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The Nonprofit Implications of For-Profit Community Development

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I. INTRODUCTION

Nonprofit community development organizations are shifting directions. Community development activists historically focused on improving the supply and quality of affordable housing as a means to spur local economies and community health. This vision has shifted in recent years. Community organizations now have a broader vision of development. Although housing continues to play a central role in community development efforts under the new vision, other activities designed to directly improve the economic opportunities of underskilled and underemployed individuals have taken a greater role.[1]

In recent years, community development initiatives have also taken a turn toward for-profit business ventures as a means to spur local economic growth. Many nonprofit organizations are now contemplating the use of for-profit business ventures as a means to provide low- and moderate-income community residents with marketable skill sets and to infuse economic life into formerly economically depressed neighborhoods.[2] Economic revitalization of communities has become the new focus of community development.

Economic revitalization through the use of for-profit business ventures raises a number of challenges for nonprofit organizations.[3] Nonprofits may

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1. *See, e.g.*, Norman J. Glickman & Lisa J. Servon, *More than Bricks and Sticks: Five Components of Community Development Corporation Capacity*, 9 HOUSING POL'Y DEBATE 497, 501 (1998).

2. The label "for-profit" merely refers to the tax status of the organization. It is not intended to reflect the actual profitability of any particular venture. In fact, "charities' unrelated [for-profit] business activities are not very profitable." Evelyn Brody & Joseph Cordes, *The Unrelated Business Income Tax: All Bark and No Bite?*, *in* EMERGING ISSUES IN PHILANTHROPY SEMINAR SERIES 2 (Urban Inst. Ctr. On Nonprofits and philanthropy & the Harvard Univ. Hauser Ctr. For Nonprofit Orgs. 1999); *see also* Michael H. Schill, *Assessing the Role of Community Development Corporations in Inner City Economic Development*, 22 N.Y.U. REV. L. & SOC. CHANGE 753, 766 (1996-1997) (community development corporation had difficulty maintaining profitability). Additionally, a nonprofit exempt activity may actually be profitable, without endangering the organization's tax-exempt status. *E.g.*, Presbyterian & Reformed Publ'g Co. v. Comm'r, 743 F.2d 148, 156 (3d Cir. 1984).

3. The discussion in this Article is limited to the involvement of nonprofit organizations in for-profit community development activities. Of course, for-profit organizations may be present

be precluded from engaging in certain activities, may be taxed on other unrelated business income (UBI), or may be able to engage in for-profit activities without paying taxes. Understanding where the line is drawn between these categories is a difficult task for any organization. Although such an understanding will ultimately depend upon an analysis of a particular organization's business plan, this Article seeks to clarify and resolve some of the tensions between the different categories of economic revitalization activities. This Article also posits potential structural and fiscal options for nonprofit organizations in dealing with the constraints placed upon each category of activity when such activity is undertaken by a for-profit branch of a nonprofit organization.

Part II of this Article begins with a discussion of economic revitalization as a means to achieve community development, emphasizing for-profit development as a vehicle for economic growth. It also exposes the problems that have arisen in the application of economic revitalization efforts and the constraints faced by nonprofit organizations unfamiliar with the mechanisms available for for-profit development. Part III presents a hypothetical case study in which one activity may be characterized in a number of different ways. Part IV analyzes the case study in light of applicable laws, regulations, and agency guidance documents, assessing if the activity may be tax-exempt, and if so, what limitations would be placed on the activity by a decision to apply tax-exempt status to it. Part V looks at the different models of incorporation that a nonprofit might use in pursuing the activity and the legal constraints imposed by each model.

This Article concludes by positing that many activities conducted in the spirit of economic revitalization can be undertaken by nonprofit organizations, but such organizations should not blindly discount one organizational form without evaluating the benefits and attendant constraints associated with the different forms of corporate governance and expected financial flows.[4] Some nonprofit organizations may not have the resources or may be hesitant to make the transition into for-profit activities due to poor legal awareness or assuredness of their actions. For

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in such community development initiatives, and may be very valuable in spurring local economic revitalization. However, due to general economic uncertainty and poor market information in low- and middle-income communities, the for-profit sector has historically underinvested or has followed the lead of the nonprofit sector.

4. For a discussion of different organizational forms taken by nonprofits just in housing development and some of the issues associated with different organizational forms in that context, see Christopher Walker, *Nonprofit Housing Development: Status, Trends, and Prospects*, 4 HOUSING POL'Y DEBATE 369, 371-85 (1993), *available at* http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_0403_walker.pdf (last visited Nov. 1, 2004).

some organizations, the cost of transition may not be worth the benefits of classifying an activity as for-profit, as opposed to nonprofit. This Article does not assume that any form of governance or financial structure is superior to any other and does not suggest any particular structure for the case study. Instead, it is designed to caution nonprofit organizations engaged in or considering for-profit economic revitalization activities to carefully consider the advantages and disadvantages of each structure and corporate form to best ensure the intra-organizational success of the venture, the success of the revitalization initiative within the community, and the security of the organization itself.[5]

II. ECONOMIC REVITALIZATION: THE NEW MODEL OF COMMUNITY DEVELOPMENT

Community development began with the provision of affordable housing. Federal policies and grant monies, along with tax deductions, encouraged the participation of nonprofit developers in housing development.[6] Federal policies also encouraged the creation of community development corporations, which have, since the late 1950s and early 1960s, dominated the provision of nonprofit housing, providing fifteen percent of all subsidized units between 1960 and 1990.[7] These nonprofit community development corporations have focused primarily on providing and ensuring an adequate and affordable housing stock. The reasons for this are many, some of which include the availability of financing and the measurability of success of housing creation. Community development corporations have helped improve considerably the quality of the nation's housing stock; however, affordability still remains a high priority for reform.[8]

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5. *See* Brad Caftel, *Legal Structures for Business Ventures: Finding the Right Legal Structure*, GRANTSMANSHIP CENTER MAG., Winter 1997, at 11.

6. *See* OFFICE OF POL'Y DEV. & RES., DEP'T OF HOUSING AND URBAN DEV., STATUS AND PROSPECTS OF THE NONPROFIT HOUSING SECTOR, No. 6758 (1995); Katherine M. O'Regan & John M. Quigley, *Federal Policy and the Rise of Nonprofit Housing Providers*, 11 J. HOUSING RES. 297, 297 (2000).

7. O'Regan & Quigley, *supra* note 6, at 298-99; *see also* AVIS C. VIDAL, REBUILDING COMMUNITIES: A NATIONAL STUDY OF URBAN COMMUNITY DEVELOPMENT CORPORATIONS (1992) (discussing the origins as well as the organizational characteristics and resources of community development corporations).

8. *See* Stuart A. Gabriel, *Urban Housing Policy in the 1990s*, 7 HOUSING POL'Y DEBATE 673, 691 (1996).

"Sometime in the mid-1980s, the image of community development underwent a subtle but important shift. . . . Many [community development corporations] . . . concentrated their earliest efforts on housing for strategic reasons, and gradually expanded into economic development and human services as the housing program took root."[9] The community development corporations advanced this shift in part because they realized that community development is a complex system which requires multiple, simultaneous initiatives to achieve important development synergies and changed attitudes among residents and investors.[10] Housing improvements alone would not serve to revitalize distressed communities — income generation, alongside cost-of-living reductions, was necessary.

As a result of this awakening, many community development corporations and community-based organizations began to utilize economic development strategies to promote community development and for-profit business ventures to achieve such community development and economic revitalization.[11] By the late 1990s the number of social service organizations and youth agencies involved in community development had grown significantly.[12] The transition to community development presents significant capacity concerns for social service organizations that are not accustomed to undertaking initiatives designed to be economically self-sufficient over the long-term.[13] Understandably, many of these community-based organizations were reluctant to jump head-long into community economic revitalization initiatives, let alone for-profit business initiatives.

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9. LOCAL INITIATIVES SUPPORT CORP. (LISC), THE WHOLE AGENDA: THE PAST AND FUTURE OF COMMUNITY DEVELOPMENT 4-5 (n.d.), *available at* http//www.lisc.org/resources/2002/03/development_775.shtml?Social+&+Economic+Development (last visited Nov. 1, 2004).

10. *See, e.g.*, Louise A. Howells, *Looking for the Butterfly Effect: An Analysis of Urban Economic Development Under the Community Development Block Grant Program*, 16 ST. LOUIS U. PUB. L. REV. 383, 384-88 (1997). In fact, "[t]he notion of linkage [between initiatives] is critical for effective community economic development." Peter Pitegoff, *Child Care Enterprise, Community Development, and Work*, 81 GEO. L.J. 1897, 1916 (1993).

11. *See generally* TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR (Burton A. Weisbrod ed., 2000). While some community development organizations were involved in economic activities in the 1960s, this first generation of activities largely failed by most measures of performance outcomes and led to the reprioritization of housing provision until the recent redefinition of community development. *See* Schill, *supra* note 2, at 766.

12. NAT'L CONG. FOR CMTY. ECON. DEV. (NCCED), COMING OF AGE: TRENDS AND ACHIEVEMENTS OF COMMUNITY-BASED DEVELOPMENT ORGANIZATIONS 7 (1999).

13. *See* Pitegoff, *supra* note 10, at 1917.

