

Obtaining 501(c)(3) Status for Economic Development Organizations: A Guide for Attorneys

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This booklet is the first in a series of monographs published by the Community Economic Development Law Project (CEDLP) to assist volunteer attorneys in representing community-based organizations engaged in the revitalization of economically distressed communities.

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ISSUE

A representative of the Cabrini Green Business Development Association (the "Association") comes to lawyer A to request from her assistance in establishing the Association as a corporation exempt from income tax under section 501(c)(3) of the Code. The Association is already classified as an Illinois not-for-profit corporation. The representative explains that the Association is comprised of both representatives of businesses and individuals from the community. The purpose of the Association is to stimulate business in the economically-blighted Cabrini Green area. To achieve that purpose, the Association will provide low interest, unsecured loans to existing businesses. It will also spend funds for aesthetic improvement of the business shopping area. The representative explains that absent these measures, it is likely that most, if not all, businesses will shut down or relocate, thereby further adding to the deterioration of the surrounding, economically depressed community.

Question

Should lawyer A assist in completing Form 1023, the application for tax exempt status under section 501(c)(3) of the Code?

Answer

If the Association is not likely to qualify as tax exempt under 501(c)(3) (even though it may qualify as tax exempt under another subsection of 501(c))* , it may be imprudent for lawyer A to assist in completing Form 1023. Why? Completion of Form 1023 for an organization which will not obtain 501(c)(3) exempt status will result

As a general rule, business development organizations will benefit only if classified as 501(c)(3) entities. Classification as tax exempt under another section of the Code will generally not result in the desired objective -- procurement of contributions from individuals and private foundations.

in: (1) frustration to the lawyer since he or she must spend a substantial amount of time in completing the Form; and (2) a potential loss of \$300 to the organization, as the filing fee.

Business development organizations must be closely scrutinized to determine if the organization is truly a 501(c)(3), and if not, then the steps that must be taken to restructure the organization as a 501(c)(3), if the board desires to go in that direction. Careful analysis of the 501(c)(3) status of an organization prior to working on Form 1023 will save potential headaches which may otherwise occur down the road.

Section 501(c)(3) v. Section 501(c)(6).

To a layperson, the organization described on page one looks charitable. A lawyer that is not well-versed in the tax-exempt field may conclude that exempt status under section 501(c)(3) of the Code will automatically be granted for the Association upon the filing of an application. This is a wrong conclusion. It is likely that the Association would not qualify under section 501(c)(3).

Two inquiries are required for any type of not for profit business development organization: first, will it qualify as a tax exempt organization under section 501(c) of the Code; if yes, then second, will it qualify under section 501(c)(3)?

Is a business development organization in an economically depressed area a tax-exempt entity? For our purposes, a business development organization is most likely to qualify as tax exempt under either section 501(c)(3) or section 501(c)(6). Sections 501(c)(3) and 501(c)(6) prohibit earnings from inuring to the benefit of private individuals. If a business development organization were to grant low interest loans to only its members, even if the purpose of the loan was to stimulate business in an effort to increase the economic viability of the neighborhood, the organization would most likely not satisfy either 501(c)(3) or 501(c)(6). "Charitable Reaganomics," whereby benefitting businesses in an economically

depressed area also benefits the disadvantaged individuals inhabiting that area, has not yet been adopted by any Administration as an exception to the private inurement prohibition.

Assuming the first hurdle is successfully cleared and the organization will not primarily benefit its own members, then the issue for business development organizations is their ability to be classified as charitable organizations under 501(c)(3) (as opposed to being section 501(c)(6) tax exempt organizations). Section 501(c)(3) describes organizations which are organized and operated exclusively for charitable purposes. Section 501(c)(6) includes business leagues, chambers of commerce, real estate boards, boards of trade and professional football leagues.

The main difference to qualification as a 501(c)(3) versus 501(c)(6) organization is that 501(c)(6) need not prove the "charitableness" of its activities. Neither a 501(c)(3) nor a 501(c)(6) are subject to income tax (except on unrelated business taxable income). An important difference, however, is that contributions to a 501(c)(3) may be tax deductible by a donor, whereas contributions to a 501(c)(6) generally will not be tax deductible by the donor. In realistic terms, business development organizations need to be structured as 501(c)(3) entities in order to attract grants from private foundations. As a general rule, private foundations will make grants only to organizations which will fulfill the foundation's qualifying distribution requirements, most notably, section 501(c)(3) organizations.

