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Although the Tax Reform Act of 1969 has produced a variety of changes, none have been so substantial as those governing privately supported charities. This article analyzes new Code provisions in terms of their operational significance to the tax exempt community development corporation. The author concludes that while a community development corporation may avoid being treated as a private foundation, or at least avoid some of the harsher incidents of that status, to do so may seriously hamper its operating efficiency. Consequently, the author suggests that a community development corporation, not expecting large amounts of governmental funding, should consider seeking a tax exemption under provisions of the Code other than those granting charitable exemptions.

I. INTRODUCTION

DE TOCQUEVILLE once commented that in no other country of the world do the citizens make such exertions for the common weal. True as this might have been and may still be, American beneficence has been inadequate to satisfy all of our societal needs. Today, there exists in this country a substantial number of persons who have been unable to prove their economic worth in what has become the most technologically advanced society in history. These are the poor. Data as to their number is readily available.[1] The available statistical data is misleading, however, since a satisfactory definition of poverty should signify more than the mere non-attainment of a defined income level. It is rather the relative inability to purchase the aggregate of "necessities" made

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[1] In 1970, approximately 25.5 million persons, 12.6% of the total population, earned less than $3,968 per year, the so-called poverty line for a family of four residing in an urban area. U.S. BUREAU OF THE CENSUS, CURRENT POPULATION REPORTS 2-4 (Series P-60, No. 77, May 7, 1971). An additional 10.2 million persons earned not more than $4,960 per year. *Id.* at 8.

available by our productive capacity. These include safe, sanitary and decent housing facilities,[2] municipal services adequate to meet existing needs,[3] consumer goods obtained under "reasonable" terms and conditions,[4] an education approaching that available to the more affluent,[5] and, generally, participation in the institutions which provide one with the financial and psychological ability to achieve.[6] Moreover, poverty is a selfnurturing process. The greater one's inability to "purchase" certain goods and services deemed to be essential by society the less is the likelihood that the individual and his progeny will attain full economic participation in our society.[7]

Surprisingly, most federal programs to date have been little more than attempts to sustain people at a "poverty level"[8] or to make

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[2] REPORT OF THE NATIONAL ADVISORY COMMISSION ON CIVIL DISORDERS 467-74 (1968); G. STERNLIEB, THE TENEMENT LANDLORD 76-86 (1966).

[3] *See, e.g.*, Hadnott v. City of Prattville, 309 F. Supp. 967 (M.D. Ala. 1970), where the court after finding no racial discrimination, upheld a method of financing certain municipal services on the basis of a taxpayer's ability to pay for them. *But cf.* Hawkins v. Town of Shaw, Mississippi, 437 F. 2d 1286, 1293 (5th Cir. 1971) (concurring opinion).

[4] REPORT OF THE NATIONAL ADVISORY COMMISSION ON CIVIL DISORDERS 274-77 (1968); T. CROSS, BLACK CAPITALISM 44-55, 168, 214-19 (1969).

[5] A. WISE, RICH SCHOOLS, POOR SCHOOLS: THE PROMISE OF EQUAL EDUCATIONAL OPPORTUNITY (1969); Coons, Clune & Sugarman, *Educational Opportunity: A Workable Constitutional Test for State Financial Structures*, 57 CALIF. L. REV. 305, 307-12 (1969). *But see* OFFICE OF EDUCATION, EQUALITY OF EDUCATIONAL OPPORTUNITY 316 (1969), the so-called "Coleman Report," which concluded on the evidence compiled that there was little correlation between the amount expended per pupil and the quality of education received.

[6] As one commentator has observed:

> "One is poor not because he has no money, but because, possibly owing to lack of money, he lacks also access to the social instrumentalities that make humanly significant action possible. In part, it is a simple matter of not having the price of admission. . . . But in larger part it is a matter of not having the character or competence . . . that establishes one's capability of taking up an opportunity . . . ."

Haworth, *Deprivation and the Good City*, in POWER, POVERTY AND URBAN POLICY 39 (1968). *See generally* Goodpaster, *An Introduction to the Community Development Corporation*, 46 J. URB. LAW 603 (1969); Phemister & Hildebrand, *The Use of Non-Profit Corporations and Cooperatives for Ghetto Economic Development*, 48 J. URB. LAW 181, 181-88 (1970).

[7] For example, many authorities have concluded that the amount of dollars expended per pupil bears a direct relationship to the quality of education the pupil receives. To the extent that per student expenditure is determined by the aggregate tax base of the community, a low tax base will produce a low educational output. Compare the conclusions of Coons, Clune & Sugarman, *supra* note 5 (a community with a low tax base is unable to provide adequately for the education of its youth) with the conclusions of L. THUROW, POVERTY AND DISCRIMINATION 37-39 (1969) (quality education is one of the more effective ways of eliminating poverty).

[8] *See, e.g.*, Social Security Act of 1935, 42 U.S.C. §§ 301-06 (aid for the blind), 1351-55 (aid for the permanently and totally disabled), §§ 601-610 (aid to families with dependent children) (Supp. V, 1969).

living at that level somewhat more tolerable.[9] More surprising is the fact that most litigation on behalf of poor persons has either been designed to produce, or, in fact, has produced, little more than the same results.[10]

It is the challenge of securing for the poor a greater economic share of and a stake in our society to which the community development corporation directs itself. It attempts to achieve this goal not by litigative or legislative advocacy,[11] but rather by creating an economic environment within a narrowly defined community conducive to participation by persons heretofore excluded from the mainstream of economic life. The purpose of this article is to explore the extent to which federal income tax policy, and more particularly, the Tax Reform Act of 1969[12] affects the ability of a community development corporation to achieve that goal. Because community development corporations can and do operate in a variety of ways, for ease of discussion it is assumed that the

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[9] *See, e.g.*, United States Housing Act of 1937, 42 U.S.C. §§ 1401-36 (Supp. V, 1969) (public housing); Housing and Urban Development Act of 1965, § 101, 12 U.S.C. § 1701s (Supp. IV, 1968) (rent supplement payments for persons residing in non-profit and/or limited distribution sponsored housing). There are, however, two notable exceptions. First is the Manpower Development and Training Act of 1962, 42 U.S.C. §§ 2571-2620 (Supp. V, 1969), which provides private enterprise with a financial incentive to train or retrain the unemployed. Second is Title I-D of the Economic Opportunity Act of 1964, 42 U.S.C. §§ 2763-68 (Supp. V, 1969), which is designed to provide large sums of money to local community development corporations in order to more adequately deal with problems of "dependency, chronic unemployment and rising community tensions."

[10] *E.g.*, Goldberg v. Kelly, 397 U.S. 254 (1970) (due process requires that a welfare recipient be given a hearing prior to the termination of welfare benefits); Shapiro v. Thompson, 394 U.S. 618 (1969) (a state must grant public assistance to qualified persons irrespective of the length of their residence in that state); King v. Smith, 392 U.S. 309 (1968) (children residing in a home where unrelated males also reside are entitled to AFDC benefits); Javins v. First National Realty Corp., 428 F.2d 1071 (D.C. Cir.), *cert. denied*, 400 U.S. 925 (1970) (a tenant of a substandard dwelling is entitled to a pro rata reduction in rent for the depreciated value of the unit); Escalera v. New York Housing Authority, 425 F.2d 853 (2d Cir.), *cert. denied*, 400 U.S. 853 (1970) (*Goldberg* rationale applied to public housing lease terminations); Edwards v. Habib, 397 F.2d 687 (D.C. Cir. 1968), *cert. denied*, 393 U.S. 1016 (1969) (a tenant is protected from an eviction motivated by the tenant's having reported housing code violations to the appropriate enforcing agency).

For the most part, litigation designed to secure a greater share of governmental largess to the poor has been unsuccessful. *See, e.g.*, Dandridge v. Williams, 397 U.S. 471 (1970); Ward v. Winstead, 314 F. Supp. 1225 (D. Miss. 1970), *appeal dismissed*, ___ U.S. ___ (1971); McInnis v. Shapiro, 293 F. Supp. 327 (N.D. Ill. 1968), *aff'd sub nom.* McInnis v. Ogilvie, 394 U.S. 322 (1969).

[11] A community development corporation exempt from federal income taxation under section 501(c)(3) of the Internal Revenue Code of 1954 [hereinafter cited as I.R.C.] is prohibited from expending any substantial effort in the legislative arena. For a discussion of this prohibition and its impact on a charitable organization see Note, *The Revenue Code and a Charity's Politics*, 73 YALE L.J. 661 (1964).

[12] Pub. L. No. 91-172, 83 Stat. 487 (1969).

corporate activities are centered in a community where: (1) there exists a substantial number of substandard dwelling units; (2) unemployment far exceeds the national average; (3) few of the industrial, commercial, retail and service facilities in the community are owned, controlled, or operated by the residents of that community; and (4) the aggregate community income is so low as to be unable to support retail or service facilities sufficient to meet everyday requirements. The corporation desires to stem the tide of economic decay by attracting venture capital and using that capital to create businesses which will employ and train a maximum number of community residents. After the point in time at which those businesses reach a satisfactory level of profitability, the ownership thereof will be transferred, in whole or in part, to community residents.[13]

II. THE COMMUNITY DEVELOPMENT CORPORATION

A. *The Case for the Community Development Corporation as a Non-Profit Entity*

It can be said with little fear of contradiction that all community development corporations possess the common goals of controlling the economic resources within a particular community and using those resources for the benefit of persons residing in that community. To achieve those goals it is necessary to utilize an entity most appropriate to maintain community control while at the same time allowing for the conduct of business activities. In addition, that entity must be structured so as to provide the financial incentives necessary to attract the needed capital.

Traditionally, an enterprise desiring to engage in business activities and seeking the equity capital to do so has found in the business corporation the opportunity to attract large amounts of capital from a variety of sources and, at the same time, provide the greatest degree of flexibility in operation.[14] For a community development corporation, however, this approach is likely to result in the production of a small amount of equity capital because of the community's inability to aggregate sufficient capital to make a substantial investment.[15]

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[13] For an analysis of the problems of stock distributions by a community development corporation see Miller, *Community Capitalism and the Community Self-Determination Act*, 6 HARV. J .LEGIS. 413, 451-55 (1969); Note, *Community Development Corporations: Operations and Financing*, 83 HARV. L. REV. 1559, 1614-1627 (1970).

[14] 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 21 (1959); C. ISRAELS, CORPORATE PRACTICE 29-45 (2d ed. 1969).

[15] *Cf.* Note, *supra* note 13, at 1616-17.