The use by nonprofit organizations of for-profit ventures is a recent phenomenon and largely a result of some important Internal Revenue Service (IRS) rulings on the subject which somewhat clarified requirements of undertaking such a business activity.[14] Nonprofit organizations have used two main methods of interaction with the for-profit sector: creating "earned-income activities" and "strategic alliances."[15] Both of these issues are addressed by this Article. Strategic alliances can be viewed as joint partnerships between for-profit and nonprofit entities which undertake a particular initiative beneficial to both groups.[16] In a recent survey, seventy-three percent of nonprofit community development organizations had strategic alliances with for-profit corporations, sixty percent of which were initiated by the nonprofit organization.[17]

Earned-income activities, on the other hand, range from income-generating activities, such as selling goods arising from exempt activities at market rate to up-scale markets to support other, more resource-intensive and less self-sufficient initiatives,[18] to establishing an unrelated for-profit enterprise.[19] Part of the pressure to establish such activities is the need to diversify funding sources as a means to protect organizational stability:[20] "Confronted with dwindling donations and a cutback of

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14. *See, e.g.*, Rev. Rul. 74-587, 1974-2 C.B. 162; Rev. Rul. 76-419, 1976-2 C.B. 146; I.R.S., Gen. Couns. Mem. 39,883 (1992).

15. ELLEN STIEFVATER, ENTREPRENEURIAL COMMUNITY DEVELOPMENT: EXPLORING EARNED-INCOME ACTIVITIES AND STRATEGIC ALLIANCES FOR COMMUNITY-DEVELOPMENT NONPROFITS 7 (Neighborhood Reinvestment Corp. & Joint Ctr. For Hous. Studies of Harvard Univ., 2001), *available at* http://www.jchs.harvard.edu/publications/communitydevelopment/stiefvater_w01-12.pdf (last visited Nov. 1, 2004).

16. *Id.* at 9.

17. *Id.* at 19.

18. The use of for-profit subsidiaries, for example, is often used to avoid the "mission versus money" conflict in the provision of the organization's primary purpose services. *See id.* at 15-18.

19. *See id.* at 10, 12.

20. STIEFVATER, *supra* note 15, at 10; *see* Glickman & Servon, *supra* note 1, at 507 ("Healthy CDCs require a sufficiently stable funding environment to initiate operations and expand them over time."); JAMES R. HINES, JR., NONPROFIT BUSINESS ACTIVITY AND THE UNRELATED BUSINESS INCOME TAX 3 (Nat'l Bureau of Econ. Research, Working Paper No. 6820, 1998). For a discussion of various funding categories available to community development corporations generally available to community development corporations, see Note, *Community Development Corporations: Operations and Financing*, 83 HARV. L. REV. 1558, 1558-75 (1970); *see generally* Note, *Financing and Operating Community Development Corporation Business Activity*, 83 HARV. L. REV. 1592 (1970) (discussing funding categories available to community development corporations undertaking business activities).

government funding, tax-exempt organizations are increasingly engaging in commercial activities as a revenue source."[21]

In a recent survey, seventy-five percent of community development nonprofit organizations expected to increase their amount of self-generated income relative to total income by an average of twenty-five percent.[22] The view of the importance of self-sufficiency is one that nonprofit managers believe will increase in the next few years.[23] This shift is evidenced, in part, by the recent growth in for-profit ventures by nonprofits: taxable, unrelated for-profit subsidiaries grew by fifty percent between 1993 and 1998.[24] In 1993, however, the percent of unrelated business income tax (UBIT) liability was a mere 1.1% of total income.[25] As discussed below, unrelated income cannot exceed a certain percentage of total income without risking loss of nonprofit status. Although the exact percentage of allowable unrelated business income is unknown, it is generally agreed that most nonprofit organizations can increase their unrelated business income substantially without fear of revocation of their nonprofit status. Therefore, both the desire and ability of community development organizations to engage in business activities are present and will be important in the next several years. This Article analyzes a case study to assist such organizations in analyzing the issues that should guide the form and manner in which for-profit business activities operate.

III. CASE STUDY

Consider a community development corporation (CDC) that has typically been involved in rehabilitating housing and the provision of affordable housing to low- and moderate-income persons in an economically distressed community. CDC's purpose statement in its Articles of Incorporation reflects the housing mission as the primary

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21. Eric W. Sokol, Comment, *Making Tax-Exempts Pay: The Unrelated Business Income Tax and the Need for Reform*, 4 ADMIN. L.J. 527, 527-28 (1991) (footnote omitted).

22. STIEFVATER, *supra* note 15, at 12.

23. *Id.*

24. Eugene Steuerle, *When Nonprofits Conduct Exempt Activities as Taxable Enterprises*, EMERGING ISSUES IN PHILANTHROPY SEMINAR SERIES 2 (Urban Inst. Ctr. on Nonprofits and Philanthropy & the Harvard Univ. Hauser Ctr. For Nonprofit Orgs., 2000).

25. HINES, *supra* note 20, at 16, 33 tbl.3; *see also* Margaret Riley, *Unrelated Business Income Tax Returns, 1999*, STAT. INCOME BULL., Spring 2003, at 141, *available at* http://www.irs.ustreas.gov/pub/irs-soi/99eounrl.pdf (last visited Nov. 1, 2004). This low figure may be the result of deductions reducing the amount of UBIT liability, but not of total UBI. HINES, *supra* note 20, at 17. For a discussion of UBIT, see *infra* Part IV.C.3.

purpose of the organization, though the Articles allow for the organization to provide economic, social, and educational support and opportunities to residents of the community and to utilize any and all means that may accomplish the organization's purposes. CDC has provided some minor social services to the community, but the resources dedicated to those services limit their effectiveness to primarily the needs of CDC housing residents. CDC has made some below-market loans to businesses located in low-income communities, but has done so primarily to established businesses that are locally-owned and managed, going through a difficult period, or to start-up home-based businesses such as child care services. These ventures represent the exception of CDC's activities and have been primarily limited to low-risk ventures, such as lending to established enterprises with historical ability to earn positive net income, and low-cost ventures, such as home-based service companies.

Following the trend of community development, CDC has changed its outlook slightly. While still interested primarily in housing, CDC is now considering a more active role in economic revitalization. CDC contemplates establishing a training business to achieve economic revitalization.[26] After conducting surveys and other economic and financial analyses, CDC has determined that an auto repair service would be the most viable service to provide the community and would provide the greatest training return for students of the business. The business, as contemplated by CDC, would provide auto repair services to members of the lower-income community (as well as other communities) at market rate, and would train and employ under-skilled workers from the community through an auto repair training program (ARTP).

One of CDC's board members is a local auto dealer who would be willing to support the venture financially through donations, but would be willing to invest more money if the venture is established as a for-profit venture providing greater economic returns for the investment. In return for this financial support or investment, the board member would request discounted repair costs for autos sent to the member's dealership for needed tune-ups and other repair work. CDC is also considering whether

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26. A training business was selected as the case study because this example reflects the human capital-based approach of many nonprofit community development organizations and has opportunities for many different organizational forms. *See, e.g.*, LOCAL INITIATIVES SUPPORT CORP. (LISC), NATIONAL SURVEY OF URBAN ECONOMIC AND COMMUNITY DEVELOPMENT MODELS (n.d.); NCCED, *supra* note 12, at 15 (noting that nearly half of all CDCs now provide training and education programs, programs that in 1994 were of such little significance that they were not even surveyed).

the business can provide a source of income for CDC, to help support other CDC ventures.

The questions before CDC are whether to establish this business as a for-profit business or a nonprofit business, which organizational form should it take (e.g., subsidiary or part of CDC activities), to what extent CDC can control the operations of the business and whether the business should focus on the provision of permanent jobs or training greater numbers of people. Where different options may be available to CDC in undertaking the project, the difficult question is which option to select. This Article seeks to help nonprofit organizations seeking to engage in for-profit community development initiatives to contextualize these decisions based upon their own initiatives, and understand to a greater extent the impacts of selecting particular corporate forms on governance structures, financing mechanisms, and other issues of importance to community development entities.

IV. CAN ARTP'S INTENDED ACTIVITIES BE EXEMPT?

Given CDC's purpose and intended activities, ARTP can likely incorporate as either a subsidiary nonprofit or for-profit organization, and may be undertaken using a number of different organizational forms, including a limited liability corporation (LLC) or a partnership. CDC can also choose to manage and operate ARTP as an activity internal to its own management structure. This Article first discusses the ability of ARTP to be granted tax exemption under Section 501(c)(3) of the Internal Revenue Code. It then discusses general issues facing any corporate form chosen. Finally, it looks at the types of organizational forms that ARTP may take, and the impacts such forms will have on revenue sources and other corporate goals. In order to be exempt, an organization must meet both an organizational and operational test to determine its worthiness for exemption.

A. *Organizational Test*[27]

ARTP's intended purposes are almost assuredly exempt at least as a charitable organization, if not as a public charitable educational

27. The language in I.R.C. § 501(c)(3) (West 2004) states that to receive exemption, an entity must be organized "exclusively" for charitable purposes. This has been interpreted, however, not to mean "solely," but rather "primarily" for charitable purposes. Treas. Reg. § 1.501(c)(3)-1(c)(1) (2004); Treas. Reg. § 1.501(c)(3)-1(a)(1) (2004).

organization as well. Part of the organizational test is whether there exists a non-exempt purpose. ARTP's status as an exempt organization depends upon whether or not the non-exempt purpose is incidental to the exempt purposes.[28] It does not appear that the conducting of "business" activities in the form of an auto repair shop will be construed as a non-exempt purpose (or otherwise unrelated purpose) as it is necessary to fulfill the exempt purpose of training unemployed and underemployed persons.[29]

1. Charitable Organization

> The term charitable is used in section 501(c)(3) in its generally accepted legal sense. . . . Such term includes: Relief of the poor and distressed or of the underprivileged; . . . advancement of education or science; . . . and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; . . . or (iv) to combat community deterioration and juvenile delinquency.[30]

The provision of vocational training to the poor, which is deemed a charitable class, is considered "relief of the poor," and therefore worthy of tax exemption.[31] To meet this requirement, however, ARTP likely must impose a needs-test to ensure that vocational training is not provided to members of non-charitable classes. A needs-test is not required for youth trainees if such training can be linked to "promotion of social welfare" by "combat[ing] juvenile delinquency," as no nexus with the poor is required for charitable organizations that promote the social welfare.[32] Finally, the

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28. *See* Pulpit Res. v. Comm'r, 70 T.C. 594, 610 (1978); Am. Inst. for Econ. Research v. United States, 302 F.2d 934, 938 (Ct. Cl. 1962).

