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**CHARITIES AND ECONOMIC DEVELOPMENT**

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# Charities and Economic Development

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Charities have been active players in community and economic development for many years. In the 1970s and 1980s, these activities often focused on the revitalization of distressed urban areas. In communities where unemployment was high, job opportunities were limited or nonexistent, and housing was inadequate and substandard, intervention in the form of economic development was considered essential to save our cities.

Over the past decade or so, the concept of economic development has broadened somewhat. Communities no longer want to hold off on pursuing economic development strategies until the bottom falls out of the local economy. The charitable sector, frequently in collaboration with institutions of higher education, state and local governments and local businesses, is beginning to take a longer range view of economic development. Many communities are pursuing preventative strategies such as the creation of economic development corporations to assist new and existing businesses and industries located in a particular geographic area through a variety of programs including loans, grants, guarantees, provision of information and expertise, and the creation of business incubators and industrial parks.

This outline briefly explains the legal standards that apply to economic development corporations seeking tax exemption as charitable organizations under Section 501(c)(3). These standards are equally applicable in the context of economic development activities by charities whose broader purposes include -- but are not limited to -- the promotion of community revitalization. The outline also summarizes the rules governing grants from foundations and charities to support economic development activities.

## I. Economic Development as a Charitable Activity

Section 501(c)(3) provides exemption for organizations formed for “charitable” purposes. The term “charitable” encompasses a number of separate purposes, including “relief of the poor and distressed,” the “promotion of social welfare by organizations designed to . . . lessen neighborhood tensions . . . or combat community deterioration and juvenile delinquency,” and “lessening the burdens of government.”<sup>1</sup> Economic development corporations can obtain exemption on the basis that their activities accomplish some or all of these purposes.

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<sup>1</sup> Treas. Reg. § 1.503(c)(3)-1(d)(2).

A. Relief of the Poor and Distressed and the Promotion of Social Welfare

The IRS recognizes that economic development activities may help to relieve the poor and distressed and to promote social welfare, in some cases by using for-profit companies as intermediaries to accomplish the desired objective. Economic development corporations may be entitled to exemption under Section 501(c)(3) even though they provide services to for-profit companies where, in the words of the IRS, “the ultimate good received by the general public outweighs the private benefit accorded to the direct beneficiaries [the for-profit companies].”<sup>2</sup>

1. Revenue Rulings

The IRS has issued several revenue rulings that outline the types of economic development activities that are appropriate for Section 501(c)(3) organizations, as well as what activities are insufficient to support exemption.

a. Rev. Rul. 74-587

In this ruling, the IRS granted exemption under Section 501(c)(3) to an organization that devoted its resources to programs to stimulate economic development in economically depressed inner city areas. The organization made loans and purchased equity interests in businesses unable to obtain funds from conventional sources because of the financial risks associated with the location. The funds were intended to help create or grow businesses and preference was given to businesses that would provide jobs and job training opportunities in the community. The activities of this organization satisfied several charitable purposes, including lessening of prejudice and discrimination, lessening neighborhood tensions, and combating community deterioration by helping to establish and rehabilitate businesses in the area.<sup>3</sup>

b. Rev. Rul. 76-419

The IRS similarly granted exemption to an organization that purchased blighted land in an economically depressed community, converted the land into an industrial park, and induced businesses to locate new facilities in the park through favorable lease terms that required employment opportunities for unemployed and underemployed residents of the area. The organization gave priority to tenants that agreed to hire low skill workers and provide job training.<sup>4</sup>

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<sup>2</sup> See, e.g., “Economic Development Corporations: Charity Through the Back Door,” by Robert Louthian and Marvin Friedlander, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for Fiscal Year 1992, at p. 151.

<sup>3</sup> Rev. Rul. 74-587, 1974-2 C.B. 162.

<sup>4</sup> Rev. Rul. 76-419, 1976-2 C.B. 146.

c. Rev. Rul. 77-111

In contrast to the rulings cited above, in this ruling the IRS denied exemption under Section 501(c)(3) to an organization whose purpose was to revive sales in a city suffering from continuing economic decline. The organization proposed to limit further decline by working with the city to construct a shopping center that would compete with retail centers located in suburbs. The shopping center space would be provided to tenants on favorable terms. The tenants would be required to hire a certain percentage of minorities. In this case, there was no showing that the businesses would not have located in the area but for the existence of the shopping center, and there was no requirement that they would provide jobs to disadvantaged residents of the area. Accordingly, the IRS concluded that the benefits provided to the businesses outweighed the public benefit and precluded exemption.<sup>5</sup>

d. Rev. Rul. 78-86

This ruling involved an organization that provided off-street parking for local merchants in an economically depressed neighborhood. While the IRS agreed that the provision of such parking helped to bring additional customers into an economically depressed neighborhood, it found that the benefits went disproportionately to the member-merchants who supported the organization. Accordingly, the IRS denied exemption on the ground that the private benefits to the businesses outweighed any public benefit.<sup>6</sup>