Faced with this likelihood, the community development corporation must seek much of its equity from without the community, while still seeking to prevent dilution of intra-community control. It is in the attempt to satisfy the competing goals of community control and capital attraction that a community development entity organized as a business corporation is most likely to fail. Assuming statutory authority to do so, it might issue non-voting common or preferred stock.[16] Unfortunately the typical investor will in all likelihood demand some accountability from the organization in which his funds are invested, assuming no ready market through which he can recoup that investment. Accountability in a corporate context usually presupposes some form of voting control or voting power, something which the community development corporation desires to avoid with respect to "outsiders." While it is possible to achieve accountability at the sacrifice of only short run control by issuing redeemable voting stock, care must be taken to assure potential investors that the later redemption will not be treated as a dividend.[17] More important, funds necessary for redemption might better be applied to furthering the purposes for which the development corporation was organized. Further, investors generally desire an adequate return from their investment, in the form of either dividends or an increase in the value of their stock. Given the kinds of ventures in which community development corporations typically engage, an attractive return, at least in the short run, is highly speculative.[18] Consequently the market for community development corporation stock outside the community would be limited, at best.

Because the financial incentives available to equity investors in the business corporation are virtually non-existent in the community development corporation, the entity ought to be organized in such a manner as to create a different kind of incentive, one accruing at the time of the initial investment rather than at some future date. By casting the entity as a non-profit corporation, permitting qualification as a charity under the Internal Revenue Code, the corporation may provide such an immediate incentive in the form of the charitable

[16] Illinois appears to be the only state which prohibits a corporation from issuing non-voting stock of any class or kind. *See* ILL. REV. STAT. Ch. 32 § 157.28 (1954).

[17] I.R.C. § 302.

[18] ECCO, an economic development corporation in Columbus, Ohio, has formed a business subsidiary, the ECCO Development Corporation. Estimates are that the subsidiary will generate no funds available for dividends for "several years." Note, *The Neighborhood Development Corporation: A Case Study of the East Central Citizen's Organization*, 1970 U. ILL. L.F. 49, 64 (1970). This comports with the experience of Action Industries Inc. in Venice, California. *See* Note, *supra* note 13, at 1570.

deduction allowed to those contributing funds.[19] Postponing for a moment the possibility of charitable status for the organization, the question is whether a non-profit corporation can engage in business activities to the same extent as a business corporation. It is now clear in most states that the non-profit nature of an organization does not preclude its undertaking any activity, including those traditionally undertaken only by business corporations.[20] For purposes of this discussion, the only relevant distinction is the non-profit corporation's incapacity to distribute its net earnings to members, directors or officers.[21]

B. *The Community Development Corporation as a Charitable Organization*

Should the corporation obtain non-profit status, so as to qualify more easily as a charity under the Internal Revenue Code, the resultant exemption will restrict not only the ability to distribute proceeds of any business venture but its authority to engage in such a venture as well. Organizations exempt from federal income taxation are those

> . . . organized and operated exclusively for . . . charitable . . . purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation and which does not participate in or intervene in . . . any political campaign on behalf of any candidate for public office.[22]

An organization satisfying the statutory criteria, in addition to being

[19] It is arguable that one inclined to invest in a community development corporation is better off financially if his investment is treated as a charitable contribution rather than a stock purchase. This may be illustrated by a perhaps overly simplified example. Assume an individual in a 50% tax bracket possesses $5,000 in cash which may be used either for the purchase of stock or for a charitable contribution. If that $5,000 is used to purchase stock, it *may* be recovered at some later date with or without appreciation. In addition, the investor *may* receive dividends, either in cash or stock. The same $5,000 donated to charity, will result in a permanent loss to cash flow of $2,500 but the balance, produced as a result of tax savings, may be invested at normal or above normal rates of return, resulting in an assured return of the full $5,000 at some definable time.

[20] MODEL NON-PROFIT CORP. ACT § 26 (1964). *See, e.g.*, OHIO REV. CODE ANN. § 1702.01 (Baldwin 1971). *See generally* H. OLECK, NON-PROFIT CORPORATIONS, ORGANIZATIONS AND ASSOCIATIONS 3, 115 (2d ed. 1965); Lesher, *The Non-Profit Corporation — A Neglected Step Child Comes of Age*, 22 BUS. LAWYER 951 (1967); Phemister & Hildebrand, *supra* note 6.

[21] There are, of course, other major differences, for example: to whom the assets must be distributed on dissolution; the inability to issue shares which reflect an indicia of ownership in the corporation; and the increased supervisory powers of the Secretary of State. *See* MODEL NON-PROFIT CORP. ACT §§ 26, 46, 87-90 (1964).

[22] I.R.C. § 501 (c)(3).

exempt from federal taxation, acquires the ability to attract funds by reason of the charitable deduction granted to donors by the Code.[23]

Assuming that the articles of incorporation are appropriately drafted,[24] the question remains whether the activities of a community development corporation are such as to qualify it for a charitable exemption. The answer to this question depends upon how charity is defined for purposes of the Code and the effect of business activities on that definition. Charity is not expressly defined in the Code. Rather the definition corresponds to its generally accepted historical meaning[25] which has been variously stated as: "trusts, for the *relief of poverty*; trusts for the advancement of education; trusts for the advancement of religion; and trusts for *purposes beneficial to the community, not falling under any of the preceding heads*;"[26] organizations " 'such as are calculated to relieve the poor and to promote such education and *employment* as the laws of the land recognize as useful;' "[27] or organizations which contain "any benevolent or philanthropic objective not prohibited by law or public policy which tends to advance the well-doing and well-being of man."[28] Thus, charity is something more than "mere almsgiving, or relief of poverty."[29] It includes undertakings which are deemed by society, at any given time, to be generally beneficial to an indeterminate but substantial number of persons.

Treasury Department regulations generally follow this broad notion of charity. They define charity to include "[r]elief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science . . . lessening the burdens of Government . . . lessen[ing] neighborhood tensions and eliminat[ing] prejudice and discrimination . . . ."[30] The regulations, like most judicial interpretations, are too broad to be definitive.

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23 I.R.C. § 170(a)(1).

24 *See* Treas. Reg. § 1.501 (c)(3)-1(b)&(c) (1959).

25 Rev. Rul. 67-325, 1967-2 CUM. BULL. 113; Reiling, *Federal Income Taxation: What is a Charitable Organization?*, 44 A.B.A.J. 525, 526 (1958).

26 Commissioner For Special Purposes of the Income Tax v. Pensel, [1891] A.C. 531, 583 (emphasis added). The fourth category has been one of constant concern to courts both here and in the British Commonwealth. For a comprehensive, albeit confusing, analysis of how that concern has been reflected see Fridman, *Charities and Public Benefit*, 31 CAN. B. REV. 537 (1953).

27 Jackson v. Phillips, 96 Mass. 539, 555 (1867) (emphasis added); *cf.* Kain v. Gibboney, 101 U.S. 362, 365 (1879).

28 Peters v. Comm'r, 21 T.C. 55, 59 (1953). *See also* Arthur Jordan Foundation v. Comm'r, 210 F. 2d 885, 888 (7th Cir. 1954).

29 Schell v. Leander Clark College, 10 F.2d 542, 553 (N.D. Iowa 1926).

30 Treas. Reg. 1.501 (c)(3)-1(d)(2) (1959).

Therefore, to determine whether a community development corporation is charitable one must look to the rationale for providing tax exemptions to charitable organizations.

The rationale behind charitable exemptions appears to be founded on two interrelated yet distinct notions. The first is that the charity is expending its funds for programs which, if not privately financed, might otherwise have to be undertaken by the government with public funds.[31] This reason, however, merely poses the question why all of the income of all organizations should not be taxed at perhaps a higher rate, thereby providing the funds necessary to do what private philanthropy is now doing? The answer, quite simply (and this is the second basis upon which the tax exemption rationale rests), is that our society feels very strongly that privately supported endeavors are superior to a substantial assumption of those activities by a governmental body. Private philanthropy is thought to provide the best means for achieving creativity, experimentation and flexibility. In addition it insures, in this area at least, the maintenance of a pluralistic balance between government and the private sector.[32] That being the rationale, and our assumption being that the primary purpose of the community development corporation is to provide employment opportunities, on-the-job training and ownership of economic resources by those previously excluded therefrom, it is necessary to determine whether the model community development corporation described earlier fits within the rationale for a charitable exemption.

Some commentators have suggested that the creation of new business enterprises in deteriorating areas does fit the rationale for a charitable exemption,[33] and indeed some community development

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[31] Helvering v. Bliss, 293 U.S. 144 (1934). Watson v. U.S. 355 F.2d 269 (3d Cir. 1965). Harrison v. Barker Annuity Fund, 90 F. 2d 286, 288 (7th Cir. 1937). Young Men's Christian Association of Germantown v. City of Philadelphia, 323 Pa. 401, 413; 187 A. 204, 210 (1936). *See* H.R. REP. NO. 1860, 75th Cong., 3rd Sess. 19, 20 (1938); A. JOHNSON, PUBLIC POLICY AND PRIVATE CHARITIES 1 (1931); Note, *Tax Exemptions of American Church Properties*, 14 MICH. L. REV. 646, 647 (1916).

[32] *See* TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS, 89th Cong., 1st Sess. 5 (Comm. Print 1965) (prepared for the House Committee on Ways and Means) [hereinafter cited as TREASURY REPORT]; *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 6, at 5346-5402 (1969) [hereinafter cited as *Senate Hearings*]; *Hearings on Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 1, at 79-89 (1969) [hereinafter cited as *House Hearings*]. *See generally* Creel, *The Role of the Foundation in Today's Society*, 9 N.Y.U. CONFERENCE ON CHARITABLE FOUNDATIONS 1 (1969); Flechner, *Charitable Foundations and Their Benefits*, 34 NEB. L. REV. 630 (1955); Sacks, *The Role of Philanthropy: An Institutional View*, 46 VA. L. REV. 516 (1960).

[33] *See, e.g.*, Miller, *supra* note 13, at 434-39; Note, *Tax Exemption for Organizations Investing in Black Businesses*, 78 YALE L.J. 1212 (1969).

corporations organized and operated along the lines posited have been granted exemptions.[34] The accepted notion of "lessening the burdens of government" is not, however, a sufficient statement of the reasoning behind such exemptions. Experience indicates that community development corporations actually do little to lessen the financial burdens of government; by relying on federal assistance programs they merely redirect those burdens into new areas.[35] Thus, we are confronted not with the circumstance of private philanthropy undertaking what government would have to do otherwise, but rather an attempt by the "private sector" to attract government funds into the economic development arena in addition to receiving the tax benefits normally available only to those which save the government that expense. It is apparent, therefore, that the availability of a charitable exemption rests upon: (1) the general benefits to society of having persons employed and/or trained for employment; (2) the government's inability to create and operate the enterprises necessary to job creation, training and economic security; and (3) the reluctance of private enterprise to undertake these kinds of programs.[36]

Assuming that a community development corporation is organized to provide something which society deems beneficial and which neither can be provided by government nor is being provided by private enterprise, the question remains whether the vehicle used to provide those benefits — the operation of businesses for profit — is appropriate in light of advantages accorded the community development corporation by way of federal income tax exemption. In context the question is whether the benefits accruing to society are sufficient to balance the relative disadvantage at which competitive businesses are placed by reason of the tax exemption granted to the community development corporation.