29. More suspect categories of activities have received exempt status. *See, e.g.*, Rev. Rul. 73-105, 1973-1 C.B. 264 (tax-exempt museum selling souvenir items not exempt); Rev. Rul. 68-167, 1968-1 C.B. 255 (assistance to needy women who cannot otherwise support themselves to help them earn income held exempt); Tech. Adv. Mem. 200021056 (May 25, 2000) (consignment shop helping "industrious and meritorious" women sell goods held exempt).

30. Treas. Reg. § 1.501(c)(3)-1(d)(2) (2004).

31. *See* Rev. Rul. 73-128, 1973-1 C.B. 222.

32. Rev. Rul. 80-215, 1980-2 C.B. 174. However, this may be a difficult means by which to achieve charitable status, as employment restrictions limit the trainee population severely to those between the ages of 16 and 18 years of age. Otherwise, a private letter determination is necessary to find out whether the IRS would consider employment of individuals under 25 years as eligible for a "combating juvenile delinquency" exemption.

community need not be in economic deterioration or decline for ARTP to qualify as charitable.[33]

2. Educational Organization

Educational organizations[34] need not provide formal classroom instruction to be considered "educational."[35] The IRS has often determined educational organizations to be both educational and charitable in nature.[36] To be an "educational" organization, the school, be it an academic, professional, or trade school, must have "a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on."[37] Training programs such as those proposed by ARTP can meet this standard.[38] The curriculum[39] factor is generally the most important of the four factors in determining the eligibility of an entity as an educational

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33. *See* Rev. Rul. 76-147, 1976-1 C.B. 151 (improving quality of life and provision of information benefited entire community, not only private interests of area's residents).

34. "Educational" is defined as relating to (1) "[t]he instruction or training of the individual for the purpose of improving or developing his capabilities;" or (2) "[t]he instruction of the public on subjects useful to the individual and beneficial to the community." Treas. Reg. § 1.501(c)(3)-1(d)(3)(i)(a)-(b) (2004). Educational organizations do not "include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to educational activities." Treas. Reg. § 1.170A-9(b)(1) (2004).

35. *See* Treas. Reg. § 1.501(c)(3)-1(d)(3)(ii); Gen. Couns. Mem. 38,015 (July 13, 1979), *rev'd on other grounds*, Gen. Couns. Mem. 39,039 (Sept. 27, 1983) ("[T]he concept of education is not static. . . . [and therefore] the relevant statutory language must be read in the light of current educational formats."). To qualify as a public educational charity, the organization's primary function must be the presentation of formal instruction. Treas. Reg. § 1.170A-9(b)(i) (2004). "Formal instruction" is defined as "disciplining mind or character within an educational framework" and/or "developing academic, technical, or vocational abilities." Gen. Couns. Mem. 38,015 (July 13, 1979), *rev'd on other grounds*, Gen. Couns. Mem. 39,039 (Sept. 27, 1983). Therefore, if the Board wanted to establish ARTP as a public educational charity (for marketing purposes, for instance), it would not be able to do so as an "activity" of CDC (though possibly as a single member limited liability corporation, though it could still conduct such exempt educational operations as a CDC "activity."

36. *E.g.*, Rev. Rul. 77-272, 1977-2 C.B. 191; Rev. Rul. 60-143, 1960-1 C.B. 192.

37. Treas. Reg. § 1.501(c)(3)-1(d)(3)(ii) (2004).

38. *See, e.g.*, Rev. Rul. 76-205, 1976-1 C.B. 154.

39. Curriculum need not be "similar to that of the conventional school or college[,]" but it must be homogeneous and provide continuity in educational programs. Gen. Couns. Mem. 33,544 (June 21, 1967). Generally, "a 'curriculum' exists whenever the instruction provided constitutes that necessary to achieve the proposed educational goal. . . . even one-subject schools and heterogenous schools . . . could come within this definition." Gen. Couns. Mem. 38,015 (July 13, 1979), *rev'd on other grounds*, Gen. Couns. Mem. 39,039 (Sept. 27, 1983).

organization.[40] Training programs can meet this standard.[41] Provision of an acceptable regular faculty should be easy under ARTP's proposed scheme with a core of experienced auto mechanics.[42] Similarly, provision of a regularly enrolled student body should not be difficult, given the length of time intended for ARTP's training program, which, at a minimum would be approximately six months.[43] Therefore, CDC must provide formal instruction by "training students in a classroom or similar place of regular attendance by teaching by a faculty a specific curriculum of study so that they may become proficient in that specific [field]."[44]

To qualify as an exempt educational organization, CDC must provide a public, not private, benefit, the benefit must be provided exclusively to a charitable class, and the charitable class must benefit in a nonselect manner.[45] This nonselect manner is important to ensure that CDC's members do not benefit disproportionately, thereby calling into question private inurement concerns.[46]

Provision of work experience in selected trades and professions to high school graduates and college students has been deemed charitable in that it advances scientific or educational goals, but has not risen to the level of an "educational organization."[47] Charitable classification via the "advancement of education" does not depend upon affiliation with a traditional educational institution, resulting in organizations teaching

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40. Gen. Couns. Mem. 38,731 (May 26, 1981).

41. *See, e.g.*, Rev. Rul. 72-101, 1972-1 C.B. 144 (craft skills courses in a particular industry were sufficiently homogenous and continuous to serve as a regularly scheduled curriculum).

42. "Faculty" is defined as "individuals who are capable of transferring knowledge to others" which "may mean . . . anyone from a holder of a doctorate in molecular biology to an experienced auto mechanic." Gen. Couns. Mem. 38,015 (July 13, 1979), *rev'd on other grounds*, Gen. Couns. Mem. 39,039 (Sept. 27, 1983).

43. *See* Rev. Rul. 69-492, 1969-2 C.B. 36 (organization that offered courses during three months every year had a regularly enrolled student body); Rev. Rul. 72-101, 1972-1 C.B. 144 (organization providing classes five days a week for six weeks had a regularly enrolled student body).

44. Gen. Couns. Mem. 37,436 (Feb. 24, 1978).

45. *See* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1076-77 (1989). This appears to mean that local residents may not be selected based upon their language capacities or race, despite the fact that such characteristics provide better services to the community, since the charitable class receiving the benefit is the unemployed trainees (unless the repair shop sells its services to the community at below market rates in order to benefit the community at large). A private letter ruling would be valuable to understand the constraints *American Campaign Academy* places upon ARTP.

46. *See infra* Part IV.C.1.

47. *See* Rev. Rul. 75-284, 1975-2 C.B. 202.

industrial skills,[48] conducting work experience programs,[49] and providing apprentice training.[50]

Since the IRS will grant an exemption if ARTP is exclusively organized for one or more exempt purposes, even if the stated purposes are incorrectly labeled, should CDC decide to operate ARTP as an exempt activity, CDC should seek exemption as both an educational and charitable organization.[51] However, CDC must also analyze whether its corporate purpose, as reflected in its Articles of Incorporation, can support ARTP's intended purposes.[52] Whether ARTP's activities are considered exempt for tax purposes when undertaken by CDC will depend upon the relationship between CDC's purpose statement and ARTP's activities.

B. *Operational Test*[53]

Only an insubstantial part of an organization's activities can be in furtherance of a non-exempt purpose.[54] Substantial business operations are allowed as exempt if those operations accomplish or are in furtherance of an exempt purpose.[55] The existence of a profit margin, while creating something of a more suspect class of an activity,[56] does not conclusively

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48. *See* Rev. Rul. 72-101, 1972-1 C.B. 144.

49. *See* Rev. Rul. 76-37, 1976-1 C.B. 148 (construction training program that sold homes substantially in the same state as they existed upon completion of the training program was held exempt).

50. *See* Rev. Rul. 67-72, 1967-1 C.B. 125.

51. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)-(2) (2004). Therefore, there does not seem to be a drawback to claiming exemption by reason of being "educational," since the exemption will be granted even if ARTP only meets the charitable standard. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(iii) (2004). An "educational organization" inherently engages in a public activity, and is therefore automatically classified as a public charity, a beneficial status for purposes of donation deductability for grantors and other fewer limitations. *See* I.R.C. § 170(b)(1)(A)(ii) (2004); FRANCES R. HILL ET AL., FEDERAL AND STATE TAXATION OF EXEMPT ORGANIZATIONS § 2.04[3][c] (1994) (discussing the test for charitable organizations that wish to be characterized as public charities).

52. *See* Bruce R. Hopkins, *You and UBIT*, EXEC. UPDATE, May 2003, *available at* http://www.centeronline.org/knowledge/article.cfm?ID=2353 (last visited Oct. 18, 2004).

53. HILL ET AL., *supra* note 51, § 2.03 (outlining the operational test). For this Article, I have limited discussion to the relevant operational tests.

54. *See* Treas. Reg. § 1.501(c)(3)-1(c)(1) (2004).

55. *See* Fed'n Pharmacy Servs., Inc. v. Comm'r, 72 T.C. 687, 691 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980).