2. Private Letter Rulings

In addition to the precedential guidance cited above (which was issued in the 1970s), the IRS has issued several more recent private letter rulings that provide insight into its views as to the charitability of various economic development activities.

a. PLR 200103083

This private letter ruling involved a Section 501(c)(3) hospital located in an economically distressed community. The hospital owned an old building with so many environmental and other problems that it would be more cost-effective to construct a new building than to renovate the old one. The hospital explored options for disposing of the building and concluded that the best option was to donate it to a for-profit company that would undertake the necessary renovation to convert the building to office space that would be leased. The hospital provided evidence that this donation would result in the creation of some 250 – 400 jobs at the lower end of the economic spectrum. Accordingly, the IRS approved the transaction as consistent with Section 501(c)(3).<sup>7</sup>

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<sup>5</sup> Rev. Rul. 77-111, 1977-1 C.B. 144.

<sup>6</sup> Rev. Rul. 78-86, 1978-1 C.B. 151.

<sup>7</sup> PLR 200103083 (October 24, 2000).

b. PLR 9240001

In this private letter ruling, a private foundation earmarked funds for a community development organization that was affiliated with a local college and dedicated to supporting business growth in a rust-belt city suffering from high unemployment, population decline, business failures and urban decay. The organization provided engineering and technical support services as well as management and business assistance to existing and developing enterprises with the expectation that these businesses would become more competitive and expand, creating job opportunities and investment in the community. The IRS ruled that this use of funds for economic development was charitable under Section 501(c)(3).<sup>8</sup>

c. PLR 200603031

A private foundation proposed providing grants and entering into contracts and program-related investments with for-profit companies in the medical and health care industry to encourage the development of medical tools and technologies to benefit developing world populations. The IRS concluded that these activities furthered the foundation's scientific purpose by furthering research such as discovering cures for, curing, or eliminating diseases. Although not formally a part of the analysis, the ruling further suggests that the foundation's activities may be viewed as charitable on a separate basis by relieving the poor and distressed, since the primary objective was to save lives and reduce the disease burden in developing countries.

d. PLR 200614030

An organization that supported a local community college in an economically distressed area with high unemployment proposed to set up a business incubation center and pre-seed capital fund. The IRS ruled that the innovation center, which was intended to create opportunities for students and professors at the college to work with "cutting-edge" business endeavors, furthered the educational purposes of the organization. The pre-seed capital fund, which would match other investments in participating start up "high-tech" and "new-economy" businesses, furthered the organization's charitable purposes by promoting the creation of new "professional specialty occupations" that would further attract new industry, create new jobs and businesses and improve the area from an economic and social welfare perspective.

3. Summary

In the favorable revenue and private letter rulings cited above, the activities target appropriate community needs. The organizations identify businesses that are unable to access conventional means of investment capital and that will provide jobs in the community, particularly for disqualified groups.

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<sup>8</sup> PLR 9240001 (May 1, 1992).

Collectively these rulings show that the following factors are particularly important in determining whether economic development activities are consistent with the requirements of Section 501(c)(3) on the basis of the “relief of the poor and distressed” and/or “combating community deterioration” standards:

- the area being served is deteriorated and in need of revitalization;
- the activities are designed to attract businesses that would not, but for the assistance provided, choose to locate in the area; and
- the businesses are required to provide jobs for unemployed and underemployed residents of the community.

While the IRS generally expects all three of these factors to be present, the third factor may be considered the most important, since it provides the direct linkage between the economic development activity and assistance to the disadvantaged through the provision of jobs for unemployed and underemployed persons in the community.

#### B. Housing as a Tool for Relief of the Poor or Combating Community Deterioration

The provision of decent, safe and affordable housing for low-income persons and families is an important tool in promoting economic development. Rev. Rul. 67-138 holds that helping low-income families interested in building their own homes “provide[s] relief to the underprivileged ... and [is] a means of combating community deterioration.”<sup>2</sup> Similarly, Rev. Rul. 70-585 involves an organization that was formed to help the renewal of an impoverished community with deteriorated housing. The organization developed a neighborhood-wide rehabilitation plan and worked with local residents and government agencies to provide decent, safe and sanitary housing. These efforts, according to the IRS “combat[ed] community deterioration by assisting in the rehabilitation of an old and run-down residential area.”<sup>10</sup>