Prior to representing any business development organization, the purpose for which the organization is established must be closely scrutinized by the practitioner and compared with those rulings which have discussed tax exempt status for business development organizations. If the purpose for which a proposed business development organization has been or will be formed does not fall within one of the recognized "charitable" business development purposes, I recommend that a practitioner seriously consider not

representing that organization in the organization's attempt to obtain 501(c)(3) status.

**Business Development Organizations
that have Failed to Obtain Tax Exempt Status
as 501(c)(3) Organizations**

"Charitable" as used in section 501(c)(3) is defined to mean the "promotion of social welfare by organizations designed to accomplish" any of the following purposes:

1. Relief of the poor and distressed or of the underprivileged;
2. Lessening of the burdens of government;
3. Lessening neighborhood tensions;
4. Eliminating prejudice and discrimination;
5. Defending human and civil rights secured by law; and
6. Combating community deterioration and juvenile delinquency.

These are the general terms under which business organizations must fall in order to be classified as 501(c)(3). The following business organizations have been found not to satisfy those general criteria:

1. An organization whose purpose was to increase business patronage in a deteriorated area which was inhabited primarily by minority groups. The organization attempted to increase business patronage by: (1) presenting television and radio advertisements describing the advantages of shopping in the area; (2) creating a speakers' bureau composed of local business people who discussed the shopping environment with various groups; (3) operating a telephone service providing information to prospective shoppers on transportation and accommodations in the area; and (4) informing the news media regarding the area's problems and shopping potential.

The Service found that the organization's activities could

contribute to the achievement of charitable purposes. Nevertheless, the "overall thrust [of these activities was] to promote business rather than to accomplish exclusively 501(c)(3) objectives." Rev. Rul. 77-111.

Note: There is an interesting negative implication in this Revenue Ruling. If the services were provided only on behalf of businesses which were owned by minority groups or which were experiencing difficulty because of their location in a deteriorated section of the community, then the providing of the aforementioned activities may have qualified as "charitable" activities. As a practical matter, this is an untried and, therefore, unrecommended avenue.

2. An organization whose purpose was to revive retail sales in an area suffering from continued economic decline. To accomplish this objective, the organization purchased land for the construction of a retail center that would complement the area's existing retail facilities. This land was sold to the city without any economic benefit to the organization. The city rented all of the land to the organization and to a private developer. No financial gain accrued to the organization. The city required that minorities be utilized in both the construction and the operation of the project. Stores located within the project were also required to employ a certain percentage of minority group employees.

The Service held that the result of the organization's activities were "to benefit the businesses in the shopping center rather than exclusively to accomplish 501(c)(3) purposes." The Service implied that its decision may have been different if only businesses owned by members of a minority group were allowed to locate in the shopping center, or if the organization could prove that businesses would locate in the area only because of the existence of the shopping center. Rev. Rul. 77-111. Cf. with Rev. Rul. 76-419, discussed infra (Is the Service making a distinction between commercial and industrial development?).

3. An organization whose stated purpose was to promote growth

and development of industrial and commercial business in a certain area, expand ownership opportunities and assist in the creation of new business ventures. The area of proposed development was not limited by the organization to an area in need of substantial rehabilitation. The Service found that the organization appeared to be organized in significant part to encourage business development as an end to itself.

"The intended operation is likely to confer significant benefits on individuals and areas that are neither uniformly impoverished nor decayed." "The absence of any more significant limitations on the specific areas and individuals to be aided, together with the absence of any indication of an intention to use business programs as a means of accomplishing section 501(c)(3) purposes," was sufficient to deny 501(c)(3) status. G.C.M. 38826 (Nov. 5, 1981). A 501(c)(3) organization may provide business assistance, according to the Ruling, provided the assistance is limited to areas in need of rehabilitation or limited to situations which eliminate discrimination, poverty, or local decay.