In the abstract, there is nothing to prevent a charitable organization from conducting, either directly or through wholly owned

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[34] Note, *supra* note 13, at 1609-13; Note, *Tax and Other Legal Aspects of Business Involvement in Ghetto Development Programs*, 20 CASE W. RES. L. REV. 825, 836-37, 849-55 (1969).

[35] For an analysis of the various federal financial assistance programs and how these programs may be used by community development corporations see Note, *supra* note 13, at 1594-1607, 1627-58.

[36] Sacks, *supra* note 32, at 520-21; *cf.* Note, *Tax and Other Legal Aspects of Business Involvement in Ghetto Development Programs*, *supra* note 34. If private enterprise assumes the burden of training and employment on a significant scale, it would necessarily follow that tax exemption for community development corporations would no longer be available.

subsidiaries, businesses which compete with others not afforded tax exemption. The Treasury Department's only concern is: (1) whether the businesses are "related" to the exempt purposes of the organization; and (2) if unrelated, whether the organization is operated primarily to carry on that unrelated business.[37] The tests for determining whether a business is related to the exempt purposes of the organization are set forth in the regulations promulgated pursuant to section 513.[38] These regulations require a substantial causal relationship between the business, and presumably the manner in which it is conducted, and the accomplishment of the organization's exempt purposes.[39]

It would appear an easy task to assert the relationship between the exempt purposes of a community development corporation and the conduct of a business which employs the previously unemployed, which trains the previously untrained for future employment in the private sector and which provides the mechanism whereby the benefits of capital ownership can be secured for all. Yet the tests which the Treasury Department and the courts use to implement the regulations are far from clear and provide little predictability.

The concept of unrelated business income was first codified by the Revenue Act of 1950.[40] Excepting a few courts,[41] prior to 1950 the only question was whether the income earned by an organization eventually found its way to charitable destinations.[42] The source of the income or how that income was earned was irrelevant. Courts were unwilling to presume that Congress intended to deny exemption to an organization which used the business vehicle to feed

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[37] Treas. Reg. § 1.501(c)(3)-1(e)(1) (1967) provides:

> An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities if the operation of such trade or business is in furtherance of the organization's exempt purpose . . . and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business. . . .

[38] I.R.C. § 513 defines an unrelated trade or business to be one which is not substantially related to the exercise of the organization's exempt functions other than that organization's need for funds.

[39] Treas. Reg. 1.513-1(a)(2) (1967).

[40] 64 Stat. 947-54 (1950).

[41] John Danz Charitable Trust v. Comm'r, 231 F.2d 673 (9th Cir.), *cert. denied*, 352 U.S. 828 (1956); Ralph H. Eaton Foundation v. Comm'r, 219 F. 2d 527 (9th Cir. 1955); U.S. v. Community Services, Inc., 189 F.2d 421 (4th Cir. 1951), *cert. denied*, 342 U.S. 932 (1952).

[42] Bohemian Gymnastic Ass'n v. Higgins, 147 F.2d 774 (2d Cir. 1954); C.F. Mueller Co. v. Comm'r, 190 F.2d 120 (3rd Cir. 1951); Comm'r v. Orton, 173 F.2d 483, 486 (6th Cir. 1948); Debs Memorial Radio Fund, Inc. v. Comm'r, 148 F.2d 948 (2d Cir. 1945); Roche's Beach, Inc. v. Comm'r, 96 F.2d 776 (2d Cir. 1938); Sand Springs Home v. Comm'r, 6 B.T.A. 198, 216-17 (1927).

other charitable organizations while permitting an exemption to an organization which used the business vehicle to feed *its own* charitable activities.[43] In addition, some courts thought that the benefits accruing as a result of charitable activities were far too important to be left to the whims of private donors.[44]

Evidencing a concern for the anti-competitive effects of these judicial decisions, Congress enacted several provisions dealing with the business income of exempt organizations. The so-called "feeder" provision, now section 502, provided that an organization would not be exempt solely because all of its income was destined for charitable goals.[45] A second provision imposed a tax on the unrelated business income of an exempt organization.[46] It is significant that only section 502 dealt with the amount of business activity and then only with the situation of a business corporation which administered no charitable activities of its own, which conducted its business enterprises in direct competition with private taxable entities and whose *only* basis for exemption was the charitable destination of its income. All other exempt organizations which, in order to provide funds for *their own* exempt activities, engaged in unrelated business activities were required to pay a tax on the income generated therefrom.[47]

Theoretically then, an exempt organization which engaged in unrelated business ventures merely to finance the conduct of its own charitable activities should not have lost its exemption. By a process of confused reasoning, however, this has not been the result. In order to determine whether a business is related to the exempt purposes of an organization, the Treasury Department and the courts have used criteria, some of which are more appropriately

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[43] Roche's Beach, Inc. v. Comm'r, 96 F.2d 776, 779 (2d Cir. 1938). This reading of congressional intent is not unsupported by congressional history. As early as 1943, the Treasury Department requested that stringent controls be imposed upon the business activities of exempt organizations. *See Hearings on Revenue Revisions Before the House Comm. on Ways and Means*, 77th Cong., 2d Sess., 89 (1942). Congress failed to react until 1950.

[44] Sand Springs Home v. Comm'r, 6 B.T.A. 198, 214 (1927).

[45] Presently I.R.C. § 502, last amended by section 121(b)(7) of Pub. L. No. 91-172, 83 Stat. 542 (1969). *See generally*, Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 HARV. L. REV. 1280 (1968).

[46] Presently I.R.C. §§ 511-513 (last amended by sections 121 (a)&(b) of Pub. L. No. 91-172, 83 Stat. 536-40 (1969).

[47] Eliasberg, *Charity and Commerce: Section 501(c)(3) — How Much Unrelated Business Activity*, 21 TAX L. REV. 53 (1965); Grant, *Taxation of Charitable Organizations Engaging in Business Activities*, 4 U.C.L.A. L. REV. 352 (1957); Sugarman & Pomeroy, *Business Income of Exempt Organizations*, 46 VA. L. REV. 424 (1960).

designed for determining the primary purpose of the organization.[48] To determine whether a business is substantially related to the exempt purposes of an organization the nature and size of the business must be compared to the nature and extent of the exempt activities of the organization.[49] The factors most often considered are: the amount, in gross numerical terms, of the profit earned by the business;[50] the manner in which the business is conducted as compared to the manner in which similar businesses are conducted by profit motivated entrepreneurs;[51] the amount of time devoted to the business as opposed to the amount of time devoted to other activities;[52] and whether the income is earned fortuitously or whether it appears to be earned by design.[53] Only where it is clear, in the abstract, that the businesses are related and the amount of income is not excessive will the nature of the business activity be determinative.[54] Once having determined that the income from the business is unrelated either because of the relative time devoted to the production of that income or the amount of that income when compared with the extent of the organization's charitable activities, it follows almost *a fortiori* that the purpose to produce a profit is sub-

[48] *Cf.* Eliasberg, *supra* note 47.

[49] Treas. Reg. § 1.513-2(a)(4) (1968). *See also* Parker v. Comm'r, 365 F.2d 792, 796-99 (8th Cir. 1966), *cert. denied*, 388 U.S. 1026 (1967). In fact, the regulations specifically provide that a business is not to be treated as related merely because some use is made of the business to further the organization's exempt purpose. Treas. Reg. § 1.513-2(a)(4) (1958).

[50] Scripture Press Foundation v. U.S., 285 F.2d 800, 803 (Ct. Cl. 1961), *cert. denied*, 386 U.S. 985 (1962); Forest Press, Inc. v. Comm'r, 22 T.C. 265 (1954). *But see* St. Germain Foundation v. Comm'r, 26 T.C. 648 (1956); *cf.* Forest Lawn Memorial Park Ass'n v. Comm'r, 45 B.T.A. 1091, 1102 (1941).

[51] American Institute for Economic Research v. United States, 302 F.2d 934 (Ct. Cl. 1962); Rev. Rul. 58-482, 1958-2 CUM. BULL. 273; *Treas. Reg.* § 1.513-1(c)(1) (1968).

[52] Parker v. Comm'r, 365 F.2d 792, 796-99 (8th Cir. 1966).

[53] *Cf.* Elisian Guild, Inc. v. United States, 412 F.2d 121 (1st Cir. 1969) where the court stated that: "while the government rightly contends that failure to show a profit does not per se entitle a corporation to exempt status . . . in this case the deficit operation reflects not poor business planning or ill fortune but rather the fact that profits were not the goal of the operation." *Id.* at 125.

[54] Texas Mobile Home Ass'n v. Comm'r, 324 F.2d 619 (5th Cir. 1963) (income earned from mobile home shows by a business league designed to improve conditions in the mobile home industry held to be related); Squire v. Students Book Store Corp., 191 F.2d 1018 (9th Cir. 1951) (operation of a bookstore selling mainly to students where college held all the stock in the store was held related to the exempt functions of the college); Mobile Arts and Sports Ass'n v. U.S., 148 F. Supp. 311 (S.D. Ala. 1957) (income from ticket sales for the Senior Bowl football game held to be related to organization's social welfare purposes); Hospital Bureau of Standards and Supplies, Inc. v. United States, 158 F. Supp. 560 (Ct. Cl. 1958) (membership corporation which performed various services for its exempt member hospitals for a fee held exempt). *See* Rev. Rul. 68-581, 1968-2 CUM. BULL. 1250 (income earned from sale of goods made by students at a vocational school is related).

stantial, if not predominant, irrespective of an organization's charitable intentions. The exemption is, therefore, unavailable.[55] In this manner the complexities of the Revenue Act of 1950 can easily be avoided for the easier test imposed by the exemption statute itself — whether the organization is operated exclusively for charitable purposes.

The possibility of losing its charitable exemption is thus a substantial risk for a community development corporation intending to conduct its charitable activities through the traditional form of business ventures should its businesses become "too profitable." Indeed, that risk is ever present since a significant purpose of conducting charitable activities through a business model is to generate profits of a magnitude sufficient to provide the capital necessary for an expansion of the charitable functions.

While there are indications to the contrary,[56] the risk of a total loss of the exempt status can be diminished by operating the business enterprises through wholly-owned or majority-controlled subsidiaries. The Treasury Department has admitted, in recent congressional testimony, that there is no provision which would prevent an exempt charity from operating even an unrelated business through a subsidiary.[57] Thus, the community development corporation could use this device to insulate its charitable activities, and its charitable exemption, from the conduct of its business activities. Should the business be later found "unrelated to the parent's charitable purposes," the income flowing to the exempt organization from the subsidiary would not be taxable to the parent as "unrelated business taxable income."[58] In addition, the regulations provide that for income from an unrelated business to be taxed as such the unrelated business must be "regularly carried on" by the exempt organization.[59] What constitutes a business "regularly carried on" has been the subject of

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[55] It is now clear that a single non-exempt purpose, if substantial, will result in the denial of an exemption. *See, e.g.*, Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279 (1945).

