

# Joint Ventures with For Profit Developers

## A Guide for Community Development Corporations



Whole Foods Market, East Liberty, Pittsburgh, PA



## Acknowledgements:

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This Guide is based largely on a legal memo prepared in 2005 by Gregory Maher, then LISC's Deputy General Counsel, now LISC's Senior Vice President for Lending. Appendix A, FAQ -- Joint Ventures and Nonprofit Tax Exemption, is directly from his memo.

***Please note:*** This Guide is structured to assist CDCs in becoming educated consumers as they think about, plan and become partners in joint ventures with for-profit developers. While every effort has been made to provide accurate and generally applicable information, every project and every locale is different. In all cases you should consult with your own local professionals about the best way to proceed on your particular project and joint venture.

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Appendix C, Quick & Dirty Joint Venture Strategy Checklist, was prepared by Judy Turnock, ODI/LISC.

**This Guide was compiled by Rick Jacobus & Maegan Winning, Burlington Associates in Community Development, and edited by Judy Turnock, ODI/LISC.**

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# Joint Ventures with For-Profit Developers: A Guide for Community Development Corporations

## Table of Contents

<b>SECTION I: CDC Joint Ventures with For-Profit Developers.....</b>	<b>4</b>
<i>What Are Joint Ventures, and Why Should We Create Them?</i> ...	4
<i>Defining Roles and Responsibilities</i> .....	6
<i>Negotiation Pressure Points</i> .....	8
<i>Organizational and Management Options</i> .....	11
<b>SECTION II: Project Profiles .....</b>	<b>14</b>
<i>Lake Park Pointe Shopping Center, Chicago, IL</i> .....	14
<i>Markham Plaza, San Jose, CA</i> .....	16
<i>Vineyard Square, Chapel Hill, NC</i> .....	18
<i>Marin City Gateway Retail Center, Marin City, CA</i> .....	20
<i>Whole Foods, Pittsburgh, PA</i> .....	23
<b>SECTION III: Lessons and Recommendations .....</b>	<b>14</b>
<b>APPENDIX A: FAQ – Joint Ventures and Not-for Profit Tax Exemption ..</b>	<b>29</b>
<b>APPENDIX B: Joint Venture Agreement Planning Tool .....</b>	<b>34</b>
<b>APPENDIX C: Quick &amp; Dirty Joint Venture Strategy Checklist .....</b>	<b>37</b>

## SECTION I: CDC Joint Ventures with For-Profit Developers

### *What Are Joint Ventures and Why Should We Create Them?*

Joint ventures between a community development corporation (“CDC”) and a for-profit partner present tremendous opportunities for a CDC to build its skills and complete projects that are larger in scale and/or beyond its core competencies. However, there are a host of business issues raised by the prospect of a CDC co-owning or working closely with a for-profit on a project. Many issues need to be carefully negotiated for the CDC to protect its financial integrity and credibility.

Joint ventures also raise a number of legal issues, often bringing together corporate, partnership, tax, real estate and exempt organization law into a single realm. Therefore, careful thought must be brought to evaluating a CDC’s potential venture with a for-profit entity.

There is some misconception about what the phrase “joint venture” means. More a term of art than a phrase with precise legal meaning, it is an association of two or more people (either individuals, corporations or other entities) engaged in a business venture, traditionally for-profit. Today a joint venture typically implies a limited liability company (an “LLC”) and less frequently a limited partnership (an “LP”), usually entered into for a single project and for a finite period of time.

The most compelling reason for CDCs and for-profit organizations to enter into joint ventures is that each party brings something to the relationship that:

- the other party needs,
- can’t easily do or get without the other party, and
- which will make the resulting entity stronger than either party acting alone.

If one or the other partner feels it can pull off the project alone, or if there is no goodwill or future favor to gain between the partners, there will be little impetus for the joint venture.

#### *Among the many reasons CDCs consider joint ventures are:*

**Inadequate experience.** A CDC may not yet have done any physical development or attempted a large-scale project of a particular kind, whether housing or commercial, or it may want to branch out, for example, from housing development into commercial or retail space development. The CDC can access the technical expertise and experience of a for-profit business in a joint venture arrangement.

**Lack of staff.** The CDC may have a small staff or no staff at all, or its staff may be part-time or not have the available time required to carry out the development.

**Opportunity to achieve higher production scale.** Without the for-profit, the nonprofit might not be able to do a particular project or might have to do a smaller project which has less impact.

**Core skill building opportunity.** If structured correctly, a joint venture can present a capacity building opportunity for the CDC, with the for-profit in a mentoring role.

**Lack of financial strength.** A CDC may have a long track record, solid staff with lots of experience and capacity, but still be financially weak, for example, with a weak balance sheet and little or no fund balance.

**Access to development financing through for-profit partner.** A for-profit partner may have access to conventional financing sources that a CDC does not. The developer may be in a strong financial condition or, because of its track record and character, have access to a significant amount of capital the CDC could not attract on its own.

*For-profit developers also have many reasons for partnering with CDCs, including:*

**Access to the community.** The project may be in a community where a for-profit developer has not done business before. CDCs based in a particular community are typically more in touch with the community and can better identify the needs.

**Site Control.** CDCs may have site control of a key property which is critical to a project's viability or better access to a property through a Redevelopment Agency or City.

**Support among community residents.** CDCs may be able to garner support among neighborhood residents for a difficult project, get local elected officials on board in favor of the development, and help counter any nimbyism that could derail the project.

**Access to public funding sources.** CDCs can access many potential sources of project subsidy which either provide a priority for or are limited exclusively to nonprofits. Federal grant programs such as HOME and Community Development Block Grants (CDBG) programs, administered by HUD through local jurisdictions, the US Department of Health and Human Services' Office of Community Services (OCS) programs, administered through HHS, or AHP, administered through the Federal Home Loan Bank, make funds available to nonprofits that might not be available to for-profit developers.

**Access to attractive debt sources.** CDCs may have access to low interest financing (LISC, for example) that is unavailable to for-profits. Not only is this a financial benefit, but it often pays the early costs of the project at its riskiest stage, something many banks – and for-profit developers – are unwilling to cover.

**Access to tax credit allocations.** CDCs may have site or project control over a high scoring LIHTC project. Without access to the credits, the for-profit would have difficulty getting the deal.

**Pool of interested job applicants.** For an economic development joint venture, a CDC can be a pipeline for interested local residents to apply for the jobs to be created. That referral list may not only speed filling the jobs, it can also provide the for-profit partner with some helpful initial screening of job applicants.

## *Defining Roles and Responsibilities*

A key factor in successful joint ventures is the clear delineation of roles and responsibilities. In order to define those roles and responsibilities, each party must be aware of what it adds to the deal and what it is responsible for accomplishing. While every organization and partnership is unique, there are certain assets partners generally bring to the venture.

### *For the CDC, the typical assets include:*

**The deal.** Often the CDC will bring a deal concept to the table along with predevelopment work that has been done, including title to the project property or at least site control. The more the CDC has developed the project concept and the more up-front work the CDC has done, the more attractive the deal is for a potential partner, and the more leverage the CDC will have over a prospective joint venture partner during negotiations.

**Knowledge of the neighborhood and neighborhood support.** A CDC should know its target area(s) well and understand what the pressure points are and what the community needs, wants and will support. The CDC can shape a deal so it's consistent with a neighborhood revitalization plan, thereby ensuring the project's support and success and providing the joint venture partner with a marketing and acceptance comfort level not obtainable from a non-community-based business. The CDC also brings support from its client base and, hopefully, the larger community.

**Knowledge of the market.** Related to the above point is the CDC's knowledge of the market. Though the CDC may not have a definitive handle on all aspects of its market, it typically is in a much better position than a for-profit (particularly one not based in the neighborhood) to understand what the market is for housing, commercial space for growing businesses, retail services, community facilities such as child care and health centers, and charter schools.

**Political support.** The CDC's contacts with local political and administrative officials can be a huge factor in making the project successful. Beyond the obvious overt support for the project, it can translate into public subsidies and other support such as zoning, building and environmental reviews in a more expedited manner (or in some cases a zoning change to move the project forward).

