



**COMMUNITY ECONOMIC DEVELOPMENT  
LAW PROJECT**

**OBTAINING 501(c)(3) STATUS FOR  
ECONOMIC DEVELOPMENT ORGANIZATIONS**

**A GUIDE FOR ATTORNEYS**

**NOVEMBER 2008**

Obtaining 501(c)(3) Status for  
Economic Development Organizations

This booklet is published by the Community Economic Development Law Project (CEDLP) to assist volunteer attorneys in representing community-based organizations engaged in the revitalization of economically distressed communities. The CEDLP is a project sponsored by the Chicago Lawyers' Committee for Civil Rights Under Law, Inc. It is the only organized source of pro bono legal representation for community-based housing and economic development organizations in the Chicago metropolitan area.

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## Why Seek 501(c)(3) Status?

An organization that qualifies as a tax-exempt organization under Section 501(c)(3) of the Code has a distinct advantage over other tax-exempt organizations when it comes to fund-raising: Donations made to such organizations qualify as tax-deductible for the donors. This fund-raising advantage makes obtaining 501(c)(3) status very attractive to an economic development organization. Not all economic development organizations, even if they qualify as tax-exempt under section 501(c), can qualify as charitable organizations under 501(c)(3), and lawyers working with such organizations can prevent a waste of their own and an organization's resources by evaluating the organization's chances before filing an application for 501(c)(3) status with the Internal Revenue Service.

### **Example**

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

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

**Answer:** If the Association is not likely to qualify as tax exempt under 501(c)(3) (even though it may qualify as tax exempt under another subsection of 501(c)\*), it may be imprudent for lawyer A to assist in completing Form 1023. Why? Completion of Form 1023 for an organization which will not obtain 501(c)(3) exempt status will result in: (1) frustration to the lawyer and the client since they must spend a substantial amount of time in completing the Form; and (2) a potential loss of the \$300 filing fee to the organization. (The filing fee increases to \$750 if the organization has or expects to have average annual gross receipts over \$10,000.)

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

To a layperson, the organization described above looks charitable. A lawyer that is not well-versed in the tax-exempt field might conclude that exempt status under section 501(c)(3) of the Code will be granted automatically for the

Association upon the filing of an application. This conclusion would be wrong. It is likely that the Association would not qualify under section 501(c)(3).

## **Section 501(c)(3) or Section 501(c)(6)?**

Two inquiries are required for any type of not-for-profit business development organization. First, will it qualify as a tax-exempt organization under section 501(c) of the Code? If yes, then second, will it qualify as a charitable organization under section 501(c)(3)?

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

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

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

## **Assessing the Organization’s Chances**

Before representing any business development organization, the practitioner must closely scrutinize the purpose for which the organization is established and compare it with the stated purpose in those rulings which have discussed tax exempt status for business development organizations. If the purpose for which a proposed business development organization has been or will be formed does not fall within one of the recognized

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

“charitable” business development purposes, the practitioner should seriously counsel the organization against applying for 501(c)(3) status because it is unlikely to obtain 501(c)(3) status.

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

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

The purposes of a business organization must fall under these general terms in order for the organization to be classified as a 501(c)(3) organization.

### **Failure to Qualify**

The Service has determined that the following business organizations did not satisfy the general criteria for obtaining 501(c)(3) status:

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

The Service found that the organization’s activities could contribute to the achievement of charitable purposes. Nevertheless, the “overall thrust [of these activities was] to promote business rather than to accomplish exclusively 501(c)(3) objectives.” Rev. Rul. 77-111.

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

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

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

3. An organization whose stated purpose was to promote growth and development of industrial and commercial business in a certain area, expand ownership opportunities and assist in the creation of new business ventures. The area of proposed development was not limited by the organization to an area in need of substantial rehabilitation. The Service found that the organization appeared to be organized in significant part to encourage business development as an end to itself. "The intended operation is likely to confer significant benefits on individuals and areas that are neither uniformly impoverished nor decayed."