[56] Miller, *supra* note 13, at 444; *cf.* Squire v. Student Bookstore Corp., 191 F.2d 1018 (9th Cir. 1951); United States v. Fort Worth Club of Fort Worth, Texas, 345 F.2d 52, 57-58 (5th Cir.), *modified on rehearing*, 348 F.2d 891 (5th Cir. 1965); Rev. Rul. 67-104, 1967-1 CUM. BULL. 120.

[57] *House Hearings*, *supra* note 32, at 5098. The question of whether the subsidiaries are exempt on the rationale that they are performing, at least in part, the exempt functions of the parent, will not be treated here. Suffice it to say that such an argument ignores the insulation notion and brings the community development corporation out of a relatively cool frying pan into what might be an extremely hot fire.

[58] I.R.C. § 512(b)(1).

[59] Treas. Reg. § 1.513-1(a)(2) (1967).

some case decisions. In *Robert A. Welsh Foundation v. United States*,[60] the court was faced with the question of whether certain income generated by oil and gas leases represented royalties rather than working interests in the wells. The actual interests in the wells were held by a subsidiary of the exempt foundation, payment being made to the foundation pursuant to certain overriding royalty contracts. Because the Code excludes royalties from unrelated business income,[61] the Commissioner was compelled to argue that the overriding royalties were not in fact royalties, but instead were income from working interests and thus should be taxable as unrelated business income. In determining the income to be royalties, the court stated:

> The owner of . . . a working interest is *actively engaged in its operations at all times* and such operations . . . are the carrying on of a trade or business. On the other hand, the owner of an overriding royalty . . . is not engaged in any operations . . . . *The word* [business] . . . *implies that one is kept more or less busy,* that the activity is an occupation.[62]

Under a similar rationale, it has been held, with respect to a sale and lease-back transaction, that fiscal operating controls imposed by the lessor do not constitute an active, day-to-day participation in the business affairs of the lessee.[63] The regulations would define the unrelated business as "regularly carried on" if the activity is sufficiently consistent "to indicate a continuing purpose of the organization to derive some of its income from such activity."[64] But the noted case law suggests that the unrelated business may still be deemed not "regularly carried on" if the exempt organization does not actively engage itself in the day-to-day activity of operating that business. Thus, if a community development corporation does nothing else by reason of its stock ownership than exercise its right to select directors of the subsidiary, it may well avoid the loss of its exempt status.

Other considerations, however, have been interposed by the Tax Reform Act of 1969. Indeed, it is evident that that enactment, whether designed to encompass community development corporations or not, portends to have a substantial effect on the operations of these organizations.

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[60] 228 F. Supp. 881 (S.D. Tex. 1963), *aff'd*, 334 F.2d 774 (5th Cir. 1964).

[61] *See* I.R.C. § 512(b)(2).

[62] 228 F. Supp. at 887 (emphasis added).

[63] University Hill Foundation v. Comm'r, 51 T.C. 548, 568 (1969). *Cf.* Amon G. Carter Foundation v. United States, 58-1 U.S. Tax Cas. ¶ 9342 (N.D. Tex. 1958).

[64] Treas. Reg. § 1.513-1(a)(3) (1967).

III. THE TAX REFORM ACT

A. *A Brief History*

It was once observed that "if abuse [by private foundations] is too wide spread, the legislators may be stimulated to enact corrective measures which could easily redound to the detriment of bona fide foundations."[65] That gratuitious prophecy having gone unheeded, the legislators enacted corrective measures, and to the extent that these measures affect community development corporations, they indeed redound to the detriment of bona fide foundations.

What prompted the congressional response to private foundations can be best described by a brief (admittedly over-simplified) example. Mr. Jones (or Messrs. Henry and Edsel Ford if you will) owns the controlling interest of Y corporation, a profitable business corporation. Desiring to preserve control of the corporation for his family and, in addition, to provide a ready source for charitable contributions whenever his individual tax situation dictates, Jones creates a charitable foundation to which he donates a substantial portion of the voting and/or non-voting stock in Y corporation. The foundation's articles of incorporation are drafted so as to assure a charitable exemption and consequently to assure Jones of a charitable deduction for the fair market value of his Y stock.[66] The articles or by-laws provide that the trustees of the new foundation shall be Jones and others, either family or friends, whom he may choose. The foundation receives its income either from dividends paid by Y corporation or from investments in other securities or property secured with funds provided by those dividends, or with funds realized from the sale of a portion of Y stock. Income not used to secure more profitable investments would be accumulated until such time as the foundation is enabled to make charitable contributions and engage in speculative investment activities — the latter, more often than not, taking precedence. Finally, the foundation would not seek charitable donations from persons other than Jones and his immediate family.

This "gimmick" yields a number of benefits to Jones. First, the disposition of Y stock reduced the value of Jones' estate sufficiently to enable him to bequeath the remainder of the stock in Y corpora-

[65] Eaton, *Charitable Foundation, Tax Avoidance and Business Expediency*, 35 VA. L. REV. 987, 1036 (1949).

[66] I.R.C. § 170(b)(1)(D). This section was amended by section 201(a)(1)(B) of Pub. L. No. 91-172, 83 Stat. 549-58 (1969). For an explanation of the effects of this amendment on the contribution of capital gain property, see Myers & Quiggle, *Charitable Contributions and Bequests: The Impact of the Tax Reform Act*, 39 FORDHAM L. REV. 185 (1970).

tion to his beneficiaries without the necessity of liquidating to pay estate taxes.[67] Secondly, by reason of his position as trustee of the foundation, Jones never lost voting control of Y corporation. As implied above, the private charitable foundation could also be utilized as an easy "bail out" for one who held stock in a close corporation suffering losses, the only stipulation being that the charitable foundation be set up in such a way as to cloud that function as its primary purpose.[68] The private foundation also provided a ready source of loan capital and grant funds for the donor, his relatives and friends and enterprises controlled by these persons.[69] Finally, assuming the foundation would accumulate its earnings, the donor would get an immediate tax benefit in the form of a charitable deduction while the contemplated co-extensive benefit to society would be postponed for an indeterminate period of time.[70]

In an attempt to rectify such obvious abuses, Congress, in 1950, prohibited charitable foundations from engaging in certain self-dealing transactions, but only to the extent that the nature of those transactions indicated preferential treatment by the foundation to the creator of or substantial contributor to the foundation or to a corporation controlled by such person.[71] Congress also enacted section 504 which prohibited certain charitable foundations from *unreasonably* accumulating income or investing that income in such a manner as to jeopardize the carrying on of its exempt functions.[72] These provisions were specifically applicable only to organizations which were neither religious, educational, related to an exempt hospital or medical research facility nor *supported by government funds or direct or indirect contributions from the general public.*[73]

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[67] *See* Eaton, *supra* note 65, at 991; Note, *Criticized Uses of Federal Tax Exemption Privilege by Charitable Foundations and Educational Institutions*, 98 U. PA. L. REV. 696 (1950); Note, *The Uses of Charitable Foundations for Avoidance of Taxes*, 34 VA. L. REV. 182 (1948).

[68] Curt Teich Foundation v. Comm'r, 48 T.C. 963, 969-74 (1967); *cf.* Scholarship Endowment Foundation v. Nicholas, 25 F. Supp. 511 (Colo. 1938), *aff'd*, 106 F2d 552 (10th Cir. 1939); Davenport Foundation v. Comm'r, 16 T.C. Mem. 83 (1947), *aff'd per curiam*, 170 F.2d 70 (9th Cir. 1948); Security First National Bank of Los Angeles v. Comm'r, 28 B.T.A. 289 (1933).

[69] Home Oil Mill v. Willingham, 68 F. Supp. 525 (N.D. Ala. 1945); Griswold v. Comm'r, 39 T.C. 620 (1962); Cummins-Collins Foundation v. Comm'r, 15 T.C. 613 (1950); Estate of Agnes C. Robinson v. Comm'r, 1 T.C. 19 (1942); *cf.* Estate of Edward T. Bedford v. Comm'r, 39 B.T.A. 1039 (1939).

[70] TREASURY REPORT, *supra* note 32, at 6-7.

[71] I.R.C. § 503(c), *presently* I.R.C. § 503(b) (*redesignated as such by* § 101(j)(14) of Pub. L. No. 91-172, 83 Stat. 527 (1969).

[72] I.R.C. § 504, *repealed by* 101(J)(14) of Pub. L. No. 91-172, 83 Stat. 527 (1969).

[73] I.R.C. § 503(b), *repealed by* § 101(j)(8) of Pub. L. No. 91-172, 83 Stat. 527

The 1950 provisions, however, were unsuccessful in curbing abuse of the foundation's tax benefits. Section 503 did not prohibit self-dealing between a foundation and its contributors and affiliates, but merely prevented diversion of funds from charitable purposes to private purposes under unreasonable terms and conditions. Indeed, it is arguable that section 503 restricted rather than assisted the policing of private foundations by the Treasury Department.[74] Section 504 may have cured long term accumulations, even where a purpose for the accumulation was specified[75] but it went no further than that limitation. Furthermore, judicial interpretations of section 504 made it clear that as long as a specific project was articulated either in the document creating the organization or in the policies of the organization promulgated subsequently, and the time over which the accumulation extended did not seem patently outlandish, the provisions of

(1969) (emphasis added). A so-called publicly supported foundation was never defined statutorily. Indeed, the term went undefined until 1966, some two years following the addition of § 170(b)(1)(A)(vi), which provided a 30% deduction to "publicly supported charities." *See* I.R.C. § 170(b)(1)(A)(vi) (added by § 209(a) of Pub. L. No. 88-272, 78 Stat. 48 (1964). The definition of a publicly supported charity which the Treasury Department relied upon prior to the enactment of the 1969 act can be found in Treas. Reg. § 1.170-2(b)(5)(iii) (1966). Generally, the regulation posed two tests, the meeting of either one of which would suffice. The first test, the "*mechanical* test" is found in § 1.170-2(b)(5)(iii)(B). That is, one-third of an organization's support must come from a governmental unit or from direct or indirect contributions from the general public. The second test, the so-called "facts and circumstances" test found in § 1.170-2(b)(5)(iii)(c), provided that an organization may be treated as publicly supported if certain indices of public accountability and/or public access to their facilities are met. These include public disclosure of financial data, a governing board comprised of public officials or others representing a broad base of community support, or facilities which are generally open to the public. A community development corporation which previously relied on either of these two tests as definitive of public support may have to reassess its position in light of I.R.C. § 509(a)(2). *Cf.* S. REP. No. 91-552, 91st Cong., 1st Sess. 56-59 (1969) [hereinafter cited as *Senate Report*]; H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 1, at 41 (1969) [hereinafter cited as *House Report*]. A caveat is prompted by a proposed regulation defining an organization as publicly supported within the meaning of I.R.C. §§ 509(a)(1) and 170(b)(1)(A)(vi) even if it receives more than one-third of its support from gross investment income and consequently is disqualified under I.R.C. § 509(a)(2). Proposed Treas. Reg. § 1.170A-9(e), 36 Fed. Reg. 9300 (1971). The rationale of this proposed regulation is a mystery, given the clear congressional policy limiting the amount of investment income an organization can earn and still be treated as a publicly supported charity. Even a greater mystery is how the Treasury Department can preserve any "facts and circumstances" test in light of the statutory structure which is clearly directed at the source of funding and not at accountability of those who have corporate power to expend those funds once received. *See* Proposed Treas. Reg. 1.170A-9(e)(v)&(vi), 36 Fed. Reg. 9301 (1971).