**Attractive Public and Private Funding Sources.** If the CDC comes to the table with just preliminary commitments from public and private funding sources, the arrangement is more attractive to the for-profit – and it gives the CDC added bargaining clout.

### *The for-profit organization typically brings the following skills and experience to the table:*

**Technical Expertise and Experience.** The for-profit will bring its real estate development skills and experience to the table, just what an inexperienced CDC needs to complete a project successfully. Additionally, the for-profit's experience and track record is critical in attracting support and funding for the project.

**Staff Size.** The for-profit will usually bring a complement of dedicated full-time staff to the project.

**Financial Strength.** The for-profit has access to funds that many smaller CDCs do not. They typically have established relationships with financial institutions based on their prior experience, and many times they have company funds that can be used to finance the project. For example, in Indianapolis where an LLC joint venture contracted with for-profit builders to build new homes on lots owned by the LLC, the builders funded the costs of construction through their own financing sources.

**Access to Conventional Funding.** Separate from the issue of financial strength, the for-profit may have a relationship with banks or mortgage companies based on the for-profit's "character," i.e., its track record in completing deals skillfully, efficiently, on time, and within budget. These long-standing relationships providing access to financing may or may not correlate to the actual financial strength of the for-profit.

The specific roles and responsibilities of each partner to the joint venture generally flow from the assets, skills and expertise each brings to the table. While roles vary from partnership to partnership, there are typical roles that each partners generally plays.

***The typical CDC roles and responsibilities often include:***

- project conception and initial development, including obtaining site control and initial project design;
- identifying community needs;
- community organizing in support of the project (e.g., rallying residents in favor of a large retail or mixed-used project new to the neighborhood);
- financial application and packaging of public subsidy support; and
- marketing the units to be developed.

***The typical for-profit roles and responsibilities include:***

- project budget development;
- hiring contractor and construction manager;
- applications and financial packaging for conventional financing sources;
- general overall project development.

It is important to remember that roles and responsibilities are negotiated by the partners based on each partner's strengths. So if a CDC does not, for example, have the capacity to obtain site control and this role is taken on by the for-profit, the CDC may have to lower or change the expectations of what it can gain from the joint venture.

## *Negotiation Pressure Points*

When forming a joint venture, upfront negotiation between the partners to determine roles and responsibilities as well as risks and rewards is critical to the overall success of the project and the satisfaction of each partner about the experience. Each partner must be as realistic and specific as possible about its own positions as well as its understanding about the partner's positions. Some of the most important "hot button" issues are:

**Primary Goal of the CDC.** Is the CDC looking primarily to create a valuable community asset that will benefit low-income residents, stabilize the community and begin to revitalize the neighborhood? Is the CDC looking secondarily to share in the possible upside of an economic development project (but not if it impedes the primary goal)? Or is the primary goal of the CDC to make money from the project? Both of these cannot be the number one goal. A CDC needs to assess its goals honestly in order to represent them effectively in the negotiations. The final agreement needs to reflect those honest assessments.

**Relationship between the CDC and the For-profit.** Beyond the experience and technical knowledge of the parties, this "soft" issue is most important to the success of the venture. Do the parties trust each other? Can they communicate effectively? Can they transcend their differing organizational missions and join forces to complete a charitable project that both (1) generates profit for the investor and (2) compensates the CDC fairly, while furthering its charitable mission?

**Clear Delineation of Responsibility for Fundamental Decisions.** These responsibilities may be included in either an operating or partnership agreement but could also be done in a separate development agreement entered into between the partnership and each individual partner. For example, if the CDC and the for-profit are members of a member-managed LLC or co-general partners of an LP (see pages below), the for-profit may have the right to choose the contractor and the architect, but the CDC may retain the right to consent to the contracts hiring these parties, as well as to change order items above a certain dollar amount. On the other hand, the CDC may assume primary responsibility for marketing the units, either itself or by hiring a broker.

There is plenty of flexibility in structuring the partners' roles and responsibilities, but ultimately they should be in accord with each partner's strengths, reasonably commensurate with the fees or profits each will earn, and written clearly in a document signed by both partners.

**Profit Sharing/Developer Fees.** The key issues are how much goes to each partner and when. The CDC must be sure it's getting a fair deal. Even if the for-profit is carrying the bulk of the project/development work, the CDC should recognize it brings significant value. For example, the CDC has usually done the risky pre-development work, obtained site control of the property needed for the development, brought subsidies and/or subsidized financing to the table, or garnered community support for the project. Without these contributions there might be no deal, so don't underestimate your contributions.

*Key advisory: Pay attention to the schedule for paying developer fees to the for-profit. They should not be paid before they are earned!* If there are cost overruns beyond the contingency during the construction period, there should be enough unpaid fees held back to cover them without forcing the project to fall short. This hold back should be over and above the standard retainage that is required for construction disbursements. And the payment of fees should not take priority over achieving the charitable nature of the project.

**Maintaining CDC Involvement.** How does the CDC stay involved in the deal if it is not the managing member of the LLC? One strategy is to structure rights of intervention, such as the right to remove the managing member if it is violating the terms of the operating or partnership agreement. Another strategy is to ensure that the for-profit has to consult with the CDC about certain decisions and does not have unfettered discretion. If you keep in mind the value you bring to the joint venture, you should be able to negotiate the continuing role you deserve.

**Conflicts Resolution Mechanism.** There should be some form of arbitration or mediation built into the operational document in order to provide both parties with a mechanism for logically, fairly and expeditiously resolving disagreements that they cannot solve on their own.

**Achieving Charitable and Social Welfare Goals.** CDCs should seriously consider creating a mechanism for enforcement of the joint venture's charitable and social welfare goals in the partnership or operating agreement. These goals in an economic development project may include filling retail space with a certain number of minority-owned businesses or hiring unemployed or underemployed neighborhood residents for a percentage of jobs created. Good faith efforts by the joint venture to lease to or hire neighborhood residents should be required; they are an excellent first source for new jobs. These good faith efforts can be formalized in a first source hiring clause in the partnership or operating agreement or a separate agreement. However, the greater the number of tenants, the more difficult the hiring of local residents may be to enforce. Small businesses in particular may resist landlord interference with their hiring, a fundamental business decision. Creating incentive-based distributions to LLC members that are dependent on achieving and documenting some charitable results and/or making good faith efforts to achieve them is one strategy, and another is providing for mediation and/or arbitration if the partners can't agree on whether or not the efforts made were "good faith" efforts.

**Avoiding Excessive Private Benefit.** A CDC should generally resist issuing a reserve against or guarantee of (1) operating losses or profits for the joint venture, (2) a return of capital or fees payable to the for-profit by the joint venture, or (3) indemnification for any losses incurred by the for-profit due to its participation in the joint venture (unless caused by the malfeasance of the CDC).

**Handling Losses and Additional Capital Contributions.** Losses and additional capital contributions usually follow the partners' ownership interests and right to share profits and should not be slanted against the CDC. If the CDC has the right to share in 30% of the profits, it should be responsible for only 30% of the losses, not a higher amount. Additionally, if additional capital must be contributed to make up those losses, it should only be an amount commensurate with the CDC's ownership percentage. The CDC should also

consider placing dollar limits on any responsibility it has for additional capital contributions and/or losses.

**How the Financing Comes into the Deal.** Financing for the project may be committed to the joint venture or LLC itself, or to an individual partner, for example, loans or grants from a foundation or government entity to the CDC. If financing committed to a partner for the project is to be a debt obligation of the joint venture, it must be lent to the partnership by the partner. Otherwise, it will be deemed a capital contribution of the partner, and, in the case of bankruptcy or dissolution, its return to the partner will be subordinate to repayment of the debts of the joint venture. The tax and LIHTC implications of how funds come in the deal, whether repayment is recourse or non-recourse (in recourse debt partners or members are personally liable; in non-recourse, a creditors are limited to the project property), and who is responsible for repayment must also be considered.

**Critical Path.** Spell out the order in which development milestones need to be achieved, and when.

**Exit Strategy.** How, when, and for what price will the CDC agree to be bought out by the for-profit, or vice versa? This key point should be covered in the operating or partnership agreement.



