objectives of both non-profits and for-profits. The roots of non-profit/for-profit joint ventures date back to the early 1980's. Responding to major shifts in payment policies (sound familiar?), non-profit hospitals began to form joint ventures with for-profit hospitals in the 1980's. Also in that decade, the Tax Reform Act of 1986 launched a highly successful public-private affordable housing vehicle, more commonly referred to as the low income housing tax credit (LIHTC) program.



The LIHTC program and several other programs that involve tax credits discussed below by necessity employ a joint venture structure. As a tax-exempt entity, the joint venture becomes the vehicle for a non-profit to convert a tax credit to be granted over several years into an immediate source of project capital. However, the parties to the joint venture are both technically and practically “partners”.

Practical considerations have to do with making sure that the partnerships align with your mission and that there is a clear understanding of the roles and the responsibilities of the parties.

Woolford

WOOLFORD: SHAG has a long history of working with for-profit partners. In fact, the LIHTC program in many ways was set up to take advantage of that. Practical considerations have to do with making sure that the partnerships align with your mission and that there is a clear understanding of the roles and the responsibilities of the parties. This requires ongoing attention and solid support from your Board.

Other alternative sources of capital that require a joint venture structure are new market tax credits, historic tax credits, some types of energy tax credits and social impact bonds.⁷ This paper won't go into the details of these programs beyond making the following observations: (i) as joint ventures, general non-profit / for-profit joint venture limitations will likely apply, and (ii) each has the potential to provide new capital for social projects on attractive terms.



GORDON: The primary concerns of the IRS, when examining for-profit / non-profit relationships, are to preserve the ability of the exempt organization to pursue its charitable purposes and protect against the for-profit entity deriving "private inurement" from the tax exempt status of the non-profit. Therefore, all financial dealings must be fair and reasonable, and the exempt organization must have sufficient control over the venture's activities to fulfill its charitable purposes without interference from the for-profit entity. This can be achieved by giving the exempt organization majority control over the entire venture, or by reserving to the exempt organization complete control over those aspects of the venture that further charitable purposes. Very specific rules govern certain transactions, such as for-profit management contracts in connection with tax-exempt financed retirement communities, all designed to limit the ability of the for-profit organization to share in net revenues from the enterprise, or to maintain long-term management rights that are considered to unduly restrict the exempt organization's control over the charitable activity.

In closing, knowing how to categorize all the elements of any plan to capitalize new projects helps clarify which constraints may apply and which questions warrant the most attention. In the case of non-profits with control of attractively situated real

... non-profits with control of attractively situated real estate ... [have] opportunities to leverage profit-motivated capital and attractive terms and to transfer a substantial portion of start-up and development risk ...

estate, there are opportunities to leverage profit-motivated capital and attractive terms and to transfer a substantial portion of start-up and development risk to for-profits with deep understanding and capabilities to underwrite and mitigate such risk. These capital strategies can be particularly compelling for non-profits interested in venturing beyond the current traditional entry-fee continuing care retirement community model.

If you are interested in learning more about current and emerging collaboration opportunities, please contact me at frank@rockwoodpacific.com

- Frank Rockwood

ABOUT THE CONTRIBUTORS

Paul Gordon. Paul is a Partner at Hanson Bridgett in San Francisco and has been working with senior housing and care providers since 1975. He is the author of the book *Seniors' Housing and Care Facilities: Development, Business and Operations* (Urban Land Institute, 1998) and is considered the "godfather of senior housing" by many in the aging services field. Paul can be reached at pgordon@hansonbridgett.com.

Jay Woolford. Jay is the Executive Director of Senior Housing Resource Group ("SHAG"), the largest non-profit provider of affordable rental apartment communities for low- and moderate-income seniors in the Puget Sound region. SHAG is at the forefront of providing enhanced services to seniors residing in income restricted senior apartments. Prior to SHAG, Jay provided development advisory services for the development of CCRCs and, as a senior development executive at Sunrise Senior Living, oversaw their innovative condo-for-life initiative. Jay can be reach at: jayw@housing4seniors.com

ABOUT ROCKWOOD PACIFIC

Rockwood Pacific is a professional real estate services firm serving mission-based organizations committed to advancing wellness and longevity for older adults through better housing and better healthcare. We provide decision support, development services, financial advisory, and real estate transaction services to our clients.

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ENDNOTES

¹ Reference to for-profits includes all profit motivated “persons” ... including individuals as well as legal entities (i.e. partnerships, limited liability companies, C-corporations, ...).

² New forms of organizations, such as public benefit corporations, as well as certifications available to for-profits, such as the B-Corp designation, provide for-profits an opportunity to enjoy “goodwill” benefits that were previously limited to non-profits.

³ IRS Revenue Ruling 97-13 outlines limitations on agreements related to providing services to borrowers that are utilizing proceeds from tax-exempt financing transactions.

⁴ In a limited number of some cases, it is more advantageous for non-profits to borrow on a taxable basis such as when utilizing FHA insured financing or when total transaction size is too small to warrant the transaction cost associated with creating and maintaining a tax-exempt bond.

⁵ The EB-5 program requires a for-profit to serve in the role of the new commercial enterprise (NCE), however this for-profit NCE can provide a loan to a development project controlled by a non-profit sponsor.

⁶ In addition, to clarify “cash-out” financing opportunities with HUD 202 properties, HUD’s recent policy guidance has effectively (although not explicitly) clarified that non-profit sellers of direct loan HUD 202 properties have flexibility in how to best deploy their sales proceeds.

⁷ Social Impact Bonds (SIB) are not really bonds at all but rather a joint venture generally involving a non-profit sponsor, a government entity providing contingent payments, and a for-profit source of at-risk investment capital.

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