

**WHITE PAPER:
OPTIONS FOR LEGAL AND TAX STRUCTURES OF
BELOW MARKET RENTAL HOUSING PROJECTS**

**PRESENTED BY:
Norton Rose Fulbright Canada LLP.**



Catalyst Community Developments Society



WITH GENEROUS SUPPORT FROM



A. Context

There are many charities and non-profit organizations that wish to undertake the development of real estate. They wish to do so in order to achieve a number of objectives that are intended to further the mission, purposes and priorities of their organization.

The purpose of this White Paper is to outline the current challenges faced by these charities and non-profits wishing to undertake such development. We also describe possible solutions to these challenges. It is hoped that this White Paper will support charities and non-profits, generate discussion, and prompt consideration of changes to the *Income Tax Act* (Canada) (the “Act”) to allow such developments to proceed in a less elaborate and more efficient manner.

We describe two possible structures for the development of below market rental housing in British Columbia.

Option One - involves a proposed development that includes a “market” component. The land for the development is currently owned by a registered charity and the subsequent development will be owned by the charity, a non-profit housing organization (that is, an organization which is not a registered charity) or entities formed by them.

Option Two - outlines a structure for a similar ownership structure where there is no market component in the completed development.

The suggested structuring for these developments is proposed with a view to maintaining the tax exemptions for the organizations involved and to address other challenges faced by such organizations wishing to undertake real estate development. The issues raised by these structures are complex, there are competing objectives, and there are nuances in the law that must be considered.

Please note that in this White Paper we use the term “non-profit organization” with reference to sub-section 149(1)(l) of the Act, which references the legal requirements for organizations that wish to qualify for the “non-profit organization” tax exemption.



B. Constraints Resulting from *Income Tax Act (Canada)*

There are a number of constraints arising from the Act which have an impact upon the structuring. The Act creates an inflexible statutory framework for both registered charities and for non-profit organizations who wish to qualify for the “non-profit organization” tax exemption. The following briefly summarizes the issues which affect the proposed structure.

Registered Charity

A registered charity may:

- (a) carry on a business but only if such business is related to its charitable purposes;
- (b) make a gift but only to a “qualified donee” as defined in the Act – this includes registered charities but not non-profit organizations;
- (c) sell property but must receive fair market value consideration (unless a gift to a qualified donee);
- (d) lend funds in certain circumstances but only on fair market value terms if the borrower is not a qualified donee; and
- (e) provide housing for the impoverished, seniors and/or people with a disability (“Social Housing”).

Please note that in this White Paper we distinguish between “Social Housing” as defined above and “Below-Market Housing” which is housing that is still below market but not housing provided to the “impoverished”, seniors, or people with disabilities.

If a registered charity contravenes the Act, it could lose its charitable registration, which subjects it to a requirement to transfer its assets to another, eligible, registered charity with which it is not affiliated, or to pay the entirety of its assets to the Canada Revenue Agency as a revocation tax.

Non-Profit Organization

A non-profit organization which qualifies for the exemption in the Act:

- (a) must not be/cannot qualify to become, a charity;
- (b) cannot be organized for profit-making purposes. This is a significant issue and one that is construed very strictly by the Canada Revenue Agency. Any profit must be incidental and unforeseen; and



- (c) can provide Below-Market Housing and/or Social Housing as a social purpose.

Generally speaking a non-profit organization intending to operate Below Market Housing will need to generate revenue surplus to its expenditures in order to meet financial covenants, to provide for deferred maintenance and to be financially viable. However, once it has met its covenants, has built an appropriate capital reserve to deal with maintenance and similar issues, it cannot continue to accumulate investment capital unless there is a specific and realistic plan to use such pool of capital for its social purposes, for example, to acquire/develop another affordable housing project.

C. Other Constraints

In addition to the Act, there are a number of other constraints which must be considered.

Property Transfer Tax

In BC, a transfer of property to a registered charity is exempt from property transfer tax (“PTT”). In all other transfers, the tax will apply. The Options described below look to minimize the application of this tax.