[74] *Cf.* Curt Teich Foundation v. Comm'r, 48 T.C. 963 (1967); Cummins-Collins Foundation v. Comm'r, 15 T.C. 613 (1950).

[75] *See, e.g.*, Schoellkopf v. United States, 124 F.2d 982 (2d Cir. 1942) (implicit approval of a precatory accumulation provision of 150 years). *See also* John Danz v. Comm'r, 231 F.2d 673 (9th Cir. 1955); Arthur Jordan Foundation v. Comm'r, 210 F.2d 885 (7th Cir. 1954).

section 504(a) were not violated.[76] In addition, the Treasury Department was rarely, if ever, successful in challenging accumulations generated by speculative investments, even when those investments might have jeopardized the purposes for which the money was allegedly being accumulated.[77] Finally, even if these provisions could have cured foundation abuses, it is clear that the Treasury Department had neither the interest nor the financial wherewithal to insure foundation compliance.[78]

What followed is now history; a history which has been so well documented in the literature[79] that it no longer bears repeating. Suffice it to say that after some nine years of hearings, four reports by Representative Wright Patman's Select Committee on Small Business, one report by the United States Treasury Department and various Presidential messages, Congress enacted provisions regulating private foundations. Those provisions affect far more, however, than just the possibility of self-dealing by private foundations.[80] In the effort to curb the abuses of some, Congress has brought under its regulatory umbrella the legitimate community development corpora-

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[76] Hulman Foundation v. United States, 217 F. Supp. 423 (S.D. Ind. 1962) (accumulation of income for 12 years to construct a public coliseum held proper). *But see* Rev. Rul. 67-106, 1967-1 CUM. BULL. 127 (1967) (accumulation of income for twenty years for general distribution to a tax exempt school does not meet the specificity of project test). *See also* Stevens Bros. Foundation v. Comm'r, 324 F.2d 633, 639-40 (8th Cir. 1963); Danforth Foundation v. United States, 347 F.2d 673, 678 (8th Cir. 1965); Erie Endowment v. United States, 316 F.2d 151 (3rd Cir. 1963). *See generally* Duhl, *Tax Exempt Organizations: The Attack on Unreasonable Accumulations of Income*, 57 GEO. L. J. 483 (1969).

[77] Samuel Friedland Foundation v. United States, 144 F. Supp. 74 (D.N.J. 1956). *But see* Randall Foundation v. Riddell, 244 F.2d 803, 808 (9th Cir. 1957) which held that a charity which did little but invest in speculative stock issues was not charitable. The court, however, appeared to rest its decision more on the Foundation's not meeting the "operated exclusively for" test in 501(c)(3) rather than on its using funds in a manner which jeopardized its charitable purposes.

[78] TAX EXEMPT FOUNDATIONS: THEIR IMPACT ON SMALL BUSINESS, *Hearings Before Subcomm. No. 1 of the Select House Committee on Small Business*, 90th Cong., 1st Sess., 1-4, 218-19, 235-46, 257-59 (1967).

[79] *See* J. RUSKAY AND R. OSSERMAN, HALFWAY TO TAX REFORM 29-49 (1970); W. WEAVER, U.S. PHILANTHROPIC FOUNDATIONS 198-219 (1967); Folk, *Regulation of Charitable Foundations — The Patman and Treasury Reports*, 20 BUS. LAWYER 1015 (1965); Krasnowiecki & Brodsky, *Comment on the Patman Report*, 112 U. PA. L. REV. 190 (1963); Peril, *Tax-Exempt Targets: The Patman Report and Private Charitable Foundations*, 42 TAXES 69 (1964); Riecker, *Foundations and the Patman Report*, 63 MICH. L. REV. 95 (1964); Troyer, *The Treasury Department Report on Private Foundations: A Response to Some Criticisms*, 13 U.C.L.A. L. REV. 965 (1966).

[80] I.R.C. § 4941(a) imposes an initial tax of 5% on a disqualified person with respect to foundations [as defined in I.R.C. § 4946(b)] for *any* act of self dealing. This tax is increased to 200% on the disqualified person and 50% on the foundation if restitution is not made within 90 days of the receipt of a deficiency notice pursuant to § 6212. I.R.C. §§ 4941(b) and 4945(i).

tion, "privately" financed but clearly operated for the benefit of persons other than a contributor, his relatives or the business entities which they control. The remainder of this article will be devoted to an analysis of the private foundation provisions of the act as they are specifically applicable to community development corporations.

B. *Definition of Private Foundations — Its Effect on Financing*

In somewhat typical fashion, Congress has defined a private foundation as all organizations "described in section 501(c)(3) *other than* [those specifically excepted] . . . ."[81] Consequently, a community development corporation, the activities of which are charitable within the meaning of section 501(c)(3), must fall within one of the excepted categories in order to avoid being treated as a private foundation. These excepted categories can be classified by the nature of the organization's charitable activities and the sources from which the organization receives its funds. The activities of a community development corporation are not of the kind expressly contemplated by Congress for exclusion from private foundation treatment. Organizations excluded by reason of their activities include churches, educational institutions, hospitals, medical research facilities, governmentally or publicly supported but governmentally controlled organizations operated to administer property and make expenditures for the benefit of a college or university, units of government,[82] organizations operated for testing for public safety[83] and organizations controlled by one or more publicly supported organizations operated solely to carry on one or more of the exempt functions of those organizations.[84]

A community development corporation must then be exempt from private foundation treatment, if at all, by reason of its source of funds. One such as the Hough Area Development Corporation in Cleveland, Ohio which receives annually 1.5 million dollars pursuant to Title I-D of the Economic Opportunity Act of 1964,[85] presently has little worry of being treated as a private foundation for it clearly is one which receives substantially all of its support from a governmental unit.[86] These grants, however, are limited to the for-

81 I.R.C. § 509(a) (emphasis added).

82 I.R.C. §§ 170(b)(1)(A)(i)-(v).

83 I.R.C. § 509(a)(4).

84 I.R.C. § 509(a)(3).

85 42 U.S.C. §§ 2763-68 (Supp. V, 1969).

86 I.R.C. § 509(a)(1); I.R.C. § 170(b)(1)(A)(vi).

tuned few. Even with respect to these organizations, the probability of private foundation treatment increases as the desire for and achievement of self-support grows.

For the unfortunate many, who must rely on relatively small grants from other charitable organizations and consequently must plan for a self-sustaining position relatively early, the danger of private foundation treatment is imminent. What determines the tax treatment of these community development corporations is defined as "support" which in turn is defined to be gifts, grants, membership fees, *gross* receipts from related activities (or at least activities which are not unrelated), *net income* from unrelated business activities, *gross* investment income, and the value of services furnished by a governmental unit.[87] In order to avoid private foundation treatment, a community development corporation must normally: (1) receive more than one-third of its support from gifts, grants and membership fees or from gross receipts from activities not unrelated to its exempt purposes; and (2) may not receive more than one-third of its support from gross investment income.[88]

In making the computation necessary to find the first mandatory one-third ratio, the denominator of the fraction is the total amount of support received by the community development corporation. The numerator of the fraction is the decisive factor, for here it is that the corporation may have difficulty in achieving the required one-to-three ratio, because the numerator does not include *all* gifts, grants or contributions. Rather, the grants included in this figure are only those received from individuals, from organizations which are not themselves private foundations, or from governmental units. Further, to the extent that a grant received from an individual exceeds $5000 or is greater than two per cent of the corporation's support for the taxable year it will not be included in the computation.[89] Thus, if a community development corporation receives a number of initial operating grants from private foundations and/or substantial private donors, it may find that it has substantial "total support" — the

[87] I.R.C. § 509(d) (emphasis added).

[88] I.R.C. § 509(a)(2)(A),(B). It is possible for a newly formed community development corporation to show that *in the future* it will meet the test of 509(a)(2) even though by the statutory use of the word "normally," it would appear that the corporation must show some prior history of financial sources. Proposed Treas. Reg. § 1.509(a)-3(d)& (e). 35 Fed. Reg. 17848-49 (1970).

[89] I.R.C. § 509(a)(2) provides that the gifts, grants, or contributions must be from persons other than disqualified persons as defined in § 4946(a)(1)(A). Disqualified persons are defined to be substantial contributors [I.R.C. § 4946(a)], which in turn are defined to be persons who give more than $5,000 in any one year if that represents more than 2% of the foundation's support for that year. I.R.C. § 507(d)(2)(A).

denominator of the computation — yet lack enough of the support allowable in the numerator of the figure sufficient to meet the one-third ratio. Consequently, the corporation would be treated as a private foundation.[90]

Even assuming that a community development corporation could apply these grants to quickly establish businesses which will be treated as related and provide sufficient income to allow it to be largely self-sustaining,[91] they will still have difficulty meeting the mandatory one-third figure. Under section 509, gross receipts from related activities are included in the numerator only to the extent that they do not exceed the greater of $5,000 or one per cent of the organization's support for any taxable year.[92] Thus, the dollar amount limitations imposed by the Code may prevent the corporation from ever achieving the 1:3 ratio imposed by the Code.

If a community development corporation operates its businesses through subsidiaries rather than directly, an option which is (or at least was) the most advantageous,[93] it apparently loses even the limited advantages which formerly accrued by having the businesses not treated as unrelated. The second computation now required by the Code must demonstrate that not more than one-third of the corporation's support comes from gross investment income.[94] Gross investment income is defined as the gross amount received for interest, *dividends*, rents and royalties, but not including any such income to the extent that it is included in computing the unrelated business income tax.[95] Since any amounts received from the subsidiaries will be treated as dividends,[96] and since dividends are excluded from the computation of unrelated business income tax,[97] — the full amount of such income is used in computing the numerator of this second

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[90] I.R.C. § 509(a)(2). Proposed Treas. Reg. § 1.509(a)-3(a)(2), 35 Fed. Reg. 17845-46 (1970).

[91] This is an unlikely result since the question of whether a business is related depends upon the amount of income earned and whether that earned income was planned. *See* notes 48-51 *supra* & accompanying text.

[92] I.R.C. § 509(a)(2)(A)(ii). It appears possible to avoid this problem by operating a number of different businesses each of which earns less than the maximum $5,000 and 1%. Proposed Treas. Reg. § 1.509(a)-3(b) (example 2), 35 Fed. Reg. 17846 (1970). This option, however, would produce a nightmare for both lawyers and business planners.

