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# Follow-Up to "Annual Legal Update" at THE Foundations Seminar

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## I. The Empty House

Your alma mater, the local branch of the State University system, just derecognized the Beta chapter of your fraternity. You are the president of the local house corporation. Your house corporation now has an asset, the fraternity house, as well as a liability in the form of a mortgage debt. Even worse, some of the local alumni guaranteed the debt. What can you do?

The obvious answer is to rent the house to another fraternity or sorority. After all, this would allow the house corporation to further its goal of providing quality housing to undergraduate members of Greek organizations while retaining the house for a possible recolonization. Moreover, the rental stream would service the debt. However, this action may very well result in the loss of the house corporation's tax-exempt status. There are several rules applicable to IRC § 501(c)(7) house corporations that may lead to this result.

The first rule states that a social club may not generate more than 5% of its gross receipts from a "non-traditional, recurring business activity". If a social club exceeds the 5% limitation, it could lose its exemption. Whether an activity is non-traditional and recurring is a question of fact, and while there is no specific legal authority on the issue, there is a good chance that renting space to non-members would be considered a "non-traditional activity" of a house corporation. If so, then the leasing of a whole house to another fraternity would result in 100% of the house corporation's gross receipts being derived from a "non-traditional activity". This, of course, would jeopardize the tax exempt status of the house corporation.

As whether the rental activity is a "non-traditional recurring business" is fact sensitive, it is possible that a judge may rule in favor of the house corporation on this issue. However, the exempt status of a house corporation entering into such a rental arrangement may be jeopardized by other tax rules.

One such rule states that a house corporation may generate up to 35% of its gross receipts from investment income and other non-member income. Of that 35%, no more than 15% may be derived from "non-member use of facilities and/or services", i.e., the house. Where a local house corporation is generating 100% of its income from rental of its house to non-members, it very likely violates both the 35% and 15% tests and could, depending upon the circumstances, lose its exemption.

The same result does not necessarily follow for a national house corporation. If a national house corporation were to lease a vacant house to non-members, it may well fall within the 15% safe harbor. However, even the national house corporation may be taking a risk if its non-member income exceeds 5% of its gross receipts because, as discussed above, leasing a house to non-members may not be a "traditional activity".

A solution to the "empty house" problem may be to transfer the house to a for-profit entity. The for profit entity could lease the house to any person or entity it chooses. This may well be the best solution for local house corporations.

Every "empty house" situation is unique requiring a thorough examination of the facts and circumstances of the particular case. There is no one size fits all solution. What we can say with certainty, however, is that the easy solution of simply re-leasing the empty house to another organization may well jeopardize the house corporation's exempt status. Please contact any of our team members for further information.

## II. Foundation Grants Funding Feasibility Studies for Housing Projects

Very often a house corporation will undertake a fundraising feasibility study to verify the viability of a particular house project. Can an educational foundation fund the cost of such a study? As with all matters legal, maybe.

There is no explicit authority allowing a foundation to front the cost of a feasibility study. The safest course is for the house corporation to pay for any feasibility studies up front. Then, if the house corporation decides to proceed with a housing project, the feasibility study expenses can be included in the soft costs for the housing project. At that point, the foundation, pursuant to a grant agreement, can make a grant to the house corporation covering the educational percentage of the total housing project costs, including the feasibility study expenses.

## III. New User Fees

The IRS recently announced that user fees will increase for all applications for exemption (Forms 1023, 1024, and 1028) postmarked January 3, 2010 and later to:

- $400 for organizations whose gross receipts are $10,000 or less annually over a 4-year period;
- $850 for organizations whose gross receipts exceed $10,000 annually over a 4-year period; and
- $3,000 for group exemption letters.

A complete schedule of all user fees will be published in the annual procedure released in January 2010.