GST

Registered charities, non-profit organizations and business corporations all have different entitlements to recover GST paid. The treatment afforded to registered charities wishing to undertake real estate development is less favourable than that available to business corporations or non-profit organizations.

Financing

As construction and long-term financing is often required for real estate development, any structure proposed must be designed with financing in mind, and to meet the likely requirements of lenders.

Cash Flow Upon Project Completion

The projected financial arrangements for the project must meet the parties’ objectives. Such objectives could include: generating sufficient revenue to service project financing, to properly operate and maintain the property, to pay the charity for its contribution of that portion of the property that will not continue to be owned by the charity and used for its charitable purposes, to generate revenues for the use of the charity and the non-profit organization in their ongoing operations, and possibly to generate sufficient returns over time that an additional affordable housing project could be developed.



D. OPTION 1

The structure outlined below for discussion is based on an actual project in progress in Vancouver and is presented in the nature of a case study.

This option involves a registered charity (the “Charity”) and a non-profit housing organization (“Non-Profit”). The Charity is registered under the Act and is, in type, a charitable organization¹. The Charity is a religious organization which owns a building, used as a church, that has reached the end of its useful lifetime.

The Non-Profit is a non-profit organization for the purposes of the Act and is thus tax-exempt. It is not a registered charity. The Non-Profit has property development expertise and wishes to develop, own and manage Below Market Housing as defined above.

Construction and long-term “takeout” financing from a financial institution will be needed.

The goals of the various participants in entering into the proposed structure are intended to further the missions of the respective entities, as follows:

1. Charity will have a new space to be owned solely by the Charity without long-term debt (the “Church”);
2. Charity will own Below Market Housing through a controlled entity;
3. Charity will have a revenue source (from leasing a portion of the development to a retail tenant(s), from which to generate revenue to support its mission and operations;
4. Non-Profit will own Below Market Housing;
5. Non-Profit will generate revenues to support its mission of providing Below Market Housing; and
6. the incidence of tax, particularly income and capital gains tax, property transfer tax, and GST, will be minimized for all parties.

¹ The Act creates three types of registered charities: charitable organizations, public foundations and private foundations. Each type of charity is governed by different rules.



Proposed Development

The proposed development will demolish the existing building owned by the Charity and construct a six-storey building comprised of ground-floor retail space, a second floor Church, and four floors of Below Market Housing.

Considerations in Creating the Structure

There are a number of important considerations that were contemplated in developing the proposed structure:

1. transferring the property by way of a lease or a sale to a new company that would develop the property was considered. However, unless structured as a lease (less than 30 years), the transfer of land to and from the new company would result in property transfer tax. The conveyance of land from the Charity must take place at fair market value and the Charity must receive fair market value consideration. The new company, as a taxable entity, would be required to pay income tax on its profit, thereby reducing the amount available to reinvest in Below-Market Housing;
2. the timing and incidence of GST. The Charity would only be entitled to claim 50% of the input tax credits (ITC's) during construction;
3. the related business rules in the Act which restrict the Charity's ability to develop property for uses which are not charitable uses e.g. retail space, Below-Market Housing; and
4. the restrictions in the Act regarding the intentional generation of profit by non-profit organizations wishing to preserve their tax exemption.

Proposed Structure

The basic steps are as follows:

1. The single title owned by the Charity is sub-divided into four air space parcels as follows-
 - Parcel A: Title to what will be floors 5 and 6 is sold for fair market value to a new non-profit organization to be controlled by the Charity that will provide Below Market Housing ("Charity-controlled NPO"). Payment for the fair market value will be documented by a promissory note having fair market value terms;