[93] *See* notes 56-62 *supra* & accompanying text.

[94] I.R.C. § 509(a)(2)(B).

[95] I.R.C. § 509(d) (emphasis added).

[96] *Cf.* Crosby Valve & Gage Co. v. Comm'r, 380 F.2d 146 (1st Cir.) *cert denied*, 389 U.S. 976 (1967); Rev. Rul. 68-296, 1968-1 CUM. BULL. 105.

[97] I.R.C. § 512(b)(1).

fraction whether or not such dividends are received from related businesses.

There is a possibility, albeit slight, that the dividends received from related businesses will not be treated as gross investment income[98] which must be included in the second fraction, but rather as gross receipts[99] which may be included in the first fraction. The Treasury Department regulations illustrate the distinction between gross investment income and gross receipts with an example of an organization whose purpose it is to provide housing for low income war widows. The rents received, according to a proposed regulation, are to be treated as gross receipts from the operation of a related business and not as gross investment income.[100] The rationale for this treatment appears to be that an exempt organization should not be penalized merely because its income must, of necessity, come from rents rather than alternative sources. It can be argued by analogy that all related income should be treated as gross receipts rather than gross investment income irrespective of the form in which that income is received. This would be consistent with experience which has indicated that income defined as gross investment income has generally been that derived from businesses unrelated to the exempt purposes of the foundation. Therefore, the argument goes, Congress was concerned only with unrelated gross investment income.

Nothing in the official reports supports such a conclusion however. In fact, it appears that this regulation is little more than a noble attempt by the Treasury Department to "strong arm" the statute. Section 509(e) specifically includes all "passively earned" income as gross investment income except to the extent that such income is included for purposes of computing unrelated business income. Since the rentals given in the example are not so included,[101] the regulation clearly violates the plain language of the statute. Given this clear contradiction along with the fact that the regulation is merely temporary, present reliance on it would be misplaced.

What we have then is a situation wherein a community development corporation is treated as a private foundation for no reason other than the practical reality that private foundations, or even income from related businesses, are the only sources of available financing. This makes little sense assuming that the community devel-

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98 I.R.C. § 509(a)(2)(B).

99 I.R.C. § 509(a)(2)(A)(ii).

100 Proposed Treas. Reg. § 1.509(a)-3(m)(1) & (2), 35 Fed. Reg. 17851-52 (1970).

101 I.R.C. § 512(b)(3)(A).

opment corporation can be organized in a way so as to insure public accountability for its activities, clearly a possibility under the old "facts and circumstances" test, but congressionally altered by the 1969 Tax Reform Act.[102]

C. *Effect of Private Foundation Status on the Operations of a Community Development Corporation*

The scheme of the Reform Act is one of preserving the exempt status of private foundations while making them pay for the exercise of that "privilege", both generally and for specific acts or failures to act.

(1) *Tax on Investment Income*

All private foundations must pay a four per cent tax on net investment income.[103] Net investment income is defined as the gross amount of interest, dividends, rents and royalties, to the extent not included in computing unrelated business income tax, less the allowable expenses incurred in producing that income.[104] No statutory distinction is drawn between income which is produced from related businesses and that which is not. This tax on investment income was intended to serve two purposes: (1) to impose a user or excise tax on the privilege of retaining exempt status, and (2) to provide the Treasury Department with the financial resources necessary to enforce the remaining provisions of the act.[105]

It is, of course, possible for a community development corporation to avoid this excise tax and at the same time maintain its hope for self-sufficiency by operating its businesses directly rather than through subsidiaries. In this way, any income earned from those businesses would not be treated as dividend income and consequently would

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[102] *See* note 73 *supra.* It is not as if Congress was unaware that the definitions used for determining whether an organization was privately or publicly financed would include organizations not conceived of as presenting a regulatory problem. Congress appeared to be fully aware of this possibility but, at least with respect to defining an organization one way or the other, apparently chose to ignore it. *See Senate Hearings, supra* note 32, at 5412-15, 6189, 6000-01, 6429-31. Congressional attempts to compensate for private foundation classification by other means — i.e., allowing a "50% contribution deduction" to selected private foundations (I.R.C. § 170(b)(1)(A)(vii) & (viii)) and exempting "operating foundations" from a tax on the failure to distribute income (I.R.C. § 4942(a)(1)) — may be of little value once the initial classification as a private foundation has been made. *See* Sugarman, *Foundation Operations Under the Tax Reform Act*, 48 TAXES 767 (1970).

[103] I.R.C. § 4940(a).

[104] I.R.C. § 4940(c).

[105] *House Report, supra* note 73, at 19-20; *Senate Report, supra* note 73, at 27-28.

not be denominated as investment income. Yet an assessment of the relative risks may well dictate the subsidiary approach as the better route, notwithstanding the four per cent tax and the effect which that tax might have on future expenditures for additional economic development projects.

In the first place, operating the businesses directly rather than through subsidiaries would subject each business to the liabilities of the others and, in addition, subject the general assets of the corporation, including its endowment, to the liabilities of all the businesses.[106] Secondly, as noted above, operating the businesses directly would dissipate any insulation of the community development corporation's exempt activities from the operation of businesses which, if they became too successful, might well be treated as unrelated. Consequently, it seems that a community development corporation which may be classified as a private foundation has little alternative but to subject itself to the four per cent tax when and if its business subsidiaries become profitable and until such later time as these businesses are disposed of or transferred to residents of the community in which the development corporation operates.

(b) *Tax on failure to distribute income*

Prior to 1969, section 504 of the Code provided for the revocation of a foundation's tax exemption upon a determination that income was being unreasonably accumulated. Evidencing a concern with the harshness of this provision as well as with the Code's scheme of defining an unreasonable accumulation, Congress in 1969 repealed section 504 in favor of a tax on accumulated earnings.[107] Section 4942 now imposes on private foundations a 15 per cent tax on all income remaining undistributed at the beginning of the next succeeding taxable year.[108] This tax is increased to 100 per cent on any income not distributed within 90 days after the foundation receives a deficiency notice from the Commissioner.[109]

For purposes of determining what must be distributed income is

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[106] The assumption is that if the businesses are operated as subsidiaries, those subsidiaries can be so organized and operated as to avoid creditors piercing the corporate veil. *See, e.g.*, Steven v. Roscoe Turner Aeronautical Corp., 324 F.2d 157, 160-61 (7th Cir. 1963); North v. Higbee Co., 131 Ohio St. 507, 3 N.E. 2d 391, *cert. denied*, 300 U.S. 655 (1936). *See generally* H. HENN, LAW OF CORPORATIONS § 148 (2d ed. 1970); F. POWELL, PARENT AND SUBSIDIARY CORPORATIONS 9 (1931); Comment, *Disregarding the Corporate Entity: Contract Claims*, 28 OHIO ST. L. J. 441 (1967).

[107] *Senate Report, supra* note 73, at 35; *House Report, supra* note 73, at 25.

[108] I.R.C. § 4942(a).

[109] I.R.C. §§ 4942(b) & 4942(j)(2).

generally defined as the gross amount of income, including net *short term* capital gains, less those deductions normally allowable to a corporation subject to taxation under section 11 of the Code.[110] In addition, income is defined as that which is imputed from the net aggregate fair market value of all the assets of the foundation (other than those used directly in carrying out the organization's exempt functions) at the rate of six per cent per annum.[111] Net aggregate fair market value is determined by computing the excess of the fair market value of those assets over the existing acquisition indebtedness with respect to those assets.[112] The amount which then must be distributed is the greater of the actual adjusted net income and that which is imputed from the net asset value.[113]

A community development corporation which has been determined to be a private foundation may well find its operations hampered by the requirement that it distribute its income. Assuming an income in excess of that imputed from its assets, a community development corporation has two choices. Its first choice is to reinvest those funds in the same business which produced the income or, alternatively, retain that income in the business, if operated as a subsidiary.[114] If the business which produced the income can be described as one which directly carries out the corporation's exempt purposes, a somewhat doubtful proposition if the business earns sufficient income to risk being treated as unrelated within the meaning of section 513, then that expenditure, at least theoretically, might be treated as a qualifying distribution. Theoretically, because a contribution to an organization controlled directly or indirectly by the foundation is excluded from the definition of a qualifying distribution.[115] Thus, if the business is operated as a subsidiary and if the subsidiary is treated as a separate entity for purposes of section 4942, any distribution to that subsidiary will not be treated as qualifying even if the subsidiary performs part of the exempt functions of the parent.[116]

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110 I.R.C. § 4942(f)(1). Modifications to the definition of income are set forth in I.R.C. § 4942(f)(2). Modifications with respect to allowable deductions are contained in I.R.C. § 4942(f)(3).

111 I.R.C. § 4942(e)(1)-(3).

112 I.R.C. § 4942(e)(1)(A). Acquisition indebtedness is defined as any unpaid amount with respect to a particular asset, which is attributable to the acquisition of such asset. I.R.C. § 514(c)(1).

113 I.R.C. § 4942(d).

114 It is unlikely that retention of income in an operating subsidiary will avoid the provision of section 4942. *Cf.* Rev. Rul. 68-296, 1968-1 CUM. BULL. 105.

115 I.R.C. § 4942(g)(1)(A)(i).

116 While no interpretive regulations on this point have been promulgated, it is likely

The second available choice, that of investing the income in new businesses, presents the same dilemma but with different dimensions. First, the amount of capital necessary for the establishment of a new business, even with the availability of the various federal loan programs, can be quite substantial. Indeed, this capital requirement is undoubtedly more substantial than the amount which can realistically be anticipated as yearly earnings. So unless a community development corporation can match those earnings with additional grant money, it may be forced to accumulate. Accumulation is permissible (*i.e.*, it may be treated as a qualifying distribution) only if the period of time does not exceed five years and then only if the corporation can demonstrate to the Secretary that a specific project is contemplated, that the project is of a charitable nature and that the project is better served by the accumulation than by an immediate distribution.[117] If the pre-1969 case law is any indication of how the Secretary will deal with the question of specificity, it is clear that merely some general idea of the kind of venture contemplated will not suffice.[118] Most community development corporations have not yet reached the level of sophistication necessary to develop a five or even two year plan, much less the ability to sufficiently document the funds needed and the projected time period for acquiring those funds. Secondly, if the phrase "assets . . . used . . . directly for the carrying out of the foundation's purpose" is interpreted as co-extensive with existing notions of relatedness as used in section 513, extreme caution must be exercised with respect to the kinds of new businesses contemplated.

It is possible, if not likely, that the businesses will earn no income, at least for a certain period of time. In such a situation income will be computed on the basis of the corporation's net asset value, possibly forcing the community development corporation to liquidate some of its productive assets or dip into its endowment in order to make a qualifying distribution. The only way to avoid this result is to convince the Treasury Department that the assets are being used directly to further the organization's exempt purpose. Given the fact that the businesses are producing no income, the likelihood is that the businesses will be treated as related and *a fortiori* furthering the organization's exempt purposes. But a tax on any un-

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that the subsidiary will in fact be treated as a separate entity. *See* note 118 *infra* and accompanying text.

