

G. ECONOMIC DEVELOPMENT CORPORATIONS

Charity Through the Back Door

by

Robert Louthian and Marvin Friedlander

1. Introduction

Where an organization benefits a charitable class of individuals directly, the charitable purpose intended to be accomplished is clear. If the direct beneficiaries of an organization do not represent a charitable class, such as the "poor and distressed" or "underprivileged," exemption is not necessarily precluded but, instead, will be dependent on whether the activity furthers charitable purposes. Assistance to for-profit businesses located in depressed areas may accomplish charitable goals such as the relief of community deterioration and the relief of the poor and distressed (through increased employment opportunities) even though the businesses are not proper charitable objects. Thus, an organization may justify exemption on the basis that its charitable purposes may be accomplished either through direct assistance to members of a charitable class or by accomplishing charitable ends through the use of individuals who are not themselves members of a charitable class.

Certain organizations which ultimately accomplish exempt purposes through the provision of assistance to for-profit businesses are collectively referred to as "economic development corporations" and include "incubators," and "Small Business Investment Corporations" (SBICs), and also "Section 301(d) Licensees" (a.k.a. "Minority Enterprise Small Business Investment Companies" and "MESBICs") which is a specialized form of an SBIC. While the incubator is not a statutory entity, SBICs and section 301(d) licensees are creatures of the Small Business Investment Act which is administered by the Small Business Administration (SBA).

Within the various types of exempt organizations described in IRC 501(c), the most likely under which economic development corporations seek tax-exempt status is as a charity under IRC 501(c)(3). Therefore, this is the article's primary focus. However, we encounter economic development corporations under IRC 501(c)(4), social welfare organizations, and IRC 501(c)(6), business leagues. One may also see an IRC 501(c)(12) cooperative utility organize an industrial park, but such events are rare.

2. Economic Development Corporations

Economic development corporations generally are established to assist existing and new businesses located in a particular geographic area through a variety of activities including grants, loans, provision of information and expertise, or creation of industrial parks. Incubators are a type of economic development corporation generally formed to provide assistance to induce new businesses to locate in communities whose economies are depressed or deteriorating, or to provide assistance to existing, emerging businesses so that they may remain in such communities. Incubators provide low-interest loans, facilities and equipment to new and emerging businesses as well as clerical and technical services in an effort to encourage such businesses to locate in the depressed areas. The services provided to the new businesses are offered by the incubator at reduced rates or even free of charge. Incubators may be set-up and/or sponsored by local and state governments, they may be affiliated with universities, or they may be an offshoot of an existing tax-exempt organization. In many cases, incubator organizations operate a "technology center" where businesses can be assisted (nurtured) through provision of business expertise, lower rental rates or pooled or shared services.

3. Exemption under IRC 501(c)(3)

In applying for exempt status, most economic development corporations would prefer the favored status of IRC 501(c)(3) exemption. To be recognized as exempt under 501(c)(3), the organization must demonstrate that it is both organized and operated exclusively for charitable purposes. Recall that Regs. 1.501(c)(3)-1(d)(2) provides that the term "charitable," as used in 501(c)(3), includes the relief of the poor and distressed, lessening the burdens of government, and the promotion of social welfare by organizations designed to lessen neighborhood tensions, eliminate prejudice and discrimination or combat community deterioration and juvenile delinquency. Perhaps an economic development corporation will claim that its activities accomplish all of these purposes. The specialist, however, should attempt to focus on the particular basis (or bases) upon which exemption may be recognized or retained and ascertain, using a facts and circumstances approach, whether the activities are likely to accomplish exempt purposes.

The theory behind recognizing economic development corporations as exempt under IRC 501(c)(3) is that although services are provided directly to for-profit businesses, the ultimate good received by the general public outweighs the private benefit accorded to the direct beneficiaries. In light of this, the most

important factual determination for the specialist to make is whether the activities of the incubator serve a public rather than a private interest consistent with Regs. 1.501(c)(3)-1(d)(1)(ii). In applying the facts and circumstances test, the Service has provided some guidance in the form of three revenue rulings.