This opinion should warn the practitioner that careful delineation be made of the services to be provided and the area and people to be benefited.

Business Development Organizations That Have Qualified as Charitable Organizations Exempt from Tax Under Section 501(c)(3) of the Code

The following business organizations have been held to satisfy the general criteria of section 501(c)(3):

1. Business development organizations which have focused on youth employment and the training of underprivileged youth will, as a general rule, qualify as either charitable or educational 501(c)(3) organizations. See, e.g., Rev. Rul. 67-72, Rev. Rul. 73-128, Rev. Rul. 976-37.

2. An organization which devoted its resources to programs designed to stimulate economic development in high density urban areas inhabited mainly by low-income minority and other disadvantaged groups. In the area to which the organization directed its efforts many of the businesses had declined or fallen into disrepair; others had discontinued operations. To accomplish its purposes, the organization provided funds and capital to corporations or individual proprietors "who [were] not able to obtain funds from conventional commercial sources because of the poor financial risks involved in establishing and operating enterprises in these communities or because of their membership in minority or other disadvantaged groups." The financial assistance was either in the form of low cost or long term loans or the purchase of equity interest in the enterprises. Ostensibly, the organization selected recipients by an examination of those undertakings that would fulfill a community need and offered the greatest potential for community benefit. Preference was given to businesses that would provide training and employment opportunities for the unemployed or underemployed residents of the area.

Through its program of financial assistance, the organization aided minority owned businesses, thereby promoting the social welfare of the community. According to the Service, the assistance helped to lessen prejudice and discrimination against minority groups by demonstrating that the disadvantaged residents of an impoverished community could operate businesses successfully if given the opportunity and proper guidance. The assistance helped to relieve poverty, while at the same time lessening neighborhood tensions and dissatisfaction arising from the lack of employment opportunities. Moreover, the organization combated community deterioration by helping to establish businesses in the area and by rehabilitating and assisting businesses that had deteriorated.

3. An organization which purchased blighted land in an economically depressed community, converted the land into an industrial park, and encouraged industrial enterprises to locate new

facilities in the park in order to provide employment opportunities for low income residents of that area. The Service held that this organization was operated exclusively for charitable purposes. First, the organization leased lots in the park to industrial enterprises on terms sufficiently favorable to attract tenants to the economically depressed area. Second, the organization required the tenants through their leases with the organization to hire a significant number of presently unemployed persons in the area and to train them in the needed skills. Third, in selecting tenants for its industrial park, the organization considered only those industrial enterprises whose hiring policies conformed to current fair employment legislation. "By inducing industrial enterprises to locate in an economically depressed area and to hire and train the under-employed and unemployed in that area, the subject organization is similarly devoting its resources to uses that benefit the community in ways the law regards as charitable." Rev. Rul. 76-419

Pulling the Ends Together

These rulings, though creating some uncertainty as to what constitutes a legitimate 501(c)(3) business development organization, do provide the practitioner with clear "do's" and "don'ts." In order to facilitate the granting of 501(c)(3) status for a business development organization, the organization should be formed and operated for any or all of the following purposes:

1. To provide financial assistance to minority-owned organizations and low-income individuals residing in an economically depressed community or area. The boundaries of the area should be spelled out, as well as evidence indicating the financial decay of the area.
2. To enable individuals who are either low income, members of a (oppressed or underprivileged) minority or chronically unemployed to own or operate (or both) businesses and cooperatives in the area.

3. To engage in employment development, training and entrepreneurial instruction to the underprivileged and unemployed in the area. The objective of the above purposes is to follow as close as possible the fact situation in Revenue Rulings 74-587 and 76-419.

Given that Revenue Ruling 77-111 appears to cut into the breadth of 76-419, an organization which is formed for the purpose of developing vacant lots in an economically-depressed area should be extremely careful in applying for tax-exempt status. In this regard, if the organization is primarily comprised of representatives of businesses in the area, and the direct effect of stimulating further business activity in the area appears to be primarily beneficial to the current businesses, then there is a substantial risk that the Service will not grant 501(c)(3) status to the organization. This is both a private inurement question and a charitable issue. Any business development organization should be comprised primarily of individuals from the neighborhood and only secondarily by representatives of business.

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