##### 1. Rev. Proc. 96-32

During the early 1990s, many organizations that wished to own and operate low-income housing had difficulty obtaining exemption under Section 501(c)(3) unless they represented, in their exemption application, that they would only serve a population of residents of those who were very low income (*i.e.*, 50% or below area median income). After a great deal of controversy, the IRS recognized the community benefits that accrue from the development of housing that serves a mixed-income population. Rev. Proc. 96-32, issued following a process of notice and public comment, establishes a safe harbor guideline for organizations that seek exemption under Section 501(c)(3) on the basis of

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<sup>2</sup> Rev. Rul. 67-138, 1967-1 C.B. 129.

<sup>10</sup> Rev. Rul. 70-585, 1970-2 C.B. 115.

relief of the poor and distressed. The guideline provides a safe harbor for projects in which (1) at least 20% of the units are for residents with incomes that are 50% or less of area median income or 40% of the units are for residents with income that are 60% or less of area median income; (2) on an overall basis, at least 75% of the units are for residents with incomes at 75% or less of area median income; and (3) there are rental restrictions for low-income residents to ensure that the housing is affordable. Rev. Proc. 96-32 also makes it clear that organizations may qualify for exemption without meeting the safe harbor based on other facts and circumstances.<sup>11</sup>

## 2. 501(c)(3) Organizations Serving as General Partners in Low-Income Housing Tax Credit Limited Partnerships

Rev. Proc. 96-32 has proved to be a complete success in providing concrete guidance on the standards for exemption for 501(c)(3) organizations that propose to own low-income housing projects themselves. However, many 501(c)(3) organizations want to take advantage of the low-income housing tax credit under Section 42 as a source of financing for the construction or rehabilitation of low-income housing projects. Rev. Proc. 96-32 provides no guidance in these situations, and the absence of guidance in this area has hampered the effective use of the low-income housing tax credit by Section 501(c)(3) organizations for a number of years. Several years ago a coalition of leading nonprofit housing and community development organizations asked the IRS to develop standards in this area<sup>12</sup> and the IRS is expected to issue guidance in this area in the near future.

### C. Lessening the Burdens of Government

The IRS also grants exemption under Section 501(c)(3) to organizations that serve to lessen the burdens of government. In determining whether an organization is entitled to exemption on this basis, there is a two-part test: first, the activity carried on by the organization must be a burden of the government, and second, the organization must actually lessen that burden.<sup>13</sup> Lessening the burdens of government is a difficult standard to meet, and requires a showing of more than just general government enthusiasm for a particular economic development project. The IRS looks at the following facts and circumstances, among others, in making this determination:

- whether there is a statute authorizing creation of the organization;
- the degree of control exercised by the government over the organization;

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<sup>11</sup> Rev. Proc. 96-32, 1996-1 C.B. 717.

<sup>12</sup> Letter to Steven T. Miller, Director of Exempt Organizations, TE/GE Division, Internal Revenue Service, from Michael I. Sanders and Celia Rody regarding "Proposal for Safe Harbor Guideline for Section 501(c)(3) Organizations Serving as General Partners of Tax Credit Limited Partnerships," May 2, 2002.

<sup>13</sup> Rev. Rul. 85-1, 1985-1 C.B. 177 and Rev. Rul. 85-2, 1985-1 C.B. 178.

- the organization’s interrelationship with a governmental unit;
- whether the organization’s activities were previously conducted by a government unit;
- whether the organization defrays expenses that would otherwise have to be paid by the government;
- whether the organization receives financial support from the government; and
- whether the activities carried on by the organization could be performed directly by the government.<sup>14</sup>

Although none of these factors, standing alone, is conclusive, an organization must be able to point to the existence of some of these factors to justify exemption under Section 501(c)(3) on the grounds of lessening the burdens of government.

The following rulings provide examples of how the IRS has applied the lessening the burden of government standard.

1. PLR 200537038

An organization established to attract high-technology industries to an impoverished region established an “innovation and incubator center” with commercial tenants and engaged in various other activities to entice high-technology employers to come to the area and expand the local skilled workforce. Both private and government entities provided the funding for the organization to use in its economic development activities and the organization provided letters from the state governor, the president of the largest state university and other state officials attesting to the importance of the organization in the state’s efforts to promote growth of high-technology jobs and general economic development. In this case, the IRS found that the organization’s activities lessened the burdens of government because the state considered economic development to be a crucial burden, the organization worked closely with the state and its economic development authority and the state legislature had allocated money to the organization to advance its work.<sup>15</sup>

2. PLR 9530024, PLR 9530025 & PLR 9530026

In a series of private letter rulings, the IRS ruled that a community foundation could hold a significant interest in the Kansas City Royals major league baseball franchise following

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<sup>14</sup> See, e.g., “Lessening the Burdens of Government,” by Robert Louthian and Amy Henchey, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for 1993, at p. 17.

