
Economic Development as a Charitable Activity

April 5, 2017

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Agenda

- Legal Background and Why This is Important
 - Meeting Charitability Standards – What We Know
 - What About Private Benefit?
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Background: Charitable Purpose

Private foundations and public charities such as community foundations are exempt from Federal income taxation under Section 501(c)(3) of the Tax Code. To obtain and retain this privileged tax-exempt, charitable status, they must demonstrate that they are organized and operated exclusively for one or more charitable purposes. Penalties may be levied on organizations that make non-charitable expenditures.

Organizations qualified under Section 501(c)(3):

- ✓ Must serve the public interest rather than private interests
 - ✓ Activities that serve non-charitable interests must be “insubstantial”
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Background: Charitable Purpose - Organized

To demonstrate that it is “organized” for charitable purposes, a charity must show that all of its organizational documents, whether articles of incorporation, charter, by-laws or trust documents, empower it only to engage in charitable activities.

Background: Charitable Purpose - Operated

To demonstrate that it is “operated” for charitable purposes, a charity must show that, in compliance with its organizational documents, it conducts activities that serve public rather than private interests. A charity may not be operated for the benefit of private interests, such as a small group of designated individuals, the creators of the organization or their family members, or businesses that are controlled by any of these persons.

What Are the Risks For Public Charities?

- **Intermediate Sanctions** under IRC Sec. 4958 can impose penalty taxes on an organization and even individual managers for transactions that provide excessive benefits to insiders.
 - **Unrelated Business Income Tax (UBIT)**: when a public charity engages in a revenue-generating trade or business that is unrelated to its charitable purpose, it may be subject to a tax on its net profits.
 - **Loss of tax exemption** in egregious cases or for repeated violations.
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Charitable Purposes Under the Code

Per IRC 501(c)(3):

- Religious
 - Charitable
 - Scientific
 - Literary or educational
 - Testing for public safety
 - Fostering national or international amateur sports
 - Prevention of cruelty to children or animals
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Charitable Purposes Under the Treasury Regs

Per Treas. Reg. §1.501(c)(3)-1(d)(2), charitable in the “generally accepted legal sense” includes:

- Relief of poor and distressed or underprivileged
 - Advancement of education or science
 - Erection or maintenance of public buildings, monuments or works
 - Lessening the burdens of government
 - Promotion of social welfare by any of the above **OR**
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Promotion of Social Welfare By:

- Lessening neighborhood tensions
- Elimination of prejudice or discrimination
- Combatting community deterioration

Bottom line: promoting new business, jobs or economic growth is not enough - SOMETHING MORE must go hand-in-hand with economic development

“Charitable” Economic Development (Rev. Rul. 74-587)

Development targeting disadvantaged populations or economically depressed areas can qualify as charitable because it will provide relief of the poor or distressed. In this case, a charity sought to provide capital to new business through low-cost loans and purchase of equity with emphasis on those businesses that offered training and jobs. Factors supporting charitability included:

- “High density urban areas inhabited mainly by low-income minority or other disadvantaged groups,”
 - lack of capital for development; and
 - business owners with “limited entrepreneurial skills.”
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Rev. Rul. 76-419

Encouraging industry to locate in economically depressed area to provide new employment opportunities was deemed a charitable activity. In this case, the charity purchased land and developed an industrial park with favorable terms for new business.

- Location was pre-identified as economically needy
 - High unemployment or underemployment
 - Area of urban blight
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What is Not “Charitable” Economic Development (Rev. Rul. 77-11)

Two organizations formed to promote economic development in blighted areas did not operate primarily for **the relief of the poor or distressed**:

The first organization was formed to increase business patronage in a deteriorated area mainly inhabited by minority groups. Its promotional efforts included television and radio advertisements extolling the virtues of the area’s shopping as well as the formation of a speaker’s bureau through which local businessmen could meet with various groups and discuss the shopping area.

The second organization sought to revive retail sales in an economically declining area. It purchased land on which it intended to build a shopping center that would complement the area’s existing stores. The organization sold the land to the city at no economic advantage to itself and then rented the land back with a private developer. This developer would be in charge of constructing and leasing the retail space. City rules required that both the construction and operation of the center employ minorities, and the stores located in the shopping center would be required to employ a certain percentage of minority employees as well.

Neither organization, the IRS held, would qualify for charitable status. Although the activities of the business promotion group **might** contribute to the achievement of charitable purposes such as the relief of the poor and distressed, “their overall thrust is to promote business rather than to accomplish exclusively 501(c)(3) objectives.”

Negative Rulings: PLR 201327016

An organization was formed to assist families in financial need, by **providing loans, employment assistance, grants and other types of support**. However, this organization did not qualify as charitable under this ruling due to the following factors:

- The program did not establish that it lessened prejudice and discrimination against a minority group;
- it was not operating in an impoverished area or otherwise relieving poverty and lessening neighborhood tensions or combating community deterioration;
- services were not limited to businesses that were experiencing difficulty because of their location in a deteriorating area;
- there was no evidence of review and consideration of loan applications and no evidence that recipients were needy;
- payments made to for-profit businesses as an incentive to hire additional employees constituted significant private benefit to those businesses; and
- recruiting activities and the manner they were conducted were found indistinguishable from a for-profit recruiting firm.

What About Private Benefit?

- Economic development will naturally result in benefits to private individuals and businesses
 - It helps to be very clear on the charitable class or group being served and check whether all those receiving assistance are part of the class or group
 - With respect to anyone else, the benefit must be incidental (incidental is a “mere byproduct of the public benefit”)
 - Private benefit can apply to anyone
 - Private inurement is a benefit to “insiders”
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Take-Aways

Programs that target a broad and more economically diverse geographic area will have a harder time demonstrating charitability.

The mere presence of minorities or members of other disadvantaged groups will not, alone, make an area an appropriate target for economic development assistance.

The aid may not be distributed so widely that already-successful business owners will benefit. Similarly, businesses that would likely choose to locate in the area whether or not they receive assistance are not appropriate targets for aid or other incentives.

Targeting businesses that are unlikely to provide training or jobs to local residents will reduce the likelihood that a program is deemed charitable, and finally, primarily commercial activities will negate charitability.

Questions?

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