*Entrance to Whole Foods parking lot, East Liberty, Pittsburgh*

## *Organizational and Management Options*

The structure and management of a joint venture can take many different forms, each has its own pros and cons. The basic options are **general partnerships**, **limited partnerships (LPs)**, **limited liability companies (LLCs)** and **contractual relationships** (where the CDC or its affiliate is the owner of a property and the for-profit entity enters into an agreement with the CDC to provide development services). The first three options involve an ownership position for the for-profit; the fourth does not.

### *General Partnerships*

Each partner is *jointly and severally* responsible for the obligations of the partnership arising from the wrongful acts or omissions (i.e., intentional acts or negligence) of another partner acting either in the partnership's ordinary course of business or with the authority of other partners, and for breaches of trust by a partner acting within the scope of his or her apparent authority or by the partnership in the course of its business.

A partner is *jointly* liable for all other debts and obligations of the partnership. Partners have a general obligation to contribute toward the losses sustained by the partnership. They also have contribution obligations after the dissolution of the partnership. Each partner may take an active role in the operation of the business of the partnership.

General partnerships are the least advantageous ownership option and are *not* recommended.

### *Limited Partnerships*

A limited partnership must have a general partner, who has unlimited liability for the general debts and obligations of the partnership. Limited partners are not jointly or severally liable for the obligations of the partnership, whether incurred through negligence, directly or contractually. They are liable for the obligations of the partnership only up to the amount of their capital contribution plus any amount of undistributed profit to which they are entitled.

Although a limited partner may not take an active role in the daily operation of the business of the partnership, under the law of most states it may consult with and advise or render professional services to a general partner with respect to any matter, including the business of the partnership. It may also be a contractor for, or an agent or employee of, the LLC or of a general partner, or be an officer, director, or shareholder of a general partner that is a corporation. A limited partner may approve (1) amendments to the organizational documents, (2) changes in the nature of the business, or (3) removal of a partner.

The management structure can be a single general partner, co-managing general partners, or one managing general partner (with more responsibilities) and a non-managing general partner.

LPs are generally not as advantageous an ownership option as LLCs.

## *Limited Liability Companies*

An LLC has elements of both corporations and partnerships. Owners of an LLC are called “members,” as opposed to the “partners” in a partnership or the “shareholders” of a corporation. Like shareholders in corporations, members are afforded limited liability; they are only liable for the amount of their investment. Unlike a corporation and more like a partnership, the net income received by the LLC itself is not taxed, because an LLC is not regarded as a legal “person” for federal income tax purposes. In other words, only the members pay taxes, so if a member is a tax-exempt entity, for example, a CDC, it keeps *all* income it earns except any which might be subject to UBIT (unrelated business income tax, discussed further below).

An LLC structure provides the following advantages:

- **A flexible management structure is permitted.** Management may (1) rest in the hands of all members, (2) be centralized in the hands of one member, (3) be delegated to a manager who is not a member, or (4) be delegated to a Board of Managers. Thus, a CDC may assume the management role it desires and need not be confined to the role of a limited partner under state law.
- **There is no need to have a general partner.** There is no need to form a corporate general partner and to capitalize that corporation in order to preserve the limited liability of the members, as is necessary with an LP. One caveat: an undercapitalized LLC may lose its limited liability through a challenge similar to "piercing the corporate veil" in a corporation.
- **Multiple classes of ownership are possible.** Like a corporation, an LLC has flexibility on capital contributions, and there can be different classes of ownership with different rights and obligations.

### *Ownership Percentages in GPs, LPs and LLCs:*

Ownership can be split 50/50, or 99/1 or in any percentage in between. However, each partner/member must have and maintain a minimum net worth benchmarked on the expected financial obligations of the joint venture.

### *Profit and Loss Sharing for GPs, LPs and LLCs:*

Profits and losses are generally shared at the same percentages as partner/member ownership interests. If profits and losses are shared at percentages that differ from ownership interests, the difference must be based on “substantial economic effect.” This means that if a member of an LLC has the right to share in profits in an amount greater than its ownership interest, it must have a risk of loss with respect to an LLC obligation that makes the higher profit rights seem reasonable. For example, a member could agree to assume a greater share of liability for a debt obligation of the LLC and thus be justified in receiving a greater share of the profits.

Profits allocated to a tax-exempt nonprofit may be subject to unrelated business income tax (UBIT), which is equal to federal corporate income tax rates. The IRS's concern with UBIT is that if a CDC is regularly engaged in an activity that is commercial in nature and not in pursuit of the CDC's tax-exempt purpose, then the income produced should be treated the same as the taxable earnings of a for-profit business, that is, paying income tax on them.

CDCs therefore have to structure their involvement in profit-making activities with the UBIT rules in mind. In order to be subject to UBIT, for example, the activity of the joint venture must not be "substantially related" to the exempt purposes of the exempt organization, which means there is no "causal relationship" between the conduct of the business activity and the achievement of the tax-exempt purpose. One example of such an activity might be [example?]. . . . Even so, there are exceptions to UBIT that allow the CDC to structure its involvement in a way that it can receive much-needed revenue without becoming liable for UBIT. If the CDC's income, for example, is derived in a "passive" manner, i.e., not obtained as the result of competitive activity, the income is not subject to UBIT. The most common examples of passive income are: (1) annuities; (2) dividends; (3) interest; (4) rents; and (5) royalties.

A second UBIT test is that the business generating the profits must be "regularly carried on," that is, conducted with frequency and continuity. Therefore, a one-time activity which produces income, such as a sale of real property or the sale of some kind of equipment or other materials, does not subject the CDC to UBIT.

### *Contract Co-Developers*

An alternative to having the for-profit assume an ownership position is entering into a simple contract for services, which can occur at various stages of the development.

#### *Advantages:*

The CDC has unfettered control over the project, without having to cede control to the for-profit.

The CDC does not have to share the upside potential, for example, if a CDC is the sole owner of a supermarket.

#### *Disadvantages:*

If there are development problems or delays, the for-profit does not have much incentive to stay in the deal when it does not have capital at risk. The CDC could be stuck holding the proverbial bag.

The CDC must bear the risk of loss by itself, i.e., its charitable assets are exposed to a greater extent than if its liability were limited, as in a GP, LP or LLC.

The CDC cannot as easily learn from the for-profit if it is not a co-owner, because the for-profit, largely a consultant, has little reason to share its expertise.

## SECTION II: Project Profiles

### *Lake Park Pointe Shopping Center, Chicago, IL*

**Partners: Trkla, Pettigrew, Allen & Payne (TPAP) and Fund for Community Redevelopment & Revitalization**



#### ***Background***

The Lake Park Pointe Shopping Center is a \$9.8 million supermarket-anchored retail center completed in 1999 in the North Kenwood area of Chicago's south side. Built at the northwest corner of 47th Street and South Lake Park Boulevard, it provides quality retail goods and services to a revitalizing mixed-income community.

The venture was developed by the Fund for Community Redevelopment & Revitalization, a nonprofit CDC, and TPAP, a for-profit developer. Glenn Azuma and Cliff DiLorenzo of TPAP saw the opportunity to offer new retail facilities in a profitable project to a vastly underserved market. Members of the Fund sought also to create employment opportunities for neighborhood residents in construction and in businesses in the center. They also saw it as strategically located, close to Lake Shore Drive (90,000 vehicles daily), near Hyde Park and the University of Chicago, and several other major institutions, and a critical project to leverage additional neighborhood reinvestment.

Project planning began in 1994 when the Fund issued a Request for Proposals. The CDC worked with the City of Chicago to acquire several land parcels and negotiated a redevelopment agreement. TPAP was selected as the joint venture partner, with work beginning in 1996.

The partners had similar but not necessarily identical interests, and it was clear their interests were not in conflict. Priorities were made clear to each other at the beginning of planning, and a process was established to negotiate differences. They shared the goal of completing a successful project that

would be both profitable and beneficial to the community. TPAP sought credit tenants; the Fund wanted to be sure that the tenants were those most desired by local residents. The Fund wanted to maximize employment opportunities for its community; that was only a secondary goal of TPAP. They structured a partnership that valued the contributions of each, and the operating agreement defined everyone's roles, responsibilities, and tasks.