Rev. Rul. 74-587, 1974-2 C.B. 162, held that an organization that devoted its resources to programs to stimulate economic development in economically depressed, high-density, urban areas, inhabited mainly by low-income minority or other disadvantaged groups, qualified for exemption under IRC 501(c)(3). The organization made loans and purchased equity interests in businesses unable to obtain funds from conventional sources because of financial risks associated with their location and/or because of being owned by members of a minority or other disadvantaged group. The organization established that its investments were not undertaken for profit or gain, but to advance its charitable goals. Funds for its program were obtained from foundation grants and public contributions.

Rev. Rul. 76-419, 1976-2 C.B. 146, held that a nonprofit organization that purchased blighted land in an economically depressed community, converted the land into an industrial park, and induced industrial enterprises to locate new facilities in the park through favorable lease terms that required employment and training opportunities for unemployed and underemployed residents of the area, is operated exclusively for charitable purposes and is exempt under IRC 501(c)(3).

The rationale for exemption in these rulings includes relieving poverty and lessening neighborhood tensions caused by the lack of jobs in the area; combatting community deterioration by establishing new businesses, rehabilitating existing ones, and eliminating conditions of blight; and lessening prejudice and discrimination against minorities.

Rev. Rul. 77-111, 1977-1 C.B. 144, held that two organizations formed to promote economic development in deteriorated areas did not qualify for exemption under IRC 501(c)(3).

In Situation 1, the organization's purpose is to increase business patronage in a deteriorated area mainly inhabited by minority groups. It accomplishes this purpose by presenting television and radio advertisements describing the advantages of shopping in the area; by creating a speakers bureau composed of local businessmen who discuss the shopping environment with various groups; by operating a telephone service providing information to prospective shoppers on

transportation and accommodations in the area; and by informing the news media on the area's problems and potential.

In Situation 2, the organization's purpose is to revive retail sales in an area suffering from continued economic decline. The organization proposes to limit further decline of retail sales within the area caused by competing, outlying shopping centers by constructing a center that would complement the area's existing retail features. The organization purchased the land for the construction of a retail center that will include a department store and a shopping mall. The land purchased by the organization was sold to the city at no economic benefit to the organization. Additional land for the project was acquired by the city through its use of eminent domain. The city rents all the land to the organization and to a private developer who actually will construct and lease out the project. The city requires that minorities be utilized in both the construction and operation of the project and stores located within the project are required to employ a certain percentage of minority group employees.

The revenue ruling holds that although the organizations' activities might contribute to achieving 501(c)(3) purposes, their overall thrust was to promote business as an end in itself rather than to accomplish exclusively exempt purposes. Rev. Rul. 77-111 distinguishes itself from Rev. Rul. 74-587 by stating that unlike the organization in Rev. Rul. 74-587, the organizations in Situations 1 and 2 do not limit their assistance to businesses located in a deteriorated area that could not obtain conventional financing. The organization described in Situation 1 does not limit its activities to businesses similar to those assisted in Rev. Rul. 74-587, but also to businesses which are not owned by minority groups and which are not experiencing difficulty because of their location in a depressed area.

The activities of the organization in Situation 2 result in major benefits accruing to the stores that will locate within the shopping center. It does not limit its aid to businesses that are owned by members of a minority group or to businesses that would only locate within the area because of the existence of the center. The end result is that the organization's activities are directed to benefit the businesses in the shopping center rather than exclusively to accomplish 501(c)(3) purposes.

In analyzing the revenue rulings, the following factors are necessary to conclude that an economic development corporation is primarily accomplishing charitable purposes despite the element of private benefit present. Assistance is targeted (1) to aid an economically depressed or

blighted area; (2) to benefit a disadvantaged group, such as minorities, the unemployed or underemployed; and (3) to aid businesses that have actually experienced difficulty in obtaining conventional financing (a) because of the deteriorated nature of the area in which they were or would be located or (b) because of their minority composition, or to aid businesses that would locate or remain in the economically depressed or blighted area and provide jobs and training to the unemployed or underemployed from such area only if the economic development corporation's assistance was available.