56. While the courts have held that a parking garage was "carried on only because it is necessary for the attainment of an undeniably public end," the IRS does not follow the decision. Monterey Pub. Parking Corp. v. United States, 321 F. Supp. 972, 977 (N.D. Cal. 1970), *aff'd*, 481

establish an activity as having a non-exempt purpose:[57] "the purpose towards which an organization's activities are directed, and not the nature of the activities themselves, is ultimately dispositive of the organization's right to be classified as a section 501(c)(3) organization."[58]

Related to the operational test is the commensurate test, which assesses whether a charitable organization's activities are commensurate in scope and extent with its resources.[59] To meet these dual requirements, ARTP cannot expand beyond the needs of the community or its training capabilities, and must expend a proper amount of its resources in the training program rather than in fund-raising and other activities. This requirement should not be difficult for ARTP to meet.

C. *General Issues of Concern*

1. Private Benefit

a. Private Inurement

Some commentators suggest that the term "private" in private inurement means

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F.2d 175 (9th Cir. 1973); *see* Rev. Rul. 78-86, 1978-1 C.B. 151; *infra* text accompanying note 58 (discussing further the use of profits to determine purpose).

57. *See* Rev. Rul. 68-26, 1968-1 C.B. 272; Aid to Artisans, Inc. v. Comm'r, 71 T.C. 202, 211 (1978) ("[The] presence of profitmaking activities is not per se a bar to qualification of an organization as exempt if the activities further or advance an exempt purpose.").

58. B.S.W. Group, Inc. v. Comm'r, 70 T.C. 352, 356-57 (1978). The factors of this test were described "as the particular manner in which an organization's activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits." *Id.* at 357. The courts have also found that, while "reject[ing] the notion . . . that efficiency and success automatically negate tax-exempt status," an organization's "conduct of a growing and very profitable . . . business must embue it with some commercial hue." Presbyterian & Reformed Publ'g Co. v. Comm'r, 79 T.C. 1070, 1083, 1087 (1982). Some of the methods used to determine if an exempt activity has a "commercial hue" included the presence of substantial profits, the method of pricing of the goods, consistent and comfortable net profit margins, and competition with commercial enterprises. *Id.* at 1083-86. While the court of appeals rejected this line of reasoning, stating that "the inquiry must remain that of determining the purpose to which the increased business activity is directed," the ongoing use of such a criterion warrants caution in this area and a management structure that protects against the loss of CDC's exempt status. Presbyterian & Reformed Publ'g Co. v. Comm'r, 743 F.2d 148 (3d Cir. 1984).

59. *See* Rev. Rul. 64-182, 1964-1 C.B. 186.

> unwarranted personal benefits and other forms of non-exempt uses and purposes. Consequently, the private inurement doctrine forbids (1) the flow or transfer of income or assets of a tax-exempt organizations, that is subject to the doctrine, through or away from the organization, and (2) the use of such income or assets by one or more persons closely associated with, or for the benefit of one or more other persons with some significant relationship to, the organization, for inappropriate purposes.[60]

The IRS has stated that private "[i]nurement is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to accomplishing exempt purposes."[61] Under this view, the discounted rate for tune-ups of the board member's automobiles may not constitute private inurement, as it (1) may be considered a volume-based discount which could be available on equal terms to similar entities (though provision of such discounted rates to all entities may result in a greater size and extent of operation than warranted by the exempt purpose, and excluding such similar entities may result in a finding of private inurement) and (2) providing such a volume-based discount furthers the exempt purposes of the ARTP by providing an incentive for continued and sustained training opportunities.[62] "There is no

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60. BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 485 (8th ed. 2003). The IRS defines a private shareholder or individual as "persons who, because of their particular relationship with an organization, have an opportunity to control or influence its activities." Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

61. Gen. Couns. Mem. 38,459 (July 31, 1980).

62. The second rationale, however, when extrapolated, runs dangerously close to creating additional unfair competition with other auto repair commercial enterprises. A private letter ruling on this issue would likely be necessary to determine the reasonableness of the transaction. The reasonableness standard is "to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." Treas. Reg. § 1.162-7(b)(3) (2004). If the benefits derived by the auto dealership or Ray Lopez, as an insider, are not a "disproportionate share of the benefits of the exchange[,]" then likely the transaction will not constitute private inurement. Priv. Ltr. Rul. 91-30-002 (Mar. 19, 1991). This intent, however, must also be viewed with respect to the IRS definition of "insider" as someone who has the opportunity to invest and affect the levels of profits through referrals. Gen. Couns. Mem. 39,862 (Nov. 22, 1991). Ray Lopez clearly can affect the level of profits through referrals and, therefore, transactions or internal documents which provide him some compensation based upon ARTP profits should be made only with great care and after receiving approval from a private letter ruling. This is especially clear given the following guidelines promulgated by the IRS: "[i]nurement and private benefit may occur in many different forms, including, for example . . .

absolute prohibition against an exempt section 501(c)(3) organization dealing with its founders, members, or officers in conducting its economic affairs."[63] Some protection against the perception of self-dealing or private inurement can be achieved by requiring that a majority vote (excluding a vote by the Director involved in the transaction) be required for all transactions involving individuals that can substantially influence the decisions of the organization.[64] This is required, for example, under the New York Not-for-Profit Corporation Law.[65] A similar procedure should probably be implemented by the auto dealership as well, if such a transactional relationship is deemed desirable.

b. Private Benefit

Incidental (both qualitative and quantitative) private benefit accruing to "unrelated" third parties will not cause the loss of tax exempt status.[66] A weighing of the private benefit versus the public benefit is necessary to determine the acceptable, case-dependent limits on private benefits.[67] The benefit to the professional technicians which will form the core of the training faculty will be private benefit and not private inurement, so long as they are not able to substantially influence the operational decisions of ARTP.[68]

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receipt of less than fair market value in sales or exchanges of property. . . ." I.R.S., Hosp. Audit Guidelines, Ann. 92-83, 1992-2 2 I.R.B. 59 (June 1, 1992), 1992 WL 400443.

63. Priv. Ltr. Rul. 91-30-002 (Mar. 19, 1991).

64. *See* I.R.S., Exemption Rul. SAT GURU DHAM, Inc., (Oct. 26, 1995), *at* 1995 WL 634025. *Cf.* Priv. Ltr. Rul. 200210033 (finding organization that, among other things, required a majority vote (exclusive of affected Director) for transactions involving Directors to be exempt). ARTP would be wise to require this sort of exclusive majority vote for decisions personally affecting "private shareholders or individuals" and even "disqualified persons" under I.R.C. § 4958. *See infra* text accompanying note 72.

65. N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 2004).

66. *See, e.g.*, Redlands Surgical Serv. v. Comm'r, 113 T.C. 47, 74 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001); Priv. Ltr. Rul. 200103083 (Oct. 24, 2000).

67. This includes a quantitative and qualitative benefits analysis. *See, e.g.*, Sonora Cmty. Hosp. v. Comm'r, 46 T.C. 519, 525-26 (1966), *aff'd*, 397 F.2d 814 (9th Cir. 1968). For quantitative weighing considerations, see, e.g., Rev. Rul. 75-286, 1975-2 C.B. 210; Rev. Rul. 68-14, 1968-1 C.B. 243. For qualitative weighing considerations, see, e.g., Gen. Couns. Mem. 39,862 (Nov. 22, 1991); Gen. Couns. Mem. 37,789 (Dec. 18, 1978); Rev. Rul. 70-186, 1970-1 C.B. 128 (noting that the exempt activity cannot be conducted without incurring incidental private benefit).

68. While some day-to-day management responsibility must be provided to the faculty, the organization can be structured in a way to limit the influence the faculty has over ARTP's operations. This could include preventing their membership as officers or directors of the organization, excluding them from any profit-sharing arrangement, etc. A private letter ruling

The private benefit earned by the professional technicians must be an "insubstantial part"[69] of the organization's activities.[70] Activities constituting less than ten percent of an organization's total activities have been considered insubstantial.[71]

c. Excess Benefit Transactions

Excess benefit transactions (i.e., sanctions intermediate between revocation of exempt status and a lack of sanctions) apply only to transactions with public charitable organizations and social welfare organizations. Organizations or individuals[72] engaging in the improper transaction are taxed under a penalty excise tax and managers of the tax-exempt organization that entered into the transaction are personally at risk of receiving a penalty.[73]

2. Funding Availability

Under any of the schemes discussed below, the following revenue sources are available: a) nonprofit entities (which are assumed to be not substantially unrelated to the exempt purposes of CDC) could receive support from: (1) CDC,[74] (2) city/state job training funds, (3) bank loans,[75] (4) contributions from the auto dealer/board member (with compensation

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would be valuable with respect to this aspect of the operation as well so as to protect investments, as there will be a significant benefit to their private interests.

69. This is properly referred to as an "incidental" amount. Gen. Couns. Mem. 37,780 (Dec. 18, 1978).

70. Treas. Reg. § 1.501(c)(3)-1(c)(1) (2004).

71. *See infra* text accompanying note 84.

72. These are termed disqualified persons, which means (1) "any person . . . in a position to exercise substantial influence over the affairs of the organization" in any capacity (managerial or otherwise) "at any time during the 5-year period ending on the date of the transaction, or (2) family members of those defined above." I.R.C. § 4958(f)(1)(A)-(B) (2004).

73. *See* I.R.C. § 4958 (2004); Treas. Reg. § 53.4958-1 (as amended in 2002).

74. While CDC's dual purposes as articulated in its Articles of Incorporation of promoting economic opportunities for low-income residents of the community and providing economic, social, and educational support to residents of the community seem to avail themselves of investment-related programs, it may be necessary to clarify such a purpose in the Articles of Incorporation through amendment.