- Parcel B: Title to what will be floors 3 and 4 is sold to Non-Profit for fair market value consideration (again, documented by a promissory note having fair market value terms) to be used for Below-Market Housing;
 - Parcel C: the Charity retains what will be Floor 2 for its new Church; and
 - Remainder Parcel: the Charity sells title to what will be the ground floor retail space and underground parking plus the common property such as fire exit stairs and other building services to a business corporation (“RevenueCo”) in consideration for shares of RevenueCo having a fair market value equal to the value of the air parcel being conveyed to it. The Charity and the Non-Profit will purchase shares in RevenueCo;
2. as owners of the four air space parcels, the Charity, the Non-Profit, the Charity-controlled NPO and RevenueCo create a Joint Venture (JV) to undertake the development;
 3. the JV takes out construction financing from a financial institution; and
 4. at completion, the JV is dissolved and each entity continues to own its own parcel and arranges its own long-term takeout financing, the proceeds of which will pay out the construction loan.

Specific Challenges Relating to Air-Space Subdivision

There are a number of challenges as follows:

1. **Nature of Airspace Subdivision**

An airspace subdivision effectively creates separate legal titles that are stacked on top of (or adjacent to) one another. Reciprocal easements between the various parcels are entered into to ensure that the separate parcels operate together as an integrated building.

2. **Municipal Approvals**

Typically air space parcels are created once a building is completed. However, such an arrangement would necessitate the Charity being required to undertake the entire development which it could not do and stay in compliance with the Act.



In this case therefore it was necessary for the air space parcel sub-division to be undertaken prior to the start of construction.

3. Design

The JV must engage a design team to finalize the structure of the building and its layout. Issues that need to be addressed include:

- (a) determining the allocation of parking within the building and the air space parcel(s) in which the parking will be located;
- (b) nature of the access rights that are required to ensure that the building operates as an integrated facility;
- (c) ensuring that the integration of the air space parcels and the related structure meets BC Building Code requirements; and
- (d) determining appropriate cost allocations for shared expenses that are required in connection with the operation and maintenance of the building.

4. Risks

The most significant risk related to the creation of the air space parcels prior to construction of the building is the risk that the building, as constructed, does not fit within the air space parcels that have been created. While not a risk on a vertical level, as the airspace parcel can be made wider to accommodate the area of the building, it is at the horizontal intersection of the various parcels (and the vertical intersection of any elevator corridors) where there is risk.

While nominal encroachments can be addressed through the granting of easements, material encroachments can create issues going forward between the owners of the separate parcels (for example, responsibility for the repair and replacement of capital items that are located in two separate air space parcels) and for individual owners in connection with any financing for the separate parcels. There may also be an issue with the City's issuance of an occupancy permit for units that straddle multiple parcels of land.

In the event that there are material encroachments between the separate air space parcels once the building is built, it is possible to bring a petition before the courts to cancel the air space plan and issue a new plan. This is a complicated and costly process that can take several months, however, it is an option in the event that there are material encroachments once the building is constructed.



How does Option 1 meet the Objectives of the Parties and the Project?

- Transfer of title to the various components of the building prior to the commencement of construction means that the Charity is not directly undertaking business activities unrelated to its charitable purpose - its direct activities relate to the development of a new Church.
- The Charity is not undertaking non-charitable activities as the Below-Market Housing is owned and operated by non-profit (non-charitable) entities, one of which is controlled by the Charity.
- The Charity is selling its property at fair market value. Revenue from the Charity-controlled NPO is used, in part, to repay the Church for the value of the land transferred to the Charity-controlled NPO.
- Transfer of title at an early stage minimises PTT liability as it will be charged only on land value as opposed to completed project value.
- As the development is undertaken by the JV, with the Non-Profit as the GST operator, full GST input tax credits are claimed throughout construction.

E. OPTION 2

The structure outlined below is also based on an actual project in progress in Metro Vancouver and is presented in the nature of a case study. Similar considerations noted in Option 1 above apply.