<sup>15</sup> PLR 200537038 (June 24, 2005).

the death of its long-time owner. The purpose of the transaction was to keep the team in Kansas City and the foundation would hold the interest in non-voting stock for a limited period of time while a local buyer was identified. In finding that encouraging a sports franchise to remain in Kansas City constituted a burden of government and not merely a general government enthusiasm, the IRS cited affidavits from government officials and a county resolution demonstrating that local government units had “an intense and unique interest in professional sports franchises.” The IRS also found that the foundation’s actions actually lessened this burden of government.<sup>16</sup>

## II. Making Grants or Program-Related Investments to Economic Development Corporations and/or to Support Economic Development Projects

Charitable organizations that wish to fund economic development corporations – or to make grants or program-related investments (PRIs) to support economic development projects – need to focus on the following issues. First, if the funder is a private foundation and the grantee is not a public charity, the funder must ensure that the grant meets the grantmaking restrictions imposed on it under Section 4945 and, if applicable, the PRI restrictions under Section 4944. Second, if the funder is a public charity, it must take reasonable steps to ensure that the grant will be used for charitable purposes.

### A. Private Foundation Grantmaking Restrictions Under Section 4945

The tax law requirements applicable to private foundations that make grants to support economic development activities depend on whether (i) the grantee is a public charity, or (ii) the grantee is a private foundation or noncharitable organization.

#### 1. Grants to Public Charities

Private foundations are permitted to make grants to public charities without exercising expenditure responsibility.<sup>17</sup> As such, they are free from any formal legal obligation to conduct a pre-grant inquiry concerning the public charity grantee’s ability to use the grant funds for charitable purposes; to have a written grant letter (although it is common practice to do so); or to require the grantee to provide a written report concerning the use of grant funds. Many foundations nonetheless undertake this type of due diligence, at least in the case of grants to public charities to fund specific economic development projects.

Private foundations, like other contributors, are generally permitted to rely on the IRS determination letters issued to a public charity unless and until the IRS publishes a notice

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<sup>16</sup> PLR 9530024 (May 1, 1995), PLR 9530025 (May 1, 1995) and PLR 9530026 (May 1, 1995).

<sup>17</sup> Treas. Reg. § 53.4945-5(a)(1).

that it has revoked the organization's exempt status under Section 501(c)(3) or its public charity status under Section 509(a)(1), (2) or (3).<sup>18</sup>

Accordingly, in the case of an operating support grant to a public charity grantee, there is essentially no difference under the federal tax laws in the treatment of grants made by a private foundation and those made by another public charity. In either case, the grantor organization is permitted to make a grant in reliance on the grantee's public charity status, unless and until the IRS publishes a notice revoking that status.

Most private foundation grants to fund economic development activities are project grants rather than operating support grants. In the case of a grant to fund a specific project, a private foundation has an obligation to review the description of the proposed project to ensure that it is for charitable purposes. In reviewing the issue of whether a proposed project is for charitable purposes, a private foundation may rely on the fact that the organization disclosed the proposed project (or similar activities) in its application for exemption under Section 501(c)(3) and received a favorable determination from the IRS.

## 2. Grants to Private Foundations or Noncharitable Organizations

Section 4945 imposes certain "expenditure responsibility" restrictions on grants and PRIs by private foundations to other private foundations or to noncharitable organizations.

In general, a private foundation making a grant or a PRI to another private foundation or to a noncharitable organization to support an economic development project is required to take the following steps:<sup>19</sup>

- conduct a pre-grant inquiry to make sure that the project will serve a charitable purpose and that the grantee is qualified to undertake the project;
- enter into a written grant agreement with the grantee restricting the use of grant funds for charitable purposes and requiring the grantee to repay any funds not so used;
- require the grantee to submit written financial reports on the use of grant funds, and written narrative reports on the progress of the grant in accomplishing the intended charitable purposes;
- investigate any evidence of misuse of funds by the grantee;
- report to the IRS on Form 990-PF regarding the grantee's use of grant funds to carry out the intended charitable purposes; and

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<sup>18</sup> See, e.g., Treas. Reg. §§ 1.170A-9(e)(4)(v)(b) and 1.509-3(c)(1)(iii)(a).

<sup>19</sup> Treas. Reg. § 53.4945-5(b).

- where the grantee or PRI recipient is a noncharitable organization, require the recipient to keep the funds in a separate segregated bank account.