75. While a revolving training program may make the loan less desirable commercially for the bank, the Community Reinvestment Act (which requires an analysis of lending profiles to low-income areas and businesses upon mergers and acquisitions and other major corporate changes and promotes low-income lending and investment) may make ARTP an attractive capital outlet nonetheless given its impending merger.

not tied to profits or other revenue streams to protect against private inurement),[76] (5) program-related investment loans, (6) foundation support, and expenditure responsibility grants; and b) for-profit entities could receive support from (1) CDC up to a level of "incidental" unrelated business activity, (2) bank loans (for which a commercial enterprise would be a more desirable loan recipient than would a nonprofit enterprise, given Community Reinvestment Act obligations, (3) the auto dealer/board member's equity investment, (4) program-related investments,[77] and (5) expenditure responsibility grants.[78] The amounts of each of these donations depend upon the current structure of donors, the classification of the different entities (as public charitable organizations, charitable organizations, or private foundations), and the willingness of donors to provide funds under each structure.

3. Unrelated Business Income

If there is a non-exempt activity regularly carried on by a nonprofit organization that is substantially unrelated to the exempt purposes of the organization, tax exemption for that activity cannot be granted.[79] The

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76. For a discussion of conflict of interest concerns for nonprofit organizations and how to avoid such conflicts, see DANIEL L. KURTZ, NAT'L CENTER FOR NONPROFIT BOARDS, MANAGING CONFLICTS OF INTEREST: PRACTICAL GUIDELINES FOR NONPROFIT BOARDS (2001).

77. Generally, program-related investments can only be made to exempt organizations in furtherance of the foundations' exempt purposes. *See* Treas. Reg. § 53.4944-3 (2004). However, in certain circumstances, a program-related investment (PRI) loan may be made to for-profit entities to entice them to engage in behavior they would not otherwise do, and that advances the exempt purposes of the foundation. *See* Priv. Ltr. Rul. 200136026 (June 11, 2001) (PRI loan at a below market rate to for-profit enterprise to establish a plant that would provide jobs to unemployed persons when the enterprise would not otherwise establish such an enterprise was a valid loan in furtherance of the foundation's exempt purposes); *see also* Treas. Reg. § 53.4944-3(b) (2004); Priv. Ltr. Rul. 199943044 (July 26, 1999).

78. *See* Treas. Reg. § 53.4945-5(b)(4), (c)(1) (2004); Priv. Ltr. Rul. 200222034 (Mar. 5, 2002); Tech. Adv. Mem. 86-46-003 (July 21, 1986).

79. I.R.C. § 511-513 (2004); *see* Better Bus. Bureau v. United States, 326 U.S. 279, 283 (1945). There is no clear threshold between when an activity is incidental and when it becomes substantial. Some factors used in determining whether an activity is incidental to an organization's primary activities include: (1) the income derived from the unrelated activity in comparison to the organization's total income; (2) the expenditures for the unrelated activity in comparison to the organization's total expenditures; and (3) the amount of time spent working for the unrelated activity as compared to the total hours spent on the organization's entire activities. *See* Orange County Agric. Soc'y, Inc. v. Comm'r, 893 F.2d 529, 533 (2d Cir. 1990). An example of a substantially unrelated business activity is the case of New York University's ownership of Mueller Macaroni. *See* Brody & Cordes, *supra* note 2, at 1.

important question is the "relationship between the business activities which generate the particular income in question . . . and the accomplishment of the organization's exempt purposes."[80] To determine this, one must look at the size, extent, regularity, and continuity of the activity in relation to the exempt purpose.[81] One must also consider those activities that are "not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption."[82] As discussed earlier, activities constituting less than ten percent of an organization's total activities have been considered insubstantial.[83] However,

> there is no quantitative limitation on the "amount" of unrelated business an organization may engage in under section 501(c)(3) . . . there is no categorical rule as to the amount or the percentage of an organization's income or resources that must be expended for charitable use in any given period in order to fulfill the operational requirements of charitable status.[84]

Nevertheless, it seems likely that, so long as the size and extent of ARTP does not exceed its functionality as a training program, there will be no UBI[85] derived from the sale of the services performed as part of the training program, whether operated by CDC or ARTP.

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80. Louisiana Credit Union League v. United States, 693 F.2d 525, 534 (5th Cir. 1982) (quoting Treas. Reg. § 1.513-1(d)(1) (2004)).

81. Hi-Plains Hosp. v. United States, 670 F.2d 528 (5th Cir. 1982); Treas. Reg. § 1.513-1(d)(3) (2004); *see also* Hopkins, *supra* note 52 ("A business activity of a tax-exempt organization is considered to be regularly carried on if it is pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.").

82. I.R.C. § 513(a) (2004); Treas. Reg. § 1.513-1(d)(1) (2004).

83. World Family Corp. v. Comm'r, 81 T.C. 958, 961, 966 (1983), *acq. in part and nonacq. in part*, I.R.S. Acq. 1984-2 C.B. 1 (Dec. 31, 1984). Whether more than ten percent of non-exempt income will jeopardize the status of an organization as exempt will depend largely on the type and function of the particular organization. *See* Tech. Adv. Mem. 9,636,001 (Sept. 6, 1996). For community development organizations, it may be wise to operate under the ten percent rule, even if there is no clear bright line. *See* External Memorandum from Greg Maher, LISC Deputy General Counsel, to Interested Parties (Oct. 7, 1998) [hereinafter *LISC Memo*] (on file with author) ("Overview of Important Tax-Exemption Issues for Community Development Corporations (CDCs) as Charitable Entities").

84. Gen. Counsel Mem. 34,682 (Nov. 17, 1971).

85. *Compare* Rev. Rul. 76-94, 1976-1 C.B. 171, *with* Rev. Rul. 73-127, 1973-1 C.B. 221.

Where a secondary activity is a non-exempt activity carried out by an exempt organization unrelated to the exempt purposes of the exempt organization, the income derived from the unrelated business activity may be taxed under the UBIT.[86] The IRS has often ruled that income derived from goods sold through charitable training programs, where the creation of training programs are the purposes under which the organizations were established, does not create UBI.[87] The question is whether the activities producing the income contribute importantly to the advancement or accomplishment of exempt purposes.[88] Furthermore, the goods sold must be in a substantially similar state to that which was produced as a result of the exempt functions.[89] Given the information provided, this seems to be the case with respect to ARTP's services, excepting the possibility of some sophisticated services that are beyond the capabilities of trainees. While

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86. I.R.C. § 511-513 (2004); I.R.S., TAX ON UNRELATED BUSINESS INCOME OF EXEMPT ORGANIZATIONS, PUB. 598 (rev. Mar. 2000); *see also* Michael L. Sanders, *Understanding "UBIT,"* GRANTSMANSHIP CENTER MAG., Winter 1995, at 22. For a good overview of some of the categories of income that may be considered non-exempt income sources, see Jonathan A. Small, *Unrelated Business Income Tax: Structure, Current Problems, Planning Opportunities and Legislative Developments*, AM. JUR. FED. TAX ¶ 20,878 (1995). Although the UBIT has been criticized as poorly enforced and a weak threat to nonprofit organizations unfairly competing with local businesses, this criticism is beyond the scope of this Article, which shall assume that the tax is applied where appropriate. *See, e.g.*, HINES, *supra* note 20, at 7-13; Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605 (1989); John M. Strefeler & Leslie T. Miller, *Exempt Organizations: A Study of Their Nature and the Applicability of the Unrelated Business Income Tax*, 12 AKRON TAX J. 223 (1996); Sokol, *supra* note 21; *see generally* JAMES T. BENNETT & THOMAS J. DILORENZO, UNFAIR COMPETITION: THE PROFITS OF NONPROFITS 19 (1989) (discussing the increasing use of unrelated business income by nonprofits and its attendant fears that charities were "not . . . becoming more charitable, but . . . more commercial").

87. *See, e.g.*, Rev. Rul. 73-128, 1973-1 C.B. 222 (manufacture and sale of toys by un- and under-employed persons is related business income); Rev. Rul. 75-472, 1975-2 C.B. 208 (proceeds from furniture shop run by halfway house residents is related business income); Rev. Rul. 68-581, 1968-2 C.B. 250 (sale of handicraft by vocational school made by students as part of course is related business income); Priv. Ltr. Rul. 9338043 (June 29, 1993) (proceeds from business activities connected with training program for disabled persons is related business income); Priv. Ltr. Rul. 97-28-034 (Apr. 11, 1997) (proceeds from business activities connected with rehabilitation program for handicapped persons is related business income); Priv. Ltr. Rul. 85-12-084 (Dec. 31, 1984) (sale of products connected with educational programs is related business income); Priv. Ltr. Rul. 199920041 (Feb. 23, 1999) (proceeds from mushroom growing and processing plant created to employ poor and drug-addicted persons is related business income); *see also* Priv. Ltr. Rul. 97-18-034 (Feb. 5, 1997).

88. *See* Treas. Reg. § 1.513-1(d)(4)(iii) (2004). This is achieved through application of the "fragmentation rule" whereby each distinct activity is evaluated for its relatedness to the organization's exempt purpose. *See* Treas. Reg. § 1.513-1(b) (2004).

89. Treas. Reg. § 1.513-1(d)(4)(ii) (2004).

CDC was not formulated with the clear purpose of operating as a training program, one of its purposes is to promote general education so this may raise some slight issues if CDC decides to operate and control the training program. However, these issues seem fairly surmountable.