In the two situations described in Rev. Rul. 77-111, there was no targeting of benefits for businesses that were actually disadvantaged because of their minority-owned composition or location. There was also no targeting of benefits for businesses that would only locate or remain in an economically depressed or blighted area and provide jobs to unemployed area residents on account of the organization's activities. Merely targeting assistance to an economically depressed area is not sufficient to overcome the private benefit derived by non-charitable business beneficiaries intended to serve as instruments to accomplish charitable purposes.

In developing economic development corporation cases under IRC 501(c)(3), the emphasis should be in having the organization provide information that shows the targeted area in which it will operate as one which is economically depressed. Federal, state or local designations of an area as depressed, or studies (including maps) are helpful. The organization also should be able to show its specific criteria used in determining whether businesses are eligible for its assistance and how such criteria relate to furthering public rather than private interests.

4. Small Business Administration Organizations

Applications are often received from organizations whose sole purpose is to administer various programs regulated by the SBA. Under the Small Business Investment Act (the Act), the SBA is authorized to license SBICs that will provide capital and long-term loans to small businesses and, in some instances, provide management and technical assistance and advice on a free basis. In order to be licensed by the SBA under the original Act, thereby qualifying for various tax and other advantages, investment companies had to be incorporated as for-profit corporations, have a private paid-in capital and paid-in surplus of not less than \$150,000 (so as to insure that they will be operated soundly and profitably), and submit copies of their Articles of Incorporation and financial and other statements

for SBA consideration and approval. After an investment company is licensed, the SBA requires it to keep extensive financial records relative to all phases of its operations; these records are reviewed in accordance with the SBA's audit and examination procedures. Under the Act, the SBA is authorized to revoke or suspend a license for violation of the Act or for violation of the SBA rules and regulations promulgated under authority of the Act.

Loans made by the SBIC are generally long-term (a minimum of five years except for special provisions relative to the so-called Special Discretionary Portfolio) and must be made to businesses that qualify as small business concerns under criteria established by the SBA. Without prior SBA approval, the total funds loaned to or invested in equity securities of a particular small business may not exceed 20 percent of the paid in capital and surplus of the SBIC. An investment company is allowed to charge as its maximum rate for interest and related charges the lesser of the maximum allowable rate prescribed by applicable State and local law or 15 percent. No minimum rate is specifically set out in either the Act or the SBA regulations. The SBIC and the small business negotiate the specific terms and conditions under which the investment company will provide assistance to the small business. These terms, however, must conform to SBA regulations, and it is expected that the investment company will secure SBA approval of any transaction that is doubtful under the regulations.

As discussed in G.C.M. 38401 (June 5, 1980), the Service would be concerned with exemption for profit-seeking SBICs because transactions had to be entered with significant attention paid to profits rather than on the basis of their potential for best achieving the organization's charitable goals.

Section 301(d) licensees originally arose as a specialized administrative application of this SBA program to minority owned and managed small business enterprises. A section 301(d) licensee, like any other SBIC licensed under the Act, was originally required to be incorporated as a for-profit corporation. By Public Law 92-595, 86 Stat. 1314 (1972), Congress amended the Act to permit the incorporation and operation of section 301(d) licensees on a nonprofit basis. Before the 1972 amendment, a section 301(d) licensee was termed a "Minority Enterprise Small Business Investment Company" or "MESBIC."

Rev. Rul. 81-284, 1981-2 C.B. 130, holds that a nonprofit section 301(d) licensee which was formed to relieve poverty, eliminate prejudice and discrimination, reduce neighborhood tensions, and combat community deterioration, and that provides low-cost or long-term loans to businesses not able

to obtain funds from conventional commercial sources, with preference given to businesses that provide training and employment opportunities for the unemployed or the underemployed residents of economically depressed areas, may qualify for exemption under IRC 501(c)(3). The ruling states that unlike the organization described in Rev. Rul. 74-587, a nonprofit section 301(d) licensee is required to comply with certain regulations promulgated by the SBA. The SBA regulations permit a section 301(d) licensee to determine the terms of each loan made, including the rate of interest, according to the circumstances of each situation. Also, the SBA regulations do not require that a section 301(d) licensee operate at a profit. However, the SBA regulations do require that the interest rates charged by a section 301(d) licensee must be sufficient, in the aggregate, to recover the cost to the organization of acquiring its loan funds. Further, the SBA regulations impose various considerations that will restrict the degree of financial support that may be offered to a prospective recipient. These considerations relate to the type of business to be aided by the loan, the extent to which the recipient can provide security, and the relationship between the section 301(d) licensee and the recipient.