### ***Roles and Responsibilities***

Because of its broad-based community support, the CDC was able to assemble and hold the land with City assistance, at little expense to the for-profit developer. Because of its nonprofit status, the CDC also obtained City support for a land cost write down and secured additional financing at favorable terms. The CDC also accessed predevelopment funds from LISC to cover initial planning and design costs during the start-up period.

TPAP brought to the project a long history of development experience, credibility in the financing and retail leasing communities, professional relationships, and an entrepreneurial approach to emerging markets and unfamiliar site configurations. They also benefited from a thorough knowledge of urban communities and the advantages that CDCs can offer to projects.

### ***Challenges***

The developers faced a variety of challenges: an irregularly shaped site, lenders and tenants unfamiliar with the community, and negative perceptions about security in the community. The greatest challenge faced by the developers was the lengthy predevelopment period: land assembly, government approvals, negotiation of public incentives, fulfilling MBE/WBE requirements, and obtaining financing took 24-36 months longer than in many suburban projects. The CDC was able to carry that component of the risk, thanks to its relationship with the City.

### ***Keys to Success***

The project has exceeded expectations. The shopping center is fully leased. Five of the 12 tenants are minority-owned businesses. Credit tenants pay nearly half of the center's net income. Two-thirds of the construction contracts were awarded to minority contractors. Nearly half of the workers were Chicago residents, with most living within the center's market area. The project has leveraged additional investment in surrounding neighborhoods.

According to Karl Bradley, the CDC's Executive Director, "We identified a market with huge pent-up demand and no competition." The shopping center's success has sparked investment in the residential area, rebuilding its social fabric by changing 47th Street from a barrier to a bridge between the North Kenwood and Hyde Park communities. Azuma of TPAP called the deal an economic "grand slam home run."

## *Markham Plaza, San Jose, CA*

### **Partners: CORE Development and Emergency Housing Consortium**

#### ***Background***

CORE Development is a for-profit developer involved in the creation of both affordable and market-rate housing in Santa Clara County, with an emphasis on development in the City of San Jose. CORE Development has a staff of seven in its development division, and its sister building division, CORE Builders, also has a staff of seven. CORE Development provides in-house expertise in pre-development, entitlements, feasibility analysis, and site acquisition, and uses consultant teams to manage projects through development; affordable housing project management is usually provided by independent contractor Martha Putnam.

Emergency Housing Consortium (EHC) is the largest shelter provider in Santa Clara County, operating a number of shelter facilities throughout the county. EHC has 106 full-time and 22 part-time staff, most of whom are involved with shelter operations and service provision. Prior to Markham Plaza, EHC did not have significant development capacity or experience.

Markham Plaza is a 305 unit SRO development in San Jose, California, completed in 2003. The development was a two phase 9% tax-credit project, with a total cost of \$40,000,000, 58% of which was financed by tax-credit equity. The SRO units are intended for populations taking either a second step out of a homeless shelter, or in the case of some residents, a direct step from the shelter, depending on their level of preparedness. Given the target population, the project integrates a significant amount of services, including a computer training center and on-site counseling and case management facilities.

#### ***Roles and Responsibilities***

Martha Putnam from CORE undertook the bulk of the work of structuring and financing project acquisition and development, while CORE and EHC shared outreach and some site preparation/entitlement work. While EHC was privy to all aspects of the development, it played primarily a mentee role: a key purpose of the project for EHC was to build its capacity through involvement with CORE in the development process. Putnam was the project manager, the only development staff involved from CORE, although CORE Builders built the project and played a significant design role. A number of EHC staff were involved in the project, but mainly in an observing/learning capacity.

EHC did play a significant role in identifying the needs of the target community, however, and used its experience in service provision and shelter administration to determine unit requirements and indeed requirements of the project as a whole. CORE's strength was in the development and construction of the project; EHC brought the service and needs assessment components, leveraging its familiarity with the target population.

Because CORE financed the project and took on all of the development risk, it also received the entire developer fee. CORE is in charge of asset management in the short term but will eventually divest all responsibility for the project, and EHC will be the owner and manager. As Martha Putnam put it, "they get the deal, and they get the asset," and they built development capacity through involvement in the project. Although CORE does develop affordable housing projects in which it

retains a long-term interest, Markham Plaza is “not a long term hold.” The deal is structured so that the project may revert to EHC in as few as 3 years. Markham Plaza was “more of a turnkey design-build project,” according to Putnam.

The partnership was structured with EHC as the managing general partner, CORE as the co-general partner, and the investors (Fannie Mae and PNC) as limited partners.

### ***Challenges***

Working with another organization is always a challenge, although in this project, the challenges related more to the project itself than to the partnership, since CORE took on almost exclusive development responsibility. Putnam identifies one challenge for a larger developer working with a small local organization: significant staff turnover. Involvement of a number of different people with varying levels of experience over the life of a project, typically a minimum of 4 years, can be a significant source of frustration. When experience ranges from significant previous development experience to recent college graduates with none, the frustration can be intense. Since EHC did not play a significant project management role, the turnover was not a real barrier.

### ***Keys to Success***

Both partners brought significant relevant skills to the project, but the key to making Markham Plaza work was the budget, which both ensured overall financial feasibility and satisfied stringent local government requirements. In particular, Putnam was able to negotiate low cost land acquisition: at roughly \$10,000/unit, it is significantly lower than many similar projects. CORE’s building team was able to create a project that met EHC’s needs, even integrating significant green components which promised a healthier living environment for a population that suffers high rates of chronic diseases.

## *Vineyard Square, Chapel Hill, NC*

**Partners: Orange Community Housing Land Trust and Centex Corporation**



### *Background*

The Orange Community Housing Land Trust (OCHLT), located in Chapel Hill, North Carolina, works to create permanently affordable rental and ownership housing, through the land trust model: land ownership by the Trust, which leases homes to residents long-term. Leases all include restrictions on equity appreciation and resale prices. OCHLT partnered with Centex Corporation, one of the largest private homebuilders in the country.

Vineyard Square, a 200-home townhouse development, began as developer Centex's proposal. When the Chapel Hill town government requested that Centex devote 15% of the development to affordable homeownership, Centex came to OCHLT. Robert Dowling, Executive Director of OCHLT, said that though Chapel Hill did not have a formal inclusionary housing program, it did make the affordable component a part of the project approval process, suggesting that the affordable units become part of the Land Trust so they would remain permanently affordable. Centex agreed to the town's stipulation, and dedicated 30 units to OCHLT.

### *Roles and Responsibilities*

The partnership was structured so that OCHLT was responsible for marketing the units during Centex's construction period. Each time a potential buyer obtained financing, OCHLT contracted to buy the unit from Centex. The sale between Centex and OCHLT occurred simultaneously with the conveyance of the unit to the affordable buyer, through a 99-year ground lease. Centex also paid a \$2,500-3,000 per-unit marketing fee to OCHLT. This arrangement meant Centex assumed the risk of slow sales, because OCHLT had no obligation to purchase a unit unless or until a buyer was in place. This proved to be a good arrangement for OCHLT, because some unexpected staff turnover stretched out the marketing period beyond what had been anticipated. Centex, however, deemed

even the extended carrying costs “a small line-item in the budget,” since the affordable units represented a small percentage of the overall project.

The project’s market rate two- and three-bedroom units were approximately 2000 square feet, with prices ranging from \$230,000 to \$275,000. The affordable units were 1000 - 1250 square feet for a similar number of rooms, priced at \$90,000 to \$105,000, and OCHLT purchased them at a premium from Centex. The gap was covered by CDBG and HOME subsidies, which added additional resale restrictions to the OCHLT lease restrictions. In addition to the marketing fees already paid by Centex, OCHLT will also receive resale fees on any resales. The affordable units were sold and occupied before the rest of the development was even completed.