B. Program-Related Investment Rules Under Section 4944

1. General Rules

Section 4944 imposes an excise tax on private foundations that make speculative or high-risk investments, which are classified as “jeopardy investments.” There is an exception under Section 4944 for PRIs, which are defined as investments that meet the following requirements:

- (i) the primary purpose of the investment is to accomplish charitable purposes;
- (ii) no significant purpose of the investment is the production of income or the appreciation of property; and
- (iii) no purpose of the investment is lobbying or campaign intervention.<sup>20</sup>

PRIs accomplish a charitable purpose where they significantly further the foundation’s charitable activities and there is a direct relationship between the investment and the charitable goal such that the investment would not otherwise be made. PRI distributions of funds satisfy private foundation minimum distribution requirements. As the funds are recovered through loan payments or return of equity, they increase the minimum distribution requirements of the foundation in the year they are received.

There are a series of examples of qualifying PRIs described in the Treasury Regulations. In one, the PRI recipient was a small business owned by members of an economically disadvantaged minority group and located in a deteriorated urban area. The business was unable to acquire lending from any banks and the PRI loan carried interest below the rate that would normally be charged for commercial loans of comparable risk. This loan qualified as a PRI because it furthered a charitable goal – encouraging the economic development of certain minority groups – and did not involve legislative or political campaign activity.<sup>21</sup> A related example demonstrates that an equity investment in the small business could have qualified as well.<sup>22</sup> Other examples found in the Regulations involve a loan made to a major employer in a deteriorated urban area, and a loan to a successful publicly-traded corporation in return for its expansion into a deteriorated neighborhood.<sup>23</sup>

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<sup>20</sup> Treas. Reg. § 53.4944-3(a).

<sup>21</sup> Treas. Reg. § 53.4944-3(b), Example 1.

<sup>22</sup> Treas. Reg. § 53.4944-3(b), Example 3.

<sup>23</sup> Treas. Reg. § 53.4944-3(b), Examples 4, 5.

The regulations under Section 4945 impose additional expenditure responsibility requirements on the making of PRIs, including a requirement that the PRI be documented by a written commitment in which the recipient agrees:

- (i) to use the PRI funds only for the purposes of the investment and to repay any portion not used for such purposes;
- (ii) to submit annual financial reports of the type ordinarily required by commercial investors and a statement that it has complied with the terms of the investment;
- (iii) to maintain books and records providing information about the investment and to make them available to the foundation at reasonable times; and
- (iv) not to use funds for lobbying, campaign intervention, voter registration or if the recipient is a private foundation to make any grant that does not comply with Section 4945(d)(3) or (4).

2. Private Letter Rulings Approving PRIs for Economic Development

a. PLR 200043050

A private foundation that promoted the health, development and economic security of vulnerable children and recognized a general need for investments in greater child-care capacity created a program-related investment program of guaranteeing loans, subsidizing interest payments on loans and in some cases even depositing funds into encumbered deposit accounts at lending institutions so that child-care centers could access capital at rates they could afford and use the funds to build and expand child-care centers. The IRS approved these as program-related investments.<sup>24</sup>

b. PLR 200136026

A private foundation engaged in environmentally-friendly international development projects proposed investing in a for-profit corporation that functioned as a venture capital fund. The funds would be used to finance environmentally oriented businesses to contribute to conservation and economic development and in return the foundation expected to receive a rate of return that was significantly less than what the market expected from international venture capital fund investments of comparable risk. The IRS approved the program-related investment, primarily citing the charitability of preserving and protecting the environment relying on the fact that the fund's investments would be limited to environmental and economic development goals.<sup>25</sup>

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<sup>24</sup> PLR 200043050 (July 25, 2000).

<sup>25</sup> PLR 200136026 (June 11, 2001).

C. Public Charity Grantmaking Restrictions

Public charities are not subject to the expenditure responsibility requirements described above. Accordingly, they have more flexibility in grantmaking, although they are still required, under the tax laws, to use their funds for charitable purposes. In the case of a grant to another public charity for general operating support, a public charity funder may rely on the grantee's IRS ruling in the same manner as a private foundation, as described above. A public charity cannot make a general operating support grant to a noncharitable organization.

In the case of a grant to fund a specific project, whether conducted by another public charity, a private foundation or a noncharitable organization, the public charity funder is required to take reasonable steps to ensure that its grant funds are used for charitable purposes. Typically this involves reviewing the project to make sure that it meets fundamental charitability standards, having a written grant letter with the grantee, and requiring reports that will enable the charity to monitor the use of grant funds for the intended charitable purposes.