The principal difference between a section 301(d) licensee and the organization described in Rev. Rul. 74-587 is the presence of the limitations imposed by the SBA regulations. A section 301(d) licensee may be prevented by the SBA regulations from engaging in certain loan transactions which it might otherwise wish to engage in to further its exempt purposes. In contrast, the organization described in Rev. Rul. 74-587 is free to engage in transactions without regard to the limitations imposed by the SBA regulations. Nonetheless, the SBA regulations do not foreclose all opportunities for a section 301(d) licensee to achieve charitable purposes, nor do they compel it to enter into transactions that do not further a charitable purpose. Although a narrower range of permissible transactions is available than to the organization described in Rev. Rul. 74-587, a section 301(d) licensee may still provide loans to businesses that cannot secure financing through conventional commercial sources, the operation of which businesses will achieve charitable purposes in the manner described in Rev. Rul. 74-587.

Rev. Rul. 81-284 is not intended to imply that all section 301(d) licensees qualify for exemption under IRC 501(c)(3). The mere fact that an organization is incorporated or operated on a nonprofit basis does not qualify it for exemption under 501(c)(3). Additionally, under section 301(d) of the Act and the regulations thereunder, an organization may be properly classified as a section 301(d) licensee even though it is not organized or operated exclusively for charitable purposes.

Whether a section 301(d) licensee qualifies for exemption under 501(c)(3) depends upon the facts and circumstances of each case.

5. Lessening the Burdens of Government

As noted earlier, Regs. 1.501(c)(3)-1(d)(2) provides that the term "charitable" includes lessening the burdens of government. Rev. Ruls. 85-1 and 85-2, 1985-1 C.B. 177, 178, provide examples of organizations that qualify as exempt under IRC 501(c)(3) on the basis that they lessen the burdens of government.

The determination of whether an organization is lessening the burdens of government requires consideration of whether its activities are considered by a governmental unit to be a burden of that governmental unit, and whether such activities actually lessen such burden. To determine whether an activity is a burden of government the question to be answered is whether there is an objective manifestation by the government that it considers such activity to be part of its burden. The interrelationship between the organization and the government may provide evidence that the government considers the organization's activities to be its burden. The fact that the government expresses approval of the activity of an organization is not sufficient to establish that the organization is lessening the burdens of government.

Extreme caution should be exercised before employing a lessening the burdens rationale for an economic development corporation. An economic development corporation qualifies under lessening the burdens of government based on a preponderance facts. Look for specific identification of the organization by the local or state government as well as significant involvement by the governmental authority.

The following specific factors represent an example favoring a lessening of governmental burdens rationale for an economic development corporation.

- (1) There is a state statute specifically authorizing government funding of an economic development corporation to operate by assisting fledgling businesses within the state as a means to help alleviate severe unemployment.
- (2) The economic development corporation was established to specifically qualify under the statute and was funded under the statute.
- (3) The state statute provides that the funding is more than a mere grant but provides the state with approval authority over projects to be financed by the

corporation and approval must be obtained from the state on an ongoing basis.

- (4) As part of its assistance, the economic development corporation operates in conjunction with a state university.
- (5) The specific cities which will be the corporation's primary beneficiaries provide officials who sit on the corporation's board of directors in their official capacity.
- (6) The commissioner of the state's Department of Economic Development utilizes the corporation as an extension to carry out services formally conducted by the Department. The Department was unable to continue such services because of budgetary constraints and is not otherwise prohibited from providing such services.
- (7) The corporation is required to provide annual reports of its activities and finances to the state government.

6. Exemption under IRC 501(c)(4)

There exists among some a general belief that IRC 501(c)(4) is automatically available for failed IRC 501(c)(3) organizations. That was neither the intent of such section nor the manner in which it should be enforced.

IRC 501(c)(4) provides for exemption from federal income tax of organizations not organized for profit but operated exclusively for the promotion of social welfare. Regs. 1.501(c)(4)-1(a)(2)(i) provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community, such as by bringing about civic betterments and social improvements.