"The absence of any more significant limitations on the specific areas and individuals to be aided, together with the absence of any indication of an intention to use business programs as a means of accomplishing section 501(c)(3) purposes," was sufficient to deny 501(c)(3) status. G.C.M. 38826 (Nov. 5, 1981). A 501(c)(3) organization may provide business assistance, according to the Service, provided the assistance is limited to areas in need of rehabilitation or limited to situations which eliminate discrimination, poverty, or local decay.

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

## **Success Stories**

The Service has ruled that the following business organizations satisfied the general criteria of section 501(c)(3):

1. Business development organizations that focus on employment and jobs skills training and the training of underprivileged youth as a general rule will qualify as either charitable or educational 501(c)(3) organizations. See, e.g., Rev. Rul. 67-72, Rev. Rul. 73-128, Rev. Rul. 76-37.

2. An organization that devoted its resources to programs designed to stimulate economic development in high density urban areas inhabited mainly by low-income minority and other disadvantaged groups. In the area to which the organization directed its efforts many of the businesses had declined or fallen into disrepair; others had

discontinued operations. To accomplish its purposes, the organization provided funds and capital to “corporations or individual proprietors who [were] not able to obtain funds from conventional commercial sources because of the poor financial risks involved in establishing and operating enterprises in these communities or because of their membership in minority or other disadvantaged groups.” The financial assistance was either in the form of low cost or long term loans or the purchase of equity interest in the enterprises. Ostensibly, the organization selected recipients by an examination of those undertakings that would fulfill a community need and offered the greatest potential for community benefit. Preference was given to businesses that would provide training and employment opportunities for the unemployed or underemployed residents of the area.

Through its program of financial assistance, the organization aided minority owned businesses, thereby promoting the social welfare of the community. According to the Service, the assistance helped to lessen prejudice and discrimination against minority groups by demonstrating that the disadvantaged residents of an impoverished community could operate businesses successfully if given the opportunity and proper guidance. The assistance helped to relieve poverty, while at the same time lessening neighborhood tensions and dissatisfaction arising from the lack of employment opportunities. Moreover, the organization combated community deterioration by helping to establish business in the area and by rehabilitating and assisting businesses that had deteriorated. Rev. Rul. 74-587 (amplified by Rev. Rul. 81-284).

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

4. An organization that operated a technical assistance program for cities, states, federal agencies and section 501(c)(3) organizations and a training program offering educational activities for economic and housing development professionals. The organization (i) provided advice to local non-profit development companies and community organizations on obtaining governmental financial assistance for efforts to increase job opportunities and foster economic development in economically disadvantaged communities, (ii) trained organizations to further economic development by activities such as fostering business ownership by members of minority groups and other disadvantaged groups in the community, and (iii) provided management counseling to businesses owned and staffed by members of disadvantaged groups in distressed areas, including Enterprise Zones, urban renewal areas, targeted investment areas, and low income neighborhoods. Although the organization charged fees for its technical assistance program services, these fees were set on a sliding scale based on ability to pay and were substantially less than the cost of providing the services, which were not available to the target group from any private sector organization, so the provision of these services qualified as a charitable activity under 501(c)(3). The training program involved training in the technical skills needed to run programs aimed at improving the economic status of depressed areas and disadvantaged persons and building minority-owned businesses; the training was provided to

economic development and housing development professionals either free or for a nominal fee. The training program qualified as educational under 501(c)(3). PLR/TAM 9431001.

5. An organization, formed to fight community deterioration in an economically depressed area where a major loss of population and jobs had occurred, that cooperated with government agencies and community groups to attract new businesses to the area and to provide stable sources of decent affordable housing in the area. The organization received government funding to build affordable housing units for low and moderate-income families and, as part of its activities, made down payment assistance available to eligible home buyers to help purchase the new housing units and offered financial counseling seminars and other educational activities to prepare buyers for home ownership. The Service distinguished the down payment assistance provided by this organization, which arose from “detached and disinterested generosity,” from another situation in which down payment assistance represented a rebate or price adjustment incident to a sale and thus was attributable to an anticipated economic benefit rather than disinterested generosity. Rev. Rul. 2006-27.

## **Tips for Practitioners**

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

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

The objective of the above purposes is to follow as close as possible the fact situation in Revenue Rulings 74-587 and 76-419.

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





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