4. Profit Sharing Arrangements

While clear case law on worker cooperative arrangements is not available, it seems that such an arrangement is possible, and may be useful in avoiding CDC managerial control of ARTP. However, the administrative difficulties in establishing a worker cooperative with a regularly rotating temporary workforce (which would likely be required for an exempted activity to avoid private benefit concerns as well as to avoid any "commercial hue" which may result from the use of a permanent workforce) may make such an arrangement impracticable or undesirable. Similar administrative difficulties may lie in the creation of a profit-sharing arrangement, though a charitable organization can have a qualified profit-sharing plan[90] for its employees without endangering its status as a tax-exempt organization.[91] This is especially true where the distribution of profits is in furtherance of the organization's exempt purposes,[92] as it would be in the case of ARTP.

5. Lease Conditions

Rental income is generally considered to be passive income and thereby excluded from the UBIT. This is the case so long as CDC does not provide tenant convenience services to ARTP or otherwise make such income non-passive.[93] Although leasing industrial buildings by a charitable organization to promote development of an economically distressed county may not constitute UBI,[94] and ostensibly this could be the form that CDC's

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90. *See* I.R.C. § 401(a) (2004) (giving requirements of qualified profit-sharing plans).

91. *See* Gen. Couns. Mem. 38,283 (Feb. 15, 1980); HOPKINS, *supra* note 60, § 19.4(i); *cf.* Priv. Ltr. Rul. 84-42-064 (July 18, 1984) (noting that profit-sharing plan distributions must be reasonable to avoid classification as private inurement).

92. *See* Indus. Aid for the Blind v. Comm'r, 73 T.C. 96 (1979), *cited in* HOPKINS, *supra* note 60, at 486.

93. *Compare* Priv. Ltr. Rul. 80-24-001 (Feb. 6, 1980), *with* Priv. Ltr. Rul. 78-40-072 (July 1978), *and* Rev. Rul. 80-297, 1980-2 C.B. 196.

94. *See* Priv. Ltr. Rul. 200213027 (Dec. 21, 2001). Since ARTP ostensibly would also be employing otherwise unemployed individuals, CDC could provide rental preference to ARTP, likely regardless of its exemption status (though possibly depending upon the level of unemployment reduced by the venture). *See* Rev. Rul. 76-419, 1976-2 C.B. 146.

rental takes, given the consideration of CDC control through overlap of directors and management,[95] such discounted rental rates may be undesirable without a showing of pre-existing reduced rental rates to non-affiliated entities. While leasing of real property is not considered UBI, leasing of personal property is treated as UBI[96] and real property rental income based on profits may also be calculated as UBI.[97]

V. MODELS OF INCORPORATION

A. *ARTP as an Internal Activity*

As discussed above, ARTP's activities are not substantially unrelated from the exempt purposes for which CDC operates.[98] Therefore, the major considerations for organizing under such a scheme are organizational. These considerations include the impact that the operations of ARTP may have upon CDC's exempt status, the additional liability that ARTP activities would impose upon CDC, and the administrative capacity of CDC to effectively manage ARTP. Therefore, the extent of the operations may be of import in determining whether or not to incorporate ARTP into the internal activities of CDC. Some of these concerns may be addressed by the creation of a wholly owned single-member limited liability corporation (SMLLC), which for tax purposes is treated as an "activity" of the parent organization.

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95. *See infra* Part V.B.

96. It will be excluded from UBIT calculations only if it is "incidental," which is defined as less than ten percent of the total rental income. I.R.C. § 512(b)(3)(A)(ii) (2004). If personal property rentals exceed ten percent, but are less than fifty percent, then only the rental income derived from the personal property rentals are included in UBIT calculations. I.R.C. §§ 512(b)(3)(A)(ii), (B)(I) (2004). If the rental income derived from personal property exceeds fifty percent of the total rental income, then the total rental income will be calculated as UBIT. I.R.C. § 512(b)(3)(B)(I) (2004); Treas. Reg. § 1.512(b)-1(c)(2)(iii)(a) (2004).

97. Rental income derived as a percentage of gross receipts is not included as UBIT, but rental income derived as a percentage of net profits is included as such. Treas. Reg. § 1.512(b)-1(c)(2)(iii)(*b*) (2004), Treas. Reg. § 1.856-4(b)(3) (2004).

98. Relevant purposes in CDC's Articles of Incorporation include: providing educational support to residents of the community, promoting economic opportunities for low-income residents of the community by making land available for projects and activities that improve the quality of life in the community; and by assisting residents of the community in improving the safety and well-being of their community.

B. *ARTP as a Subsidiary of CDC*

CDC may consider establishing ARTP as a subsidiary for a number of reasons, including availability of financing, maintenance of UBI cap limitations and ensuring exempt status. Other reasons include political concerns, protection of CDC from liability, as well as administrative reasons.[99]

A tax-exempt organization is usually controlled by another organization by means of an interlocking directorate, which may encompass a number of organizational structures. One may be the right to name a majority of directors,[100] which is the creation of a membership feature of the organization, whereby special rights are granted to the member. Ownership of stock in states that allow the formation of stock-based exempt organizations,[101] is another control scheme. The requirement of a supermajority vote for decisions (with a minority vote large enough to block particular actions granted to CDC),[102] or through the requirement that certain major decisions be subject to CDC veto are still other options.[103] In the end, the amount of direct control exerted by CDC over ARTP must be balanced against other factors in an agency test, including shared offices, services, employees, etc. CDC should be particularly careful of this form of control, as the IRS closely scrutinizes these relationships to pierce the corporate veil.[104]

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99. *See, e.g., LISC Memo, supra* note 83, at 12-14; *see also* Gail Harmon, *Separate, But One: Nonprofits Keep Their Subsidiaries*, NONPROFIT TIMES, Nov. 1997, at 66; Sheri Warren Sanker, *On the Second Tier: Nonprofits Skirting UBIT via Subsidiaries*, NONPROFIT TIMES, Sept. 1996, at 33.

100. *See* Budget Reconciliation Act of 1997 (reducing the triggering percentage of control of a non-exempt subsidiary from eighty percent to fifty percent so that payments made from a controlled non-exempt subsidiary to an exempt parent, if related to a non-exempt purpose, would constitute UBI).

101. New York nonprofit corporations cannot issue stock. Fin. Ltr. Rul. 90-11 (N.Y.C. Dept. Fin., Apr. 5, 1990), *available at* 1990 WL 312682.

102. The IRS has issued no guidance on the use of supermajorities in such contexts, though it does discuss them with respect to disqualified persons and aggregates the two organizations for purposes of the Section 501(h) expenditure test. *See* HILL ET AL., *supra* note 51, § 9.03[2][b].

103. *Compare* Gen. Couns. Mem. 39,598 (Jan. 23, 1987) (finding a subsidiary with all of its directors shared by the parent organization and where the parent retained the authority to approve or disapprove major expenditures to be a separate entity), *with* Gen. Couns. Mem. 39,646 (June 30, 1987) (clarifying that such a parent-subsidiary relationship as that described in Gen. Couns. Mem. 39,598 is not without risk of attribution).

104. *See* I.R.S., *Unrelated Business Income of Nonprofit Organizations, in* COMPENDIUM OF STUDIES OF TAX-EXEMPT ORGANIZATIONS, 1989-1998, Pub. 1417, at 481 (Aug. 2002).

If the CDC, the parent, controls the day-to-day operation of the subsidiary, then it will be treated as an agent of the subsidiary.[105] Generally, attribution of the activities of the subsidiary to the parent is only made "where the evidence clearly shows that the subsidiary is merely a guise enabling the parent to carry out its . . . [disqualifying] activities or where it can be proven that the subsidiary is an arm, agent, or integral part of the parent."[106]

Perfectly identical officers and directors would be highly suspect,[107] though not conclusive in and of its own right:

> Control through ownership of stock, or power to appoint the Board of Directors, of the subsidiary will not cause the attribution of the subsidiary's activities to the parent. We do not believe that . . . [a prior general counsel memorandum] should be read to suggest, by negative inference, that when th[e] Board of Directors of a wholly-owned subsidiary is made up entirely of Board members, officers, or employees of the parent there must be attribution of the activities of the subsidiary to the parent.[108]

If the common directors are less than a majority, this factor will not weigh heavily in favor of attribution.[109] While more than a majority may weigh

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105. Gen. Couns. Mem. 39,598 (Jan. 23, 1987); *see* Krivo Indus. Supply Co. v. Nat'l Distillers & Chem. Corp., 483 F.2d 1098, 1105 (5th Cir. 1973); Gen. Couns. Mem. 35,719 (Mar. 11, 1974) (advising that to "disregard the corporate entity requires a finding that the corporation or transaction involved was a sham or fraud without any valid business purpose, or a finding of a true agency or trust relationship between the . . . entities"); *see also* Harvey Berger, *The IRS Is Watching: "Agency" Can Cause Tax Headaches*, NONPROFIT TIMES, Jan. 1, 2002, at 16.

106. Gen. Couns. Mem. 33,912 (Aug. 15, 1968); *see also* Priv. Ltr. Rul. 200132040 (Aug. 10, 2001) (noting that clear and convincing evidence is needed to determine a principal-agent relationship and providing some general considerations in determining such a relationship); Nat'l Carbide Corp. v. Comm'r, 336 U.S. 422, 437 (1949) (providing considerations in determining an agency relationship). Based upon these cases, it appears that CDC's intended relationship includes some of the factors of an agency relationship (transmitting of money between subsidiary and parent, sharing of directors, officers, and possibly employees between subsidiary and parent, and use of the parent's name (possibly even through licensing or royalty agreements). However, careful structuring can avoid some of the other factors (that the subsidiary receives no special treatment from the parent based upon its relationship with the parent, that the parent does not act as the subsidiary's agent, and that the actions of the subsidiary do not bind the parent).