117 I.R.C. § 4942(g)(2). The intent of Congress was to permit an extension of the five year period if good cause for the extension is shown. *House Report, supra* note 73, at 26.

118 *E.g.*, Danforth Foundation v. United States, 347 F.2d 673, 678 (8th Cir. 1965).

expended endowment is likely to be difficult to avoid unless the community development corporation is exempted altogether from the provisions of section 4942.

An exemption from section 4942 is granted to so-called operating foundations.[119] These are private foundations which make qualifying distributions of substantially all their adjusted net income[120] *directly* for the *active* conduct of activities constituting the basis of the organizations' exemption, *and* which meet at least one of three other tests: — the income test, the endowment test or the support test.

The likelihood that a community development corporation will meet the tests imposed for an operating foundation are, at present, somewhat speculative and may well hinge on whether the businesses are operated directly or through subsidiaries. The problems are created by the regulatory definition of "directly for the active conduct." The proposed regulations are clear that a distribution of net investment income to a subsidiary does not qualify as an expenditure being made *directly* for the active conduct of the exempt activities; rather, the funds must be used by the exempt organization itself.[121] An exception is provided for grants to individuals or corporate enterprises where the donor maintains "significant involvement" with the activities of the donee.[122] These regulations seem to contemplate, however, that the donee be organizationally unrelated to the donor and that the purpose of the grant be to encourage such an organization to enter the foundation's particular area of endeavor. In addition, the kinds of controls over the donee's activities which the regulations anticipate are seemingly inconsistent with the rationale for operating the businesses as subsidiaries in the first instance. In any event, the obstacles imposed by section 4942 are not insurmountable, even if the community development corporation operates its business through subsidiaries. All that is required is a segregation of grant funds from income funds, with the corporation using the latter to finance its planning and community coordination activities and using the former to provide a venture capital pool for future business development.

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[119] I.R.C. § 4942(a)(1).

[120] Substantially all the net income is defined to be an amount in excess of 85 per cent. *House Report*, *supra* note 73, at 26. Proposed Treas. Reg. § 53.4942(b)-2(e), 36 Fed. Reg. 109 (1971).

[121] Proposed Treas. Reg. § 52.4942(b)-(2)(b)(1)(2)&(3) (1971), 36 Fed. Reg. 107 (1971).

[122] Proposed Treas. Reg. § 52.4942(b)-2(c), 36 Fed. Reg. 108 (1971).

Having done this, the community development corporation must then meet either the asset, endowment or support test. Under the mechanical requirements of the support test, substantially all the support, excluding gross investment income, must come from the general public and five or more exempt organizations (which may be private foundations), so long as no exempt organization is controlled directly or indirectly by one of the other five and so long as one organization does not contribute more than 25 per cent of the support. In addition, not more than one-half of the community development corporation's total support can be derived from gross investment income.[123] The endowment test also presents little more than problems of mathematical computation. Qualifying distributions must be made in an amount not less than two-thirds of the community development corporation's imputed income.[124]

Compliance with the asset test is considerably more difficult in view of intrinsic complexities which, because there are yet no interpretative regulations, are still unresolved. The asset test requires that substantially more than half the assets[125] of the community development corporation must either: (1) be devoted *directly* to the activities which form the basis of its exemption or to "*functionally related businesses*;" or (2) be stock in the controlled subsidiaries of the corporation, at least eighty-five per cent of the assets of which are devoted to the performance of the corporation's exempt functions.[126]

Here, again, if the development corporation conducts its activities directly rather than through subsidiaries, it must devote in excess of sixty-five per cent of its assets directly to the conduct of those businesses. However, these businesses need not meet the strict tests of relatedness imposed by section 513. Rather, they need only be "functionally related" to the exempt purposes of the community development corporation.[127]

A business to be functionally related must: (1) not be unrelated within the meaning of section 513; *or* (2) even if technically unrelated, must be functionally integrated with a number of other activites conducted by the development corporation which are related to the exempt purposes.[128] This means that a business which

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123 I.R.C. § 4942(j)(3)(B)(iii).

124 I.R.C. § 4942(j)(e)(B)(ii).

125 This has been defined to be an amount in excess of sixty-five per cent. Proposed Treas. Reg. § 53.4942(b)-3(c), 36 Fed. Reg. 110 (1971).

126 I.R.C. § 4942(j)(3)(B)(i) (emphasis added).

127 *Id.*

128 I.R.C. § 4942(j)(5).

may be unrelated because of the amount of income it earns or the manner in which it is conducted may nevertheless be functionally related if conducted as an integral part of the corporation's other charitable activities. The closest analogy one can find is the regulatory example where the same facility or asset is used for a dual purpose, one related and the other not. In that situation, the Treasury Department has taken the position that any income earned from the use of the facility or asset for a non-exempt purpose is unrelated income.[129] Redefining the issue within the context of that example to be whether the full value of the dual-used asset should be included within the sixty-five per cent measuring rod, the answer would seem to be that it is, even if the income derived therefrom would, in part, be taxed under section 511.[130]

It would seem then that a community development corporation which operates its businesses directly will have little difficulty being classified as an operating foundation if at the same time it can retain its exempt status. If, however, the community development corporation operates its businesses as subsidiaries, and assuming it can meet the initial distribution test by segregating its grant funds from its income, it must then show that at least sixty-five per cent of its assets consist of the stock of controlled corporations which in turn devote eighty-five per cent of their assets directly for the purposes for which the parent is exempt or to activities functionally related to those purposes.[131]

These tests may be difficult to meet for two reasons. First, the value of the subsidiaries' stock held by the community development corporation may well be less than sixty-five per cent of its other assets, including endowment, depending upon the regulations which

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[129] Treas. Reg. § 1.513-1(d)(4)(iii) (1967).

[130] The Senate, at least, thought that investments in "small business in central cities or in corporations to assist neighborhood renovation" would be functionally related if: (1) it could be reasonably said that neighborhood renovation is within the foundation's charitable purposes; and (2) a significant purpose of that investment is not the production of income. *Senate Report, supra* note 73, at 41. It should be noted that the Senate, apparently somewhat confused by the varying degrees of relatedness established by the Code, denominated these investments as "program related" investments, a term reserved for section 4944. That this designation is a misnomer is evident by the Senate's stipulation that the investment must be part of the foundation's charitable program, a notion not included within the definition of program related investments as set forth in I.R.C. § 4944(c). *See also* Proposed Treas. Reg. § 53.4942(b)-3(b)(1), 36 Fed. Reg. 109-110 (1971), and the text accompanying notes 140-42 *infra.*

[131] I.R.C. § 4942(j)(3)(B)(1). The control required of the community development corporation over the subsidiary is eighty per cent of all outstanding stock, the same as required under I.R.C. § 368(c). Proposed Treas. Reg. § 53.4942(b)-3(a), 36 Fed. Reg. 109 (1971).

the Secretary has yet to promulgate on the valuation of securities for which no market quotations are readily available.[132] Secondly, the subsidiary faces the same problem as the parent in showing that its activities are related, or functionally related to the parent's exempt purposes. Thus, to the extent that the Treasury Department may find that an asset of the subsidiary is held for the production of income, apparently even to a limited degree, the value of the asset is wholly excluded from the computation. This determination is *ad hoc* and is, therefore, subject to as little predictability as the determination of whether a business is related or unrelated within the meaning of section 513.[133]

c. *Tax on Excess Business Holdings*

Section 4943 of the Code, imposing a tax on the excess business holdings of the foundations, reflects congressional concern with the use of foundations to maintain family control of businesses, the subordination of charitable purposes to business enterprises, the potential for unfair competition with tax-paying rivals, and the inability of the prior law to sufficiently define the point at which a foundation's involvement with businesses was sufficiently significant to warrant a loss of exemption.[134] Generally, section 4943 penalizes a private foundation for holding in excess of twenty per cent of the voting control (or thirty-five per cent when it is clear that a third party has effective control)[135] of any business enterprise other than one that is either functionally related to the foundation or one which receives at least ninety-five per cent of its income from so-called passive sources.[136] The penalty is a tax of five per cent of the value of those excess holdings, increased to 200 per cent if the appropriate amount of voting control is not disposed of within ninety days after receipt of a deficiency notice.[137]

It is apparent that section 4943 jeopardizes a community development corporation only if it conducts its activities, or any part thereof, through subsidiary corporations rather than directly, and then only if those subsidiaries are not functionally related to the activities of

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[132] I.R.C. § 4942(e)(2).

[133] Proposed Treas. Reg. § 53.4942(b)-3(b)(2), 36 Fed. Reg. 110 (1971) states that "(w)hether an asset is held for the production of income . . . rather than being used directly in the active conduct of the foundation's exempt activities . . . is a question of fact."

[134] *See House Report, supra* note 73, at 27; *Senate Report, supra* note 73, at 38-39.

[135] I.R.C. § 4943(c).

[136] I.R.C. § 4943(d)(4).

[137] I.R.C. § 4943(a)&(b).

the corporation. An analytical difficulty, however, is raised by the fact that "functionally related" has the same meaning whether used under section 4942 or section 4943. While the broad question is the same under both sections — that is whether a private foundation has made proper use of its funds — the answer to that question is determined in two distinct factual contexts. Section 4942 views the question within the context of a single legal entity whereas section 4943 apparently requires that the activities of an entity be compared to the activities of an entirely separate entity to determine whether the two are sufficiently complementary to justify the investment.

While "entity comparing" appears to be what Congress had in mind under section 4943,[138] it may be difficult to make such comparisons with respect to a community development corporation. The examples used by the Senate deal with separately incorporated museum cafeterias and the Inn and Lodge at Williamsburg, Virginia. In the first place these examples concern subsidiary entities which are operated only for the convenience of visitors to those facilities, not as businesses *qua* businesses. Secondly, the comparison appears to be between the activities of the subsidiary and those of the exempt parent. It is doubtful that this analysis fits a community development corporation which conducts all of its activities, save planning for new kinds of businesses, through subsidiaries. Consequently, a community development corporation should either plan for the conduct of some of its charitable ventures directly or alternatively be prepared to justify its subsidiary holdings on grounds that they are related within the meaning of section 513.

(d) *Tax on Investments which Jeopardize Charitable Programs*

In an attempt to restrict the right of a charitable foundation to invest its funds in speculative ventures and, in addition, to impose some federal controls on the discretion usually afforded foundation managers operating in the capacity of public fiduciaries, Congress provided in section 4944 that a private foundation and its manager(s) shall be taxed at the rate of five per cent on the amount of any investment which is deemed to jeopardize the execution of the foundation's exempt purposes.[139] Notwithstanding the speculative nature of an investment, however, it does not fall within the purview

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[138] *Senate Report, supra* note 73, at 41.