### *Challenges*

OCHLT ED Dowling found the partnership overall to be fairly smooth, although there were some notable bumps along the way. In fact, the initial phase was “stop and start.” At the first meeting, Centex was taken aback at how low the OCHLT proposed price was, and it was three months before Centex returned to negotiations. Then OCHLT had to meet with Centex’s national staff to verify those prices using market data. In addition, Centex had never built units so small, so they had to design a new product, requiring more time. Negotiations dragged on over both unit mix and unit pricing: Centex wanted more large units, while OCHLT wanted smaller, lower-priced units. Ultimately, both partners compromised.

### *Keys to Success*

This partnership would never have occurred without the town’s involvement: Chapel Hill provided the incentive for the deal, and under no circumstances would Centex have pursued it otherwise. From Centex’s perspective, the affordable component was simply an added cost of doing business it had to absorb. OCHLT has engaged in other similar partnerships, and ED Dowling believes it’s a workable and efficient model. The private developer brings experience and capacity, and “they really are best at what they do,” while OCHLT is best positioned to provide the appropriate buyers. Additionally, Dowling noted, Centex treated the affordable unit buyers with as much dignity and respect as the market rate buyers. In the case of Vineyard Square, a whole new community was created, and buyers earning approximately \$30-40,000 per year were able to live in a place that would otherwise have been entirely unaffordable. Even better, notes Dowling, with the units in the Trust forever, they will remain permanently affordable.

## *Marin City Gateway Retail Center, Marin City, CA*

**Partners: Marin City CDC, BRIDGE Housing Corp., and The Martin Group**



### *Background*

Marin City USA is a 47-acre mixed-use development of affordable housing, a large shopping center, and a handful of community facilities. In 1980, residents of Marin City came together to form the Marin City Community Development Corporation (CDC), a nonprofit entity whose mission is to improve the economic and social quality of life for residents through affordable housing and job opportunities for low-income residents. Initially, with the help of foundation funds, Marin City CDC purchased a parcel of land on which it planned to build a 300-room hotel. After experiencing difficulty attracting developers to the project, the CDC decided to purchase a larger parcel that might be easier to develop. The land it identified, a 42-acre parcel of land owned by the Tamalpais Union High School District, was attractive to BRIDGE Housing Corporation, a regional affordable housing developer. The two organizations decided to purchase and develop it together.

Marin City CDC and BRIDGE then facilitated a 2-year community planning process in order to identify the community's goals for development. Residents expressed a desire for a more positive identity for Marin City, affordable housing, increased access to jobs and community services, and a supermarket. Once the planning process was completed, BRIDGE recruited a for-profit developer, The Martin Group, to work on the retail portion of the project, the Gateway Retail Center. The Martin Group then procured bank financing for the retail project, \$14 million in predevelopment funds and about \$20 million in permanent financing. Construction started in 1995 and was completed in 1998.

### *Roles and Responsibilities*

An important part of the story of Marin City USA is that it was developed by a three-way partnership between a nonprofit community development corporation, a regional affordable housing developer, and a for-profit retail developer. The CDC provided a connection to the community and

helped ensure that residents' social and economic objectives were achieved. The regional housing developer, BRIDGE, provided connections to the financial world and expertise in housing development. Finally, The Martin Group provided retail expertise. The project manager for Marin City USA, Andy Blauvelt, explained the rationale behind the partnership. "With a project that size, the gulf between the financial world and its demands and a very low-income community is really big. It's really hard to get one organization that can span it completely." Ideally, each partner's unique capacity would complement the others', and the project would move forward effectively.

Benny Steward, Executive Director of Marin City CDC, believed the CDC's role was to "shape and mold [the project] so it fits the desires and needs of the local community." Because the CDC and BRIDGE owned the property, created a land trust and then leased the property to The Martin Group, the CDC was able to play a critical role in the development team and gave it the leverage it needed to have many of its community goals written into the deal. One of these was a "first source" agreement that steered contracts and jobs toward Marin City residents. In addition to allocating jobs for residents, the CDC was able to factor the cost of a job training program, as well as other supportive services and community amenities—a garden, playgrounds, ball fields, library, and a new police and fire station—into the financing of the project. Property ownership gave the CDC a seat at the table, so it could achieve some of its community goals.

### *Challenges*

Job creation for local residents was a primary goal for the CDC. About 35% of construction jobs and 33% of retail jobs went to community residents, a significant achievement but far short of the community's goal of 50%. Furthermore, the CDC's goal of cultivating community entrepreneurs was not realized.

The Martin Group, a for-profit retail developer, was brought in to help ensure Gateway's success, as neither the CDC nor BRIDGE had commercial real estate development experience. While the community center was financed and built, and new jobs and services were created, it has not been the success partners counted on and the community hoped for. In addition to failing to meet the job goals set by the CDC, the center was unable to sustain a grocery store, one of the community's primary goals. These disappointments happened for a variety of reasons:

- Critical financial miscalculations were made, mostly because local politics and the depressed economic state of the area meant the project took 5 more years to complete than anticipated.
- Leasing difficulties resulted from the fact that rent in Marin Gateway was actually higher than in downtown Sausalito, making it very difficult to attract tenants in what was already a less desirable location. Pressure from Bank of America to pre-lease caused hasty leasing decisions, and this led to a significant and ongoing level of turnover among tenants (there was a 26% vacancy rate in Spring 2000) as well as a lower financial return.
- Marketing problems resulted from a marketing budget of only \$4,000, an incorrect assumption that anchor tenants would spearhead marketing efforts, the fact that stores opened over the course of several years rather than at one time, and an inability to win county approval for a sign on Highway 101.
- Property management was weak because of high turnover in property management staff and subsequent contracts with outside property management companies that were not particularly strong. A related cause was probably The Martin Group's purchase by Burnham Pacific during this same time.

### ***Keys to Success***

Marin City's housing stock was increased from 900 to 1240 units through this project (a one-third increase), and its quality was clearly upgraded. Furthermore, the community gained important physical, social and consumer amenities, as well as jobs. Marin City USA is a vivid example of the use of a large-scale retail development to fuel community revitalization at a time when many struggling communities are undertaking ambitious mixed-use projects. Marin City's experience may provide important lessons for others undertaking large neighborhood economic development projects.

## *Whole Foods, Pittsburgh, PA*

**Partners: East Liberty Development, Inc., and The Mosites Company, Inc.**



### *Background*

East Liberty Development, Inc. (ELDI), a CDC founded in the mid-1980s, is working to revitalize the East Liberty neighborhood of Pittsburgh. In the 1970s, urban renewal hit East Liberty like a never-ending tornado. First its commercial core was cut off from the surrounding residential neighborhood by a new four-lane one-way highway, Penn Circle, which eliminated a lot of through streets as well as any pedestrian cross walks to get from the surrounding residential neighborhoods to the shopping areas. Before long, houses remaining within the Circle and those immediately outside it were abandoned in favor of homes farther out. In the next phase of urban renewal, homes within the Circle were replaced with large-scale public housing projects and parking lots which cut off even more through-streets and walkways. This phase increased abandonment beyond the Circle, as families moved farther and farther out. Of course, as the people left, most of the businesses followed suit.

It was at this point that community leaders came together to form ELDI. While many businesses in the area opted for leaving or locking their doors and rolling down gates, East Liberty Presbyterian Church, built and endowed by the Mellon family in the 1930s and situated in the heart of the commercial core, chose a different option. The church decided to open its doors and work with ELDI. It has provided annual operating support to ELDI for over a decade now, and its efforts have also yielded a homeless shelter, soup kitchen, after-school programs and renovations of dilapidated Main Street buildings that house a host of local businesses.

After a slow start, ELDI in the mid-1990s recruited new staff and worked for three years with the community, local funders and all the government agencies to develop a Strategic Plan to revitalize

East Liberty. The Plan included broad housing and commercial/retail goals as well as Design and Use Guidelines. The Plan laid out three primary strategies:

- Within Penn Circle, replace the large-scale public housing projects with smaller mixed-income projects;
- Outside Penn Circle, reconnect to the surrounding more well-to-do residential neighborhoods, moving from those more stable neighborhoods in toward the Circle; and
- Inside and beyond Penn Circle, attract new businesses and shore up existing ones.