107. Priv. Ltr. Rul. 86-06-056 (Nov. 14, 1985).

108. Gen. Couns. Mem. 39,598 (Jan. 23, 1987); *see also* Priv. Ltr. Rul. 88-05-059 (Nov. 13, 1987).

109. *See* Priv. Ltr. Rul. 91-19-060 (May 10, 1991); Priv. Ltr. Rul. 91-08-016 (Feb. 22, 1991); Priv. Ltr. Rul. 88-21-044 (May 27, 1988).

more heavily toward attribution, it is not sufficient.[110] Since the test is day-to-day management of operations, the IRS is more concerned about tasks like review of the minutes of the subsidiary's board meetings.[111] The overlap of officers tends to connote a greater degree of day-to-day operational control than does an overlap of directors. So long as the overlapping officers are not responsible for the day-to-day management of the subsidiary, the separate corporate entity should be upheld as valid.[112] The overlap of some officers, furthermore, will be more likely to be upheld where a majority of directors are not shared with the parent organization.[113] Similar concerns are present when employees are shared between the two entities, though the concern is greatest when those employees have managerial and financial responsibility.

While the sharing of facilities and services does not generally support attribution for either a for-profit or exempt subsidiary, all costs must be shared appropriately between the organizations, including rents for use of the same space, services, employees, and any other similar costs (e.g., benefits and payroll received from the parent), and the subsidiary must pay fair market prices for goods and services.[114] In the case of a for-profit organization, the payments from the subsidiary to the parent for shared services may constitute UBIT.[115]

1. For-Profit Subsidiary Concerns

Charitable organizations can own (either through stock, or in the case of a non-stock corporation, through interlocking directorates) for-profit enterprises[116] and can provide assets and services to taxable organizations

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110. *See* Priv. Ltr. Rul. 86-25-078 (Mar. 27, 1986).

111. Tech. Adv. Mem. 87-06-012 (Oct. 31, 1986); Priv. Ltr. Rul. 88-05-059 (Nov. 13, 1987).

112. *See* Priv. Ltr. Rul. 87-16-054 (Jan. 20, 1987).

113. *See* Priv. Ltr. Rul. 83-52-091 (Sept. 30, 1983).

114. *E.g.*, Priv. Ltr. Rul. 93-08-047 (Feb. 26, 1993); Priv. Ltr. Rul. 92-42-039 (Oct. 16, 1992); Priv. Ltr. Rul. 91-19-060 (May 10, 1991); Priv. Ltr. Rul. 86-06-056 (Nov. 14, 1985); Priv. Ltr. Rul. 84-35-162 (June 4, 1984). To avoid this problem, the organizations may wish to create a consultant relationship or a lease arrangement for employees between the two entities, reflected in a cost-plus formula. *See* Priv. Ltr. Rul. 85-04-058 (Oct. 30, 1984); Priv. Ltr. Rul. 91-19-060 (May 10, 1991); Priv. Ltr. Rul. 85-04-058 (Oct. 30, 1984).

115. *See* Rev. Rul. 72-369, 1972-2 C.B. 245; Gen. Couns. Mem. 34,716 (Dec. 20, 1971); Priv. Ltr. Rul. 86-27-053 (Apr. 4, 1986). *But see* Priv. Ltr. Rul. 85-34-003 (1985) (noting that no UBIT is levied if the services provided are substantially related to the organization's exempt purposes).

116. *See, e.g.*, Priv. Ltr. Rul. 90-16-072 (Apr. 20, 1990). This can be in equity (usually stock) unless the subsidiary is a private foundation (which will likely not be the case here).

regardless of whether the organization is wholly[117] or partially[118] owned by the exempt organization.[119] A for-profit subsidiary allows for the appreciation of stock, the dividends of which may provide cash transfers to CDC.[120] Most passive earnings from for-profit enterprises are not included in the UBIT determination,[121] unless the subsidiary is controlled by CDC.[122] Dividends (a form of passive income) provided to exempt organizations, however, are not taxable regardless of level of control CDC has over ARTP, since those dividends are not deductible by the for-profit subsidiary. Liquidation of the for-profit subsidiary presents a potential taxable issue for CDC, depending upon the amount of CDC control and the form of organization of the subsidiary corporation.[123]

All CDC relations with the for-profit subsidiary should be at fair market prices, including rental values, loans, etc., or CDC runs the risk of losing its exempt status.[124] CDC's status from a publicly supported charity (if currently classified as such) may change based on funds received from ARTP. The receipt of such funds may change the private/public ratio of funds received through a gift or dividends, for instance, since such funds

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117. The IRS has generally held that wholly owned for-profit subsidiaries do not pose private benefit concerns because the stock received is equal to the value of the assets transferred. *See, e.g.*, Priv. Ltr. Rul. 82-13-133 (Dec. 31, 1981); Priv. Ltr. Rul. 84-11-090 (Dec. 15, 1983); Priv. Ltr. Rul. 85-14-040 (Jan. 9, 1985).

118. Inurement concerns may arise if CDC owns less than 100% of ARTP, if ARTP is established as a for-profit corporation. While transfer of stock at fair market prices does not raise concerns of private inurement in the case of a corporation that is not publicly traded, determining what is the fair market value for stock can be difficult and risk inurement. Priv. Ltr. Rul. 86-06-056 (Nov. 14, 1985). This goal also competes with the desire to have minority stock holders so that CDC does not control the for-profit subsidiary and therefore receive UBIT exemption from passive income sources (such as rental income).

119. Priv. Ltr. Rul. 199938041 (Sept. 24, 1999).

120. *See* HILL ET AL., *supra* note 51, § 9.10.

121. I.R.C. § 512(b)(13) (1998); *see also supra* Part IV.C.5 (discussing that rental income is generally considered passive income and therefore excluded from a UBIT analysis).

122. Control would exist where CDC owns at least 80% of the total combined voting power of all classes of stock and at least 80% of the total remaining shares. Treas. Reg. § 1.512(b)-1(l)(4)(i)(a) (2004).

123. There are different capital gains tax issues depending upon the amount of control CDC exerts over ARTP, the form in which that control is exerted, and what CDC does with the funds afterwards (i.e., uses as an investment in another unrelated business or for charitable purposes). *See* I.R.C. §§ 337(b)(2)(A) (2004), 332(a) (1998), 337(b)(2)(B)(I) (2004), 337(c) (2004). More research needs to be done in this area to determine the most advantageous ownership arrangement, should CDC decide upon creating a for-profit subsidiary, and different structures for liquifying the for-profit subsidiary (e.g., the possibility of converting the for-profit into an exempt organization prior to dissolving the subsidiary).

124. *See, e.g.*, I.R.C. § 7872 (2000) (pertaining to interest rates on loans).

are not considered public support.[125] Additionally only a small percentage of CDC's finances should be transferred to controlled for-profit subsidiaries since such finances would be unrelated to CDC's exempt purpose.[126]

2. Nonprofit Subsidiary Concerns

If CDC's purposes allow for the incorporation of ARTP's activities into its internal management structure, why might it be advantageous to incorporate a subsidiary exempt organization? There are a number of reasons: (1) the management efficiency of the different activities may be improved; (2) UBIT may be reduced;[127] (3) the overall tax burden may be reduced;[128] (4) the subsidiary may have characteristics that CDC does not, such as a pooled income fund or ability to incorporate as a public charitable educational organization; or (5) protection of back-end tax impacts upon the liquidation of the subsidiary.[129]

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125. I.R.C. § 509(a)(2)(A) (2004); Treas. Reg. § 1.509(a)-3(a)(2) (2004). Also of potential concern is the one-third limitation to receipt of funding from such investment sources as dividends. I.R.C. § 509(a)(2)(B) (2004); Treas. Reg. § 1.509(a)-3(a)(3)(i) (2004). This consideration would not apply if CDC is considered a publicly supported organization through amendment of its bylaws to become a "supporting organization." *See* Treas. Reg. § 1.509(a)-4 (2004). While a "supporting organization" must exclusively support eligible public charitable organizations the regulations have interpreted "exclusively" to mean "primarily," thereby providing the possibility that CDC could retain its status as a "supporting organization" while still supporting a for-profit enterprise (likely if such support is incidental or not substantial). I.R.C. § 509(a)(3)(A); Treas. Reg. § 1.509(a)-4(e)(1) (2004); *see, e.g.*, Priv. Ltr. Rul. 93-05-026 (Feb. 5, 1993); Priv. Ltr. Rul. 96-37-051 (Sept. 13, 1996). To become a "supporting organization" an organization cannot have disqualified persons control the organization, with control being defined as the ability, either individually or by collectively aggregating the votes of disqualified persons, to require or prevent any act significantly affecting the organization's operations. *See* Treas. Reg. § 1.509(a)-4(j)(1) (2004). *See also supra* Part IV.C.3.

126. *See, e.g.*, Priv. Ltr. Rul. 85-05-044 (Nov. 6, 1984).

127. If CDC intends to engage in incidental unrelated business activities apart from ARTP, establishing ARTP as a separate entity would protect the exempt status of CDC if the combined unrelated business activities including those under ARTP would result in substantial unrelated business activities (thereby making null CDC's exempt status). It further appears that the UBIT calculations differ between exempt and taxable controlled subsidies and this may make ARTP more desirable as one or the other, depending upon the particular envisioned relationship and passive CDC income derived from ARTP. *See* HILL ET AL., *supra* note 51, § 9.10[2][c]; *see also* I.R.C. § 512(b)(13) (certain types of passive income collected by the parent from a controlled subsidiary is deemed UBIT).

128. *See* HILL ET AL., *supra* note 51, § 9.10[1][b].