There are two revenue rulings in which economic development corporations were found to be exempt under IRC 501(c)(4). Rev. Rul. 64-187, 1964-1 C.B. 187 (Part 1), holds that a nonprofit corporation organized to provide funds through loans, to be used to purchase or develop land and facilities for industrial and commercial usage to alleviate unemployment in areas classified as "redevelopment areas" under the Area Redevelopment Act (Public Law 87-27), qualifies for exemption under IRC 501(c)(4).

Rev. Rul. 67-294, 1967-2 C.B. 193, holds that a nonprofit organization created to make loans to business entities as an inducement to locate in an economically depressed area may qualify for exemption under IRC 501(c)(4). It was concluded that by encouraging industry to settle in an economically depressed area, the organization is helping alleviate unemployment and is being operated to bring about civic betterment and social improvement.

While both of the above two organizations certainly qualify for exemption under IRC 501(c)(4), the questions left unanswered by these revenue rulings are whether the two organizations would also have qualified for exemption under 501(c)(3) and, if not, why. Operationally, it may be that the economic development corporation's criteria in selecting businesses for which it will provide assistance is too broad so it more resembles the facts in Rev. Rul. 77-111. But, it would seem that the very reason that such organization was denied exemption under IRC 501(c)(3) could also deny such organization 501(c)(4) status. For example, if the primary reason an economic development corporation is disqualified under 501(c)(3) is that its activities serve the private interests of businesses to more than an insubstantial degree, this factor may also result in disqualification under IRC 501(c)(4). IRC 501(c)(4) requires that an organization described therein be operated primarily for social welfare purposes (e.g. promoting the common good and general welfare of the community). The fact that private interests are served to a substantial degree could defeat exemption under 501(c)(4).

This article does not purport to state unequivocally that an organization which fails the operational test of the regulations underlying IRC 501(c)(3) will never qualify for exemption under 501(c)(4); however, failure to meet the requirements of the public benefit standard of IRC 501(c)(3) should raise questions about whether it can satisfy the community benefit standard of 501(c)(4). An examination of the specific activities and whether they are controlled to any significant degree by those to be benefited would be reasonable lines of inquiry.

If a case is under consideration in which an economic development corporation's exemption is under IRC 501(c)(4), it may also be wise to see whether the organization considered exemption under IRC 501(c)(3).

7. Exemption under IRC 501(c)(6)

Business leagues and chambers of commerce are often sponsors of economic development corporations. In general, a chamber of commerce is an organization

which is dedicated toward improving the general business conditions of the community.

IRC 501(c)(6) provides for the exemption from federal income tax for business leagues and chambers of commerce not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual. Regs. 1.501(c)(6)-1 provides that a business league or chamber of commerce is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. Thus, its activities should be directed toward the improvement of business conditions in one or more lines of business as distinguished from the performance of particular services for individual persons.

In Rev. Rul. 70-81, 1970-1 C.B. 131, the ruling holds that the exempt status of a chamber of commerce is not adversely affected by the development of an industrial park in order to attract new industry to the area. Sites are offered to businesses at low prices, sometimes less than cost, to induce them to locate in the community.

Rev. Rul. 81-138, 1981-1 C.B. 358, involves an exempt organization that was created by a chamber of commerce to encourage business development in a particular area. The organization obtained a mortgage to help finance the construction of a building that is leased to an industrial tenant at less than fair rental value. The ruling hold that these activities are substantially related to the chamber's exempt purpose.

The rationale for these rulings is that the exempt purpose of improving the general business conditions of a community can be accomplished by attracting new industry to the community. Moreover, the manner in which the activities were conducted demonstrated that they were not business enterprises of the kind ordinarily carried on for profit.

Economic development is seldom the sole activity of an IRC 501(c)(6) organization. Instead, economic development is often one of many activities. The above revenue rulings make it clear that the formation and operation of an economic development corporation may be in furtherance of 501(c)(6) purposes. Care should be undertaken, however, to ensure that the business league or chamber of commerce does not use the economic development corporation to provide

services to its members since this would constitute the performance of particular services prohibited by Regs. 1.501(c)(6)-1.