Following the course outlined in its Strategic Plan and its Design and Use Guidelines, ELDI began a number of stabilization strategies, such as land banking abandoned buildings and properties, holding City-owned properties, working with tenant organizations in troubled buildings, demolishing unsalvageable buildings, rehabbing appropriate existing homes, and constructing new homes on vacant land.

In 2001, Rob Stephany, ELDI's Director of Commercial Development, got a call from the Real Estate Director of a local commercial developer, The Mosites Company. Mosites had assembled a large parcel, which included an old warehouse building, at the edge of the ELDI neighborhood. Mr. Mosites was looking for a larger scale project, he lived in a neighborhood adjoining East Liberty, and he thought he saw potential. Mark Minnerly, an architect who previously worked at HUD and PPND, the Pittsburgh Partnership for Neighborhood Development, a local intermediary, moved to Mosites, and he knew ELDI and the East Liberty Neighborhood. Mosites had already approached Whole Foods, a large and highly-respected grocery chain with a reputation for training its employees and an interest in "edgy" locations. Because conventional financing could not cover the project they envisioned – there was a gap of about \$875,000 on a \$6 million project – ELDI and Mosites began discussions about a joint venture.

The result is a 32,000 square foot Whole Foods Supermarket with 60,000 square feet of parking, popular with community residents in part because 45% of the workforce are local residents. In addition, it has become a major draw for people in the surrounding higher-income neighborhoods. It has also sparked extensive additional economic and commercial development projects nearby, including Borders Books, Walgreen's, Starbucks and a Pennsylvania State Specialty Wine Store. The project has always performed well enough to allow distributions to partners, so ELDI, as a continuing advisor to the project (see below), has always had a steady stream of revenue.

### ***Roles and Responsibilities***

ELDI decided early that it would not be an effective or capable co-owner of the project. Its balance sheet was negative, so it could not guarantee loans or respond effectively to capital calls.

Additionally, two commercial projects it owned in partnership with others for over a decade, long before the current staff of 3 arrived, continued to have serious performance problems, and ELDI was nervous about another partnership. ELDI was also nervous about how the community would respond. The community was pro-change, but when the city recently arranged to bring in a Home Depot without the community's knowledge, there was outrage.

Ultimately, ELDI assumed a role it labeled "Community Development Advisor" to:

- serve as the vehicle for citizen participation during the development process,
- advise developer on design and other issues that affect the quality of life in East Liberty,
- prepare and submit grant applications to city, state and federal entities as well as non-profit sources,

- advocate for the project with governmental, financial and charitable organizations and the general community, and collect support documents as appropriate,
- collect a fee of between 5 and 15% of funds awarded for the project,
- transfer to the project by grant or loan the funds awarded, and
- during operation of the completed project, cap its distribution at 6%.

In exchange, Mosites agreed to:

- provide ELDI all technical and financial information as requested by ELDI,
- develop plans that conform to ELDI's strategic plan and design guidelines,
- negotiate in tenant leases a requirement to provide equal employment opportunities to East Liberty residents who meet tenants' hiring criteria,
- make a distribution to ELDI every time it took one for itself, and
- commence master planning efforts designed to connect whole foods to the rest of the commercial core.

### ***Creative Financing: The East End Growth Fund***

A crucial ingredient in the commercial revitalization of East Liberty is what came to be the East End Growth Fund. When ELDI and Mosites realized there was an \$875,000 gap in the Whole Foods financing, ELDI first received a \$500,000 award from HHS and then approached a local Pittsburgh foundation with its Strategic Plan, requesting a \$375,000 grant or loan to use as equity investment in the project. The foundation quickly realized the potential Whole Foods represented as a catalyst for the goals of the entire Strategic Plan, and brought others along. The foundation made a long-term \$500,000 grant to LISC, to be used

- to close the gap in the Whole Foods project;
- to leverage additional resources for this and other commercial projects; and
- for other activities in keeping with the Strategic Plan.

On the basis of these discussions and both the foundation donation and the LISC recoverable grant described above, LISC formed the East End Growth Fund. The Fund's advisory committee made investment recommendations, but it also helped ELDI with neighborhood building strategies and with aligning the existing local community development system to a targeted community-based strategy. This targeted strategy is at the heart of what is now a \$250 Million Revitalization Process, where long term and new residents and businesses benefit equally from the changes.

Even with all this support, the Whole Foods almost did not make it to the finish line because of the hard and expensive lease negotiations between Mosites, Whole Foods and their lawyers. But a Lease was ultimately signed, and ELDI learned valuable lessons from witnessing all the negotiations. The key lesson

### *Challenges*

Although Mosites already owned the property, the location was a risk. It was adjacent to a fairly trendy residential area, but disconnected by a high speed bus way and rail line system at the bottom of a deep ravine. Whole Foods was interested, but no lease had been signed, and many brokers and colleagues were trying to steer Whole Foods away from East Liberty as a bad neighborhood. There was also an \$875,000 gap in the financing, and ELDI was able to fill it with a \$500,000 award from HHS and a \$375,000 recoverable grant from LISC. ELDI used that grant to make loans to the project, including one that was repayable if/as the developer took a return on his equity. If the developer had to wait for returns, ELDI would ride out the tough times with him. In this project, both ELDI and the developer, and thus LISC, have had steady streams of revenue/returns/repayments.

### *Keys to Success*

The East Liberty Whole Foods has become a popular destination; people come from East Liberty AND all surrounding neighborhoods. It is also among the top performing Whole Foods stores nationally, even though it has the highest volume of sales purchased with government food subsidies, such as food stamps. Whole Foods has very low turnover and high employee loyalty, in large part for how well it treats its employees. Five years after opening, the East Liberty workforce is still 45% local residents.

Whole Foods is proving to be the catalyst a hand-full of people believed it would be. As additional stores on adjoining sites have come on line, ELDI is planning to add a pedestrian bridge across the highway, connecting the growing shopping destination to that higher-income neighborhood. Borders, Walgreen's, Starbucks and the specialty wine store are already in operation, and other major tenants, including Target, are interested in the site now under construction. More importantly, ELDI continues to be the broker of social equity during the neighborhood's transition, as long term residents and businesses realize the benefits of a revitalized community. Residents of the former poorly managed housing are now receiving keys to new homes, just down the street from new jobs, goods and services, and long-time businesses are re-tooling to capture new customers.

## SECTION III: Lessons and Recommendations

In joint ventures, each project and partnership brings its own challenges and successes. The case studies give an idea of the great variety of factors that can lead to successful projects. There are, however, some common lessons and recommendations that can serve as guides for CDCs considering future joint ventures.

***No Right Answer.*** The diversity of organizations and partnerships profiled demonstrates there are many possible development partnership structures that are effective. Each partnership has to be designed around the specific needs, skills, and experience of the specific partners, and the roles and responsibilities undertaken by any given partner can vary widely. There is no single best way to structure a joint venture partnership; flexibility, thoughtfulness, focus and attention to detail in the beginning are the guiding lights.

***Time and Task.*** Partners should be aware that, while it may be easy to carve out limited and well-defined partnership roles on paper, “role-creep,” – the expansion and modification of responsibilities as projects progress – is not just a possibility. It happens frequently! Also, projects often, even usually, take more time than originally projected. In general, organizations should plan for roles to change in response to unforeseen circumstances, calling for new skills and additional time and resources.

***Development Skill.*** Because complications almost always arise in the development process, especially in the very complex community development deals, CDCs should have at least one staff member who has some degree of development experience. This is true even if the CDC’s role in a given joint venture includes only minimal development responsibilities, say just to build some capacity. Some baseline understanding is important or the process may be too confusing to provide a useful learning experience or to protect the CDC’s reputation in the community.

***Value Threshold.*** Below a certain minimum threshold of organizational skill and capacity, a small CDC may be unable to add any real value to the development process. Where there is no development capacity, a CDC may even add complexity and difficulty. It may be best to be simply an onlooker.

***Risk Assumption.*** While traditional project risk may be shouldered solely by the for-profit partner, in fact, the CDC always assumes some risk of the project going badly awry. On the other hand, even if liability is joint and several, the for-profit, with deeper pockets, will necessarily assume the larger burden.