129. Priv. Ltr. Rul. 91-04-023 (Jan. 25, 1991) (treating transfers to exempt organizations from subsidiary exempt organizations through liquidation as a return of capital as opposed to income derived from a trade or business, and therefore not subject to UBIT). This is because "[t]he problem

Even if the subsidiary does not have an exempt purpose in its own right, it may have a derivative exempt purpose by engaging in activities that "are an integral part of the exempt activities of the parent organization."[130] To earn this derivative exemption, the activity cannot be an unrelated business activity or produce UBI.[131] This derivate exemption is therefore designed for situations in which the creation of the subsidiary is simply a "matter of accounting."[132] Therefore, the subsidiary must both be owned by and provide services to the exempt parent or related exempt organizations.[133] However, there remains the question as to whether a derivatively exempt organization can have UBI.[134]

3. ARTP as a Partnership or Joint Venture

The creation of a for-profit partnership or joint venture can be a good organizational form for exempt organizations wishing to conduct unrelated business activities, so long as the general requirements discussed above for

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at which the tax on UBI is directed is primarily that of unfair competition." S. Rep. No. 81-2375, at 28-29 (1950).

130. Treas. Reg. § 1.502-1(b) (2004).

131. Geisinger Health Plan v. Comm'r, 100 T.C. 394, 402 (1993)

132. Treas. Reg. § 1.502-1(b) (2004).

133. *Id.* Ownership may be established by factors other than stock ownership. *See* Rev. Rul. 58-194, 1958-1 C.B. 240 (providing that control of a nonstock corporation based on the composition of the board is sufficient to establish a parent-subsidiary relationship for the purposes of the integral part test). "Although a technical parent-subsidiary relationship between the church and the organization is lacking because of the nonstock character of the organization, a substantially similar relationship does in fact exist through the control and close supervision of its affairs by the church." Rev. Rul. 68-26, 1968-1 C.B. 272. "Close supervision" is therefore key to establishing the parent-subsidiary relationship for the purpose of the integral part test. *See* Gen. Couns. Mem. 39,003 (Nov. 29, 1982). Control of the membership of the subsidiary's Board is generally sufficient to establish this "close supervision." *See* Gen. Couns. Mem. 39,830 (Aug. 30, 1990). Control means that "at least 80 percent of the directors or trustees of such organization are either representatives of or directly or indirectly controlled by an exempt organization." Treas. Reg. § 1.512(b)-1(l)(4)(i)(b) (2004). A director is controlled by an exempt organization "if such organization has the power to remove such trustee or director and designate a new trustee or director." *Id.*

134. *Compare* Treas. Reg. § 1.502-1(b) (2004) (derivatively exempt organization is "operated for the *sole* purpose of furnishing electric power used by its parent organization") (emphasis added), *with* Rev. Rul. 58-194, 1958-1 C.B. 240 (derivatively exempt organization provided services used "*almost exclusively* by persons connected with the university") (emphasis added), *and* Brundage v. Comm'r, 54 T.C. 1468 (1970), *acq.* 1970-2 C.B. XVIII. It is unclear whether or not the proper standard is a substantially-related test or whether the integral part test imputes a stricter standard. *See* HILL ET AL., *supra* note 51, § 9.04[4]. Finally, only "activities that are essential for fulfilling the exempt purposes of the parent exempt organization" support derivative exemption. Gen. Couns. Mem. 39,830 (Aug. 30, 1990).

subsidiary are met.[135] Also required is that participation, especially as a general partner, in the joint venture or partnership furthers CDC's exempt purpose and that the partnership allows CDC to act exclusively in furtherance of an exempt purpose.[136]

This is quite possible, and under this scheme, CDC would likely be able to sell some interest in ARTP to for-profit interests, provided that as the sale is for a reasonable price and the transfer was conducted at arm's length.[137] For this to work, only the limited for-profit partners are required to contribute capital and none of the for-profit partners nor any of the officers or directors of the not-for-profit corporation can be an officer or director of the venture. Lastly, the limited partners must have lacked control over the venture's operations.[138]

If participation in the venture is substantially related to CDC's purposes, then there would be no private benefit, even if there was ownership sharing.[139] Of key concern is to protect against operating the venture in a manner so that the "for-profit organization benefits substantially from the operation of" the tax-exempt venture.[140] It is important to note that the "commercial hue" standard of CDC may be implicated by its participation in a joint venture with a for-profit enterprise, or may result in findings of private inurement.[141]

General Counsel Memorandum 39,883 helps clarify the definition of charitable somewhat in relation to activities carried out in conjunction with for-profit businesses:

> a determination of whether a community development organization furthers charitable purposes requires an analysis of the following

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135. Technically, a joint venture or partnership is established for a for-profit motive, and therefore, is not exempt from taxation. However, a joint venture or partnership can have exclusively nonprofit members. *See LISC Memo*, *supra* note 83, at 15. *See also* Rev. Rul. 98-15 (Mar. 4, 1998).

136. *See LISC Memo*, *supra* note 83, at 15. It is not necessary that CDC control the organization to ensure that CDC will act only in furtherance of an exempt purpose. *Id.* at 16.

137. This is a recent strategy used by nonprofit community development organizations. *See* Steuerle, *supra* note 24, at 1. Between 1993 and 1998, the median nonprofit ownership of for-profit business subsidiaries dropped from ninety percent to fifty percent without an overall increase in percentage of income derived from such activities, indicating the use of such subsidiaries to generate external investment. *See id.* at 2.

138. Plumstead Theatre Soc'y, Inc. v. Comm'r, 74 T.C. 1324, 1333-34 (1980). One good indicator of control is the provision of unilateral control over the dissolution of the joint venture assets.

139. Priv. Ltr. Rul. 79-21-018 (Feb. 22, 1979).

140. Church by Mail, Inc. v. Comm'r, 765 F.2d 1387, 1392 (9th Cir. 1985).

141. *See, e.g.*, Hous. Pioneers, Inc. v. Comm'r, 65 T.C.M. (CCH) 2191 (1993).

> three factors: 1) whether assistance is being provided to help local businesses or to attract new local facilities of established outside businesses, 2) whether the type of assistance provided by the community development organization has noncommercial terms and the potential to revitalize the disadvantaged area, and 3) whether there is a nexus between the business entities assisted and relieving the problems of the disadvantaged area, or between the businesses and a disadvantaged group.[142]

Under this scheme, therefore, it may be desirable to create ARTP as an organization specifically designed to enter into joint ventures and partnerships to limit the risk faced by CDC.

C. *ARTP as a Limited Liability Corporation*

Generally, single-member LLCs (SMLLCs) do not help reduce the overall tax burden of the organization (as might a subsidiary), as the IRS treats the LLC as an "activity" of the parent company and the two incomes are combined for tax purposes.[143] However, a SMLLC may help reduce the tax burden with respect to potential environmental[144] or premises liability.[145]

VI. CONCLUSION

Community development scholars have recently begun espousing the view that the provision of housing and allied social services are not enough to spur economic revitalization of an area. Economic initiatives are now considered necessary to restore the vibrancy of business districts and community interaction. Nonprofit community development entities have slowly awakened to this necessity, but have done so hesitantly, and with good reason. Competency issues have limited the ability of nonprofit organizations to enter the sphere of economic development.[146] For many

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142. Gen. Couns. Mem. 39,883 (Oct. 16, 1992).

143. Priv. Ltr. Rul. 200134025 (May 22, 2001).

144. This may be important with respect to liability under the Comprehensive Environmental Response, Compensation and Liability Act (commonly referred to as CERCLA) given that the property currently under consideration is a former gas station, which likely has an underground storage tank.

145. This may implicate Workers' Compensation premiums, for instance.

146. For a discussion of the various competency and capacity constraints CDCs face, see generally Glickman & Servon, *supra* note 1.

organizations, those issues have been overcome with respect to economic development programs generally. However, competency gaps still exist with respect to management of for-profit businesses.

For-profit ventures offer unique and large sources of financing which, in an age of reduced per-organization support and uncertain philanthropy,[147] are very appealing. While community development and improvements have occurred throughout the country, much still needs to be done. Existing businesses are still reticent to enter low-income markets. Nonprofits therefore, for the foreseeable future, will continue to be the primary engines of revitalization in low-income and distressed communities. Nonprofits are realizing the importance of tapping into for-profit initiatives as a means to revitalize local economies both from a financing standpoint and from a sustainability viewpoint. Subsidies will not last forever and for economic revitalization efforts to be successful, a transition to market rates will be necessary at some stage. Preparing for that stage earlier will ensure greater success through that difficult transition.

The case study provided in this Article is just one of many ways in which a nonprofit organization, whether a community development corporation, community development entity, or other community based organization, can seek to fulfill its community development and economic revitalization missions through for-profit ventures. As can be seen in the analysis of the case study, ARTP can be incorporated in a number of different ways, each of which brings unique issues to bear upon the organizational form and resources available to the CDC. Nonprofit entities must evaluate whether it is wise to engage in activities as for-profit or nonprofit ventures and must consider the effects such a decision may have on the organizational form the venture can take, the financing available to the organization, and the impact any relationship between the nonprofit and the venture may have on the nonprofit's continued existence as an exempt organization. These are not easy questions to answer and all are highly context-dependent. However, as this Article has shown, these issues are surmountable and most activities can be organized and financed in a manner that will achieve the purposes of the nonprofit organization. As nonprofits venture forward into the new era of economic revitalization, they should not "resist furthering their core mission . . . through a taxable entity," as for-profit business ventures can be viable options to advance the important goal of community development.[148]

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147. *See* STIEFVATER, *supra* note 15, at 4-5.

148. *See* Steuerle, *supra* note 24, at 2.

While many options to promote economic revitalization are available to nonprofit organizations, no option is the best option under every circumstance. The challenge presented by the new movement toward for-profit community development by nonprofit development organizations is to determine which organizational form will be most appropriate for its purposes, exempt or non-exempt.