This option involves two registered charities, a new non-profit housing organization (the “New Non-Profit”), a non-profit housing developer and owner/operator (the “Non-Profit Developer/Owner) and BC Housing as a capital contributor. A registered charity owns the land (the “Charity Owner”) and the land is proposed for development (the “Land”). The Charity is a religious organization and there is a church building on the Land (the “Church”) that has reached the end of its useful lifetime.

The underlying goals for the development are to create a new church space for the Charity Owner, to make available Below-Market Housing and to create a space to be purchased and used by another Charity (“Charity Purchaser”) for program purposes.



Proposed Structure

The basic steps are as follows:

1. A new society is incorporated (the New Non-Profit) controlled by the Charity Owner which is intended to own and operate Below-Market Housing units and which may engage in other activities such as providing a shelter, a food bank and other social services.
2. The Charity Owner sells a specific undivided interest in the Land to each of the New Non-Profit and the Non-Profit Developer/Owner as tenants in common for a purchase price that is equal to the fair market value of the interest in the Land (for each, the “Price”). Each of the New Non-Profit and the Non-Profit Developer/Owner would issue to Charity Owner a promissory note and/or pay cash with the aggregate amount being equal to the Price. The promissory note would bear a market rate of interest. PTT would be payable on such a transfer.
3. The New Non-Profit and the Non-Profit Developer/Owner enter into a joint venture agreement to develop the property.
4. The New Non-Profit and the Non-Profit Developer/Owner enter into pre-sale contracts with:
 - (a) a registered charity (the Charity Purchaser) for program and admin space (the “Program Space”); and,
 - (b) the Charity Owner for a new church building (the “Church Space”).
5. The New Non-Profit and the Non-Profit Developer/Owner enter into a joint venture agreement to develop the property
6. The Joint Venture enters into a agreement with respect to the construction of the new building(s) with a construction manager/general contractor and other construction professionals as required.
7. The New Non-Profit and the Non-Profit Developer/Owner would file a strata plan with respect to the development.



Coincident with the filing of the strata plan, a determination of the distribution of Below Market Housing units between the New Non-Profit and the Non-Profit Developer/Owner will take place. No PTT should be payable provided each of the Below-Market Non Profit and the Non-Profit have a value in their respective strata units that is proportionate to the fair market value of their interests in the Land prior to the filing of the plan.

After the redistribution and transfer of the Below Market Housing units to the New Non-Profit and the Non-Profit Developer/Owner, title to the remaining Land will be dealt with as follows:

- (a) New Non-Profit and the Non-Profit Developer/Owner would conclude the pre-sale of the Program Space to the Charity Purchaser. No PTT should be payable on such transfer; and
- (b) the New Non-Profit and the Non-Profit Developer/Owner transfer the Church Space to the Charity Owner. No PTT should be payable on such transfer.

Each of New Non-Profit and the Non-Profit Developer/Owner would have a loan obligation evidenced by a promissory note to Charity Owner and bank financing secured by a mortgage. Any surplus revenue from operation of the Below Market Housing could be used to repay this obligation.

Each of New Non-Profit and the Non-Profit Developer/Owner would then each own specific strata units of Below Market Housing. Over time, it would be expected that all debt would be cleared from the rental income. Presuming that the non-profit organization tax exemption in the Act remains unchanged, after the re-payment of the debt, each of New Non-Profit and the Non-Profit Developer/Owner would need to ensure that they operate in a manner which would allow them to continue to qualify for the tax exemption. For instance, New Non-Profit could reduce rents on its Below Market Housing to bring its operation to break-even, and/or it could use excess funds to pay expenses on other activities that are included in its purposes e.g. food bank, or other social services. Non Profit Developer/Owner could also reduce rents on its Below Market Housing to bring its operation to break-even or use any excess revenues to provide additional Below Market Housing in other projects.



F. Conclusion

We look forward to generating discussion regarding the proposed structures in this White Paper as many charities are looking to redeploy their aging buildings, particularly in Metro Vancouver. We believe that these are also strategies that could gainfully be employed in increasing the availability of affordable housing, something which is so evidently required at this time.

March 2018

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