***Ensure organizational and mission fit.*** For a project to run smoothly, the partners’ goals for the project must at least mesh. Partnerships by their nature add a layer of complexity to any project. If the goals and the missions of the organizations are in conflict, the project may simply become too complicated to be feasible.

***Map out roles and responsibilities.*** The success of a partnership rests on clearly defined priorities and realistic goals for the partnership and the project, with the details of the roles and responsibilities clearly laid out in the partnership agreement. Additionally, both partners must be realistic about what can be achieved. For example, it would not be realistic for a CDC partner to expect 100% of the jobs to be from the local community.

***Ensure mutual understanding and constant communication.*** In any partnership, all organizations and individuals involved must have a clear understanding of the project and their role in it, not only at the outset but throughout the development process. When all partners are truly involved, all the necessary skills and experience can be brought to bear at the appropriate time, and almost any issue can be resolved.

***Walk and talk through possible problems and scenarios in great detail.*** These early discussions, which reveal both the priorities and concerns of each partner, are the most valuable way to ensure that problems arising during the development process will not be insurmountable. Partners are in effect role-playing these scenarios in advance, so they are less likely to be surprised and inflexible when and if they do occur.

***Ensure that real value is added by both partners.*** Perhaps the most important element of a successful joint venture partnership is that both partners are adding real value to the partnership. The most successful partnerships are those where each party brings something to the relationship that the other party needs, can't easily do or get without the other party, and which will make the resulting entity stronger than either party acting alone.

***Know and trust your partner.*** Trust takes time, but between partners it is essential to a successful joint venture. Trust begins with detailed knowledge of a partner's track-record, capacity, and organizational characteristics. This point may seem blatantly obvious, but it's still worth stating. Many partners are shocked to find the reality is different from the reputation – even a good or great one. Problems in partnerships frequently arise because of inadequate advance knowledge about the other partner.

***Human relations are crucial.*** Partnerships are not simply formal or legal relationships between organizations, but also human and social relationships between individuals. Because smooth working relationships between staff of the different partners are the lynchpin of successful partnership operation, these human relations must be constantly cultivated. Awareness of this lesson is always important, and it is a critical element of every other lesson and recommendation.

## APPENDIX A

### FAQ -- Joint Ventures and Nonprofit Tax Exemption

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#### *Can a joint venture obtain tax-exempt status?*

Technically no.<sup>1</sup>

#### *What is the fundamental conflict between the purposes of, and restrictions on, a nonprofit and a for-profit?*

The CDC must be organized and operated for substantially charitable purposes and therefore cannot be operated for private benefit. A for-profit, on the other hand, is organized precisely for the possibility of private benefit inuring to investors – it is the motivating force behind investors putting their capital at risk. That being said, a joint venture between the two is legally permissible, as long as several criteria are met.

#### *Can a nonprofit be a general partner of a partnership?*

Until 1982 the IRS took the position that a tax-exempt organization's participation as a general partner in an LP was *inherently incompatible* with its exclusive operation for charitable purposes.<sup>2</sup> Since 1982 the IRS has used a two prong analysis to determine whether participation by an otherwise exempt organization in a partnership as a general partner adversely affects Section 501(c)(3) qualification.

First, whether participation by an organization furthers its exempt purpose, and second whether the partnership arrangement allows the organization to act exclusively in furtherance of an exempt purpose. As for the second part of the test, a reserve or guarantee of/against operating losses, profits or fees; the return of capital; or indemnification by the exempt organization in favor of the for-profit is evidence of the furthering of the private interests of the investor, and generally will cause concern with the IRS.

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<sup>1</sup> However, in private letter ruling 200134025 (issued on 8-27-2001), the IRS concluded that a single member LLC (SMLLC) having a tax-exempt organization as a sole member will be treated as an activity of the exempt organization, and the SMLLC's operations and finances must be included in the annual information return of the exempt organization. IRS Form 990 (an exempt organization's information return) also provides that a disregarded SMLLC is treated as a branch or division of the exempt owner, and is not required to file an application for tax-exemption.

<sup>2</sup> In 1982 a case called Plumstead Theatre Society v. Commissioner was handed down by the Tax Court regarding an organization operated to produce theatrical plays. The court concluded that the organization's serving as a general partner of a LLC was not inconsistent with exemption because the organization (i.e., the partnership) possessed the characteristics of a nonprofit theater rather than a for-profit theater. Among the important factors cited by the court was the fact that the general partner had no obligation to return the investor's capital from its own funds, and since the investor limited partners had no control over the operation of the exempt organization, the partnership did not operate for the private interests of the limited partners.

In 1998 the IRS issued Rev. Rul. 98-15. Although the ruling focused on “whole hospital” joint ventures between tax-exempt hospitals and for-profit entities, the IRS made it clear that the principles of the ruling are intended to apply beyond the medical context. Prior to Rev. Rul. 98-15, the IRS had never issued a ruling of precedent affirming the basic finding of Plumstead Theatre that an exempt organization could be the general partner of a partnership under the right circumstances. Rev. Rul. 98-15 affirmed that, and emphasized the importance of the exempt organization’s maintaining sufficient control over the operations of the joint venture, particularly when the activity conducted through the joint venture is a substantial part of the organization’s overall activities. The ruling contains two examples, one with a fact pattern obviously passing muster, the other with a fact pattern obviously failing the test and jeopardizing the organization’s tax-exempt status.

When an activity of an exempt organization is not a substantial part of the organization’s overall activities, it is referred to as an *ancillary* joint venture. Ancillary joint ventures are common in community development, especially for larger CDCs that have a large number of developments, none of which individually constitute a substantial part of their activities. In May of 2004 the IRS issued Rev. Rul. 2004-51, which provided that a tax-exempt organization may share 50/50 ownership and governance of an *ancillary* joint venture without jeopardizing its exempt status and without incurring any UBIT on its share of income from the joint venture, as long as the activity conducted by the venture is carried out in a manner that contributes importantly to the exempt organization’s exempt purpose. The ruling suggests that although an ancillary joint venture does *not* require governance *control* by the exempt organization, the IRS will continue to require that the exempt organization maintain *significant* control over the *substantive* aspects of the venture’s activities (in order to ensure that charitable goals are realized). This is a helpful ruling for community development practitioners advising joint ventures.

***Does the CDC or its affiliate have to be the managing member or general partner of the joint venture?***

No, as mentioned above, because of Rev. Rul. 2004-51 the CDC can have equal control with the non-profit in an ancillary joint venture or even assume a limited partner/passive investor role in such a structure. Where the exempt organization is not in technical control of the entity and it’s an ancillary joint venture or a passive investment, the IRS will not apply the same level of scrutiny on the arrangement. Instead, the focus will be on whether the venture serves a charitable purpose, whether the exempt organization has *significant* control over the achievement of that purpose (as opposed to actual legal control over the venture) and whether the exempt organization will receive adequate consideration for its investment (or has a reasonable expectation of a return on its investment). In a passive investor scenario, it’s important for the CDC to assess whether it will continue to have as its primary focus the exempt purpose for which it was granted exemption from federal income tax. It should not participate in a joint venture that is unrelated to its exempt purpose unless it is willing to owe UBIT (or, if the venture is a substantial part of its activities, willing to jeopardize its exemption). A "passive investment" should be only a small part of the CDC's activities. If a CDC is found to be

primarily making investments rather than carrying out its exempt purpose, its exempt status could be jeopardized.

As mentioned, in Rev. Rul. 2004-51 the IRS ruled that a tax-exempt organization could be in an ancillary joint venture without controlling it as long as it can maintain *significant* control over the *substantive* aspects of the venture's activities. In the community development context, the rights of intervention of a CDC that is not the managing member of an LLC should be considered carefully in the Operating Agreement. Distinction should be made between delegation to the managing member with and without constraint. Certain matters such as the day-to-day operation of the business can usually be delegated without significant constraints by the non-managing CDC to the for-profit managing member. Other items, such as the right to change the location of the business or the first source hiring provision of the Operating Agreement, for example, should not be allowed without the consent of the CDC. In addition, the CDC might want to have the right to take corrective action, such as removing the managing member, if it has proceeded without obtaining the CDC's required consent to certain items. That way the CDC can ensure the LLC doesn't deviate from the Operating Agreement in a manner that jeopardizes the continuing charitability of the joint venture's activity.

### ***How do I know if the purpose of the joint venture is charitable?***

#### Housing Development:

Rev. Proc. 96-32 was issued by the IRS in 1996. It provides a "safe harbor" to low-income housing providers applying for an expedited exemption ruling. Its primary focus is on the income level of households renting or buying affordable housing. The basic prongs of the rule which must be satisfied are the following:

- For each project: (a) at least 75% of the units must be occupied by residents that are at or below 80% of median income for the area, and (b) either at least 20% of the units must be occupied by residents that are at or below 50% of median income for the area, or 40% of the units must be occupied by residents that are at or below 60% of the median income for the area. Up to 25 percent of the units may be provided to at market rates to persons having incomes in excess of the low-income limit.
- The project is actually occupied by the poor and distressed. One year transition period is considered by the IRS to be reasonable (generally for occupied structures being redeveloped).
- The housing is affordable to charitable beneficiaries (limitation of percentage of income to be paid in rental for rental projects or toward mortgage payments in for-sale projects).
- If a project consists of multiple buildings and each building doesn't separately meet the requirements of the above three sections, then the buildings must share common grounds.

The Safe Harbor also discusses the “Exempt Purposes Other Than Relieving the Poor and Distressed,” states that “...organizations may qualify for exemption without having to satisfy the standards for relief of the poor and distressed by providing housing in a way that accomplishes *any* of the [following] purposes:” (1) combating community deterioration; (2) lessening the burdens of government; (3) eliminating discrimination and prejudice, (4) lessening neighborhood tensions; and (5) relief of the distress of the elderly or physically handicapped.

There are also examples in the safe harbor of projects that would qualify, and one example for homeownership indicates that the IRS will allow higher income limits for for-sale projects (the example that qualifies has 40% of units being sold to households at or below 70% of AMI, 25% of units being sold to households at or below 80% of AMI and 35% of units being sold to households at or below 115 % of AMI.

The safe harbor was not intended to supersede the previous rules on what qualifies as charitable in housing, but only to help expedite applications. It can also not be used to challenge the exemption of a nonprofit having a prior determination. However, the rule has been looked to as a benchmark of charitability, as it is as complete a treatment of the standards as has been seen in awhile.

#### Economic Development:

This is a rather convoluted and difficult to apply test, but an excerpt of it from GCM 39883 is as follows:

Based on the above revenue rulings and GCMs, a determination of whether a community development organization furthers charitable purposes requires an analysis of the following **three factors**: (1) whether assistance is being provided to help local businesses or to attract new local facilities of established outside businesses, (2) whether the type of assistance provided by the community development organization has non-commercial terms and the potential to revitalize the disadvantaged area, and (3) whether there is a nexus between the business entities assisted and relieving the problems of the disadvantaged area, or between the businesses and a disadvantaged group, like a minority, in the area...**with respect to the third factor**; the above revenue rulings and GCMs indicated that there are **three characteristics** that provide a nexus between the businesses assisted and relieving the problems of the disadvantaged area: (a) assistance recipients conducting their business in the economically disadvantaged area, (b) recipients not being otherwise able to obtain assistance from conventional sources because of the depressed nature of the area or affiliation of business participants with minority or other disadvantaged groups, and (c) assistance recipient selection is based on which recipients will offer the greatest potential community benefit by virtue of either their current operations or their promises to take certain actions benefiting the depressed area (emphasis supplied).

***What does the joint venture's organizational document need to say about the charitable nature of the project?***

Nothing, from the standpoint of the for-profit and under most state LLC and LP laws. Sometimes the agreement will only state that the purpose of the partnership is to acquire, develop and dispose of real property and do and perform any and all other activities as authorized under state law.

However, from the CDC's standpoint, and in light of Rev. Ruls. 98-15 and 2004-51 referred to above, it's important to include in the organizational document not only the charitable goals of the venture (e.g., relief of poverty, elimination of prejudice and discrimination, stemming of community deterioration), but also what activities are planned to achieve those goals (e.g., development of rental or for-sale housing affordable to low income households; creation of jobs to be filled by unemployed residents; providing of financing and technical assistance to minority entrepreneurs; establishment of new businesses in a deteriorated area). Normally the for-profit should not be concerned about adding this - even though it's unusual language - because these points should have been previously discussed or at the very least should be understood as the goals of the venture (and, for example, under the LIHTC, will be required to comply with Section 42 of the Code).

**APPENDIX B**

**Joint Venture Agreement Planning Tool**

**Partners:**

CDC: \_\_\_\_\_  
Partner: \_\_\_\_\_

**Project:**

**Social Goals:**

What are the key community goals?  
\_\_\_\_\_  
\_\_\_\_\_

First Source Hiring - construction (___%) ___N/A	___ Required	___ Best Effort
First Source Hiring - tenants (___%) ___N/A	___ Required	___ Best Effort
Small Business Tenants (___%) ___N/A	___ Required	___ Best Effort
Undesirable Tenants (attach list) ___N/A	___ Prohibited	___ Best Effort
Nonprofit Tenants (___%) ___N/A	___ Required	___ Best Effort
Affordable Housing Units (___%) ___N/A	___ Required	___ Best Effort
Other: _____ ___N/A	___ Required	___ Best Effort

Are there consequences for failure to meet these goals?  
\_\_\_\_\_  
\_\_\_\_\_

**Ownership Structure:**

Pre Development and Construction: CDC: \_\_\_% Partner: \_\_\_%  
Permanent: CDC: \_\_\_% Partner: \_\_\_%  
Will one partner serve as Managing Partner? \_\_\_\_\_  
How many board seats will each entity appoint? CDC: \_\_\_ Partner: \_\_\_  
Will ownership structure change in the future? \_\_\_\_\_  
Under what conditions?  
\_\_\_\_\_

**Roles and Responsibilities**

**CDC Roles:**

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

**Partner Roles**

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

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What happens if a partner does not fulfill its obligations?

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**Decision Making:**

*Both parties may be involved in all decisions, but list any special areas where one party has veto or final say.*

**CDC Decides**

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**Partner Decides**

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**Staffing**

*Will one or both parties commit specific staff people to work on the project?*

**CDC Staff Commitment:**

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**Partner Staff Commitment:**

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**Financing**

**CDC Investment:**

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**Partner Investment:**

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Who will be responsible for obtaining debt financing for the project? \_\_\_\_\_

Who will be responsible for obtaining public/charitable financing? \_\_\_\_\_

Will either party guarantee loans? CDC: \_\_\_\_ Partner: \_\_\_\_

Who will be responsible for cost overruns/unexpected expenses? \_\_\_\_\_

**Development Fees:**

*What fees will each party earn if the project is developed successfully?*

**CDC Fees:**

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**Partner Fees:**

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**Property Management:**

Who will serve as property manager? \_\_\_\_\_

How will property management fee be calculated? \_\_\_\_\_

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**Operating Income/Losses**

Who will receive net operating income? CDC: \_\_\_\_% Partner: \_\_\_\_%  
Who will cover any operating losses? CDC: \_\_\_\_% Partner: \_\_\_\_%

Special circumstances/conditions?

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**Termination**

When will joint venture end?

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Will one party have right to purchase joint assets?

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How will the price be determined? (Cost, Value, etc.)

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**Capacity Building:**

Is the private partner expected to help build CDC capacity?

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How will success be measured?

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**APPENDIX C**

**Quick and Dirty Joint Venture Strategy Checklist**

Social Goal(s):	Losses/Additional Capital
	Contributions/Indemnification:
Economic Goal(s):	
	Conflicts Resolution:
Capacity Building Goal(s):	
	Keeping the Books:
Neighborhood Context/Design Goal(s):	
	Development/Financing
Working Relationship Goal(s) (“soft” stuff):	Milestones:
Key Decisions Responsibility:	
	Exit Strategy:
Profit Sharing/Developer Fee:	
	Bottom Line(s) (below which we won’t go)
	Price? Other issues?
Continuing CDC Role?	



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