[139] I.R.C. § 4944(a). This tax on the foundation is increased to 25 per cent if it does not recoup that investment within 90 days after the receipt of a deficiency notice. I.R.C. § 4944(b)(1). An additional 5 per cent tax is imposed upon any manager who refuses to agree to a recoupment of the investment. I.R.C. § 4944(b)(2).

of section 4944 if it is "program related."[140] An investment is program related if it accomplishes any one charitable purpose and does not have, as a *significant* purpose, the production of income. With this exception, it would seem that a community development corporation has little to fear from section 4944. An activity designed to provide job opportunities and training is charitable, whether conducted through a subsidiary or directly.[141] Whether an additional purpose is the production of income and whether that purpose is *significant* are questions of fact, but questions which likely can be determined in favor of the community development corporation, particularly given the abuses which section 4944 was designed to correct.[142]

Section 4944, does, however, present an interesting example of how an already confusing area can be further confused, even to the present point of being all but incomprehensible. Sections 511-13 deal with the question of whether an activity is related to the exempt functions of a charity. A body of law has developed around these sections which, while far from adequate for definitional purposes, at least provides the tax planner with a modicum of predictive capacity. Sections 4942 and 4943 use the term "functionally related," a term which incorporates the previously developed notions of relatedness but broadens them somewhat to include other activities which, while not related in the strict sense, still are sufficiently related to justify a charity retaining an interest in them or expending funds to further their activities. Then, for some unknown reason, in section 4944 Congress uses the term "program related" to define an exception which, like those in sections 4942 and 4943, deals with the question of how and for what projects a private foundation may allocate its funds. "Program related investments" seem to be a broader category than "functionally related investments" because the latter includes only those expenditures which bear a relationship to the purposes and activities for which the foundation was granted its exemption, rather than expenditures which can generally be classified as for charitable purposes. It is, therefore, hypothetically possible for a private foundation to make an investment which passes the muster of section 4944 and yet, because it is outside the foundation's present charitable program or

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140 I.R.C. § 4944(c).

141 *See* notes 30-36 *supra* & accompanying text. *See also Senate report, supra* note 73, at 46.

142 *See* Randall Foundation v. Riddell, 244 F.2d 803, 808 (9th Cir. 1957); Samuel Friedland Foundation v. United States, 144 F. Supp. 74 (D.N.J. 1956).

operational activities, will not be treated as a qualifying distribution. Thus, in determining the propriety of making any specific distribution, the foundation will be safer in relying on the more restrictive functionally related definition rather than the broader program related definition, even if the immediate concern is the speculative nature of the investment.

Finally, in measuring the nature of the expenditure, section 4944 substitutes an objective "prudent trustee" standard[143] for the previously used subjective standard.[144]

(e) *Reporting Requirements*

Of those sections which circumscribe the activities of private foundations, the reporting and publicity requirements may well prove to be of most concern, particularly to the small community development corporation. The impact of these requirements may be especially great because of the time and consequent expense involved in meeting them and the expense of establishing an accounting system adequate to insure compliance.[145]

Imposition of the new reporting requirements reflects congressional concern with previous reporting requirements[146] which were inadequate because the information required was incomplete and was frequently not sufficiently current.[147] In addition, prior to the Tax Reform Act, no penalties were imposed on a charitable foundation's failure to meet the reporting requirements.

Section 6033 prescribes what must be reported and who must make the report. It provides that, with a few exceptions, all organizations exempt under section 501(a) are required to file a so-called informational return.[148] Only the information required of an organ-

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[143] *Senate Report, supra* note 73, at 46.

[144] *E.g.*, Samuel Friedland Foundation v. United States, 144 F. Supp. 74 (D.N.J. 1956). That court found it sufficient that the foundation manager, a man with vast business experience as well as "insider" knowledge of the corporation in which the investment was made, saw little danger of jeopardy to the foundation's charitable activities.

[145] Proposed Treas. Reg. § 1.6001-1(c). 35 Fed. Reg. 16049 (1970), requires most exempt organizations and all private foundations to keep permanent books of account and records sufficient to show specifically items of gross income, receipts and disbursements. The authority for this regulation is contained in I.R.C. § 6033(a)(1).

[146] I.R.C. § 6033, *as amended by* section 101(d)(1) of Pub. L. No. 91-172, 83 Stat. 419-521 (1969).

[147] *Senate Report, supra* note 73, at 52; *House Report, supra* note 73, at 36.

[148] I.R.C. § 6033(a)(1). The exceptions are churches and their auxiliaries and conventions, exclusively religious activities of a religious order and other certain narrowly defined organizations, not private foundations, whose gross receipts do not normally exceed $5,000 in any taxable year. *See* I.R.C. § 6033(a)(2).

ization exempt under 501(c)(3), however, is specifically delineated.[149]

In addition to filing an informational return, all organizations classified as private foundations which have assets of $5,000 or more at any time during the taxable year, must file an annual report.[150] The required contents of that report mirror the stipulations of section 6033(b) and must include: (1) an itemization of all securities and other assets, showing both book and market-values; (2) a list of all grants and contributions made and approved during the year, the recipient thereof, whether that recipient is related to the foundation, its managers or substantial contributors and a *concise* statement of the purpose for which the grant was made; and (3) the names and addresses of the foundation managers, and which of these persons, if any, are substantial contributors to the foundation or own 10% or more of the interest in any business entity in which the foundation also owns a ten per cent or greater interest.[151] This information must be made available by the foundation to state officials or other persons whom the Secretary prescribes,[152] and to the general public.[153] A failure to file either the informational return or the annual report or both on the appointed day carries a $10 per day fine (up to $5,000) on the foundation and, in some situations, its manager(s).[154] In addition, section 6685 provides for a fine of $1000 to be assessed against any party wilfully failing to file[155] and section 7207 provides for a fine of $1000 and a maximum one year in prison for knowingly supplying false information on either the informational return or the annual report.[156]

It is not suggested that a community development corporation will necessarily be subject to the penalties imposed by sections 6685 or 7207. What is suggested is that the penalties imposed are of sufficient severity to prod a community development corporation into

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149 I.R.C. § 6033(b). Proposed Treas. Reg. § 1.6033-2, 35 Fed. Reg. 16049-51 (1970).

150 I.R.C. § 6056(a)&(d)(1).

151 I.R.C. § 6056(b) (emphasis added).

152 I.R.C. § 6056(d)(3). The information must be made available to designated state officials by the Secretary at the request of those officials. I.R.C. § 6104(c).

153 I.R.C. § 6104(d). This is in addition to public and congressional access to the original exemption application. *See* I.R.C. §§ 6104(a)(1)(A)&(a)(2).

154 I.R.C. § 6652(d). The manager(s) is subject to the fine only after he fails to file by the time designated in a deficiency notice issued by the secretary.

155 I.R.C. § 6685. This apparently applies only to a willful failure to file the annual report, not the information return.

156 I.R.C. § 7207.

establishing a first-rate accounting procedure, ensuring that the procedure is constantly and expertly reviewed, and ensuring that those who maintain or deal with that system possess sufficient expertise. This is expensive, possibly too expensive for a community development corporation which does not possess the assets with which to achieve what it desires, much less the resources needed to secure the professional accounting assistance necessary to run a "tight ship."[157]

IV. CONCLUSION — A POSSIBLE WAY OUT

Two additional provisions have not been discussed primarily because these should pose little difficulty for a community development corporation under normal operating circumstances.[158] The sections of the Code which have been discussed, however, pose some rather difficult problems for a community development corporation dependent for its support upon private foundations and whatever additional income can be generated from its business ventures. For these entities, several alternatives exist.

First, by operating its businesses directly the community development corporation can avoid the tax on net investment income, the penalty tax on excess business holdings and possibly the tax on failure to distribute income. Yet, the avoidance of these taxes is undertaken at the risk of: (1) jeopardizing all its activities for the sake of one which was initially ill-conceived, and (2) of losing its exempt status altogether. Even assuming these risks are considered worth accepting, this alternative provides at best only a partial solution.

Secondly, the community development corporation may terminate its status as a private foundation either by changing its pattern of support or distributing its net assets to a similar organization which is publicly supported and has been so for at least five years previous to that distribution.[159] The first possibility — that of changing its pattern of support — is by hypothesis impossible. The second — that of distributing its assets to a publicly supported charity — is equally unattractive. The likelihood of discovering a community development corporation which has been in existence for five

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157 *See* Sugarman, *Foundation Operation Under the Tax Reform Act*, 48 TAXES 767, 784-86 (1970).

158 These are I.R.C. § 4941 (self-dealing) and I.R.C. § 4945 (taxable expenditures).

159 I.R.C. § 507(b). Termination in any other manner, i.e., by distributing to another charitable community development corporation which is either a private foundation or if publicly supported has not been so for the five year period, will result in a tax equal to the *lesser* of the aggregate tax benefit accruing to the corporation and its substantial contributors since its formation or the value of the net assets. I.R.C. § 507(c)&(e).

years, much less one which has been publicly supported for that time, is small. Further, lest a community development corporation prostitute its avowed purpose of community betterment by means of community control, such a publicly supported development corporation must be located, or be willing to locate, in the same neighborhood — an equally unlikely result.

The corporation could, of course, continue operating as a private foundation and accept the risks attendant to that status, but there is another alternative, at least for a new organization or one which is still awaiting a ruling on its private foundation status.[160] A community development corporation can apply for an exemption under section 501(c)(4) as a social welfare organization.

While the new act has changed the procedure for acquiring a charitable exemption,[161] it has not changed what appears to be a generally accepted principle that an organization meeting the stipulations of section 501(c)(3) may also be treated as a social welfare organization under section 501(c)(4).[162]

What is sacrificed in adopting this form is the ability to attract capital by reason of the deduction afforded the contributor. The real questions, however, are the extent of that sacrifice and whether the benefits of not being treated as a private foundation make the trade-off realistic.

The extent of the sacrifice may not be as great as might appear at first blush. In the first place, contributions to a social welfare organization are deductible under section 162 of the Code as ordinary and necessary expenses of doing business if the contributor can show that the contribution bears a direct relation to his business and that a possibility of financial return exists commensurate with the amount of the contribution.[163] While placing a heavy burden of proof on the contributor, a businessman threatened by the economic vicissitudes of a depressed neighborhood and its consequent

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160 The presumption that all organizations described in section 501(c)(3) are private foundations would seem to apply only up to and including the date on which the organization requests a contrary ruling. *See* I.R.C. § 508(b).

161 Prior to 1969, an organization could be classified as charitable without having had applied for a charitable exemption. *See Senate Report, supra* note 73, at 53; *House Report, supra* note 73, at 37. Presently, for an organization to secure a charitable exemption it must apply for such a ruling. I.R.C. § 508(a)(1).

162 Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (1959).

163 Treas. Reg. § 1.162-15(b) (1958) *as amended by* T.D. 6819, 1965-1 CUM. BULL. 90; I.T. 3706, 1945-2 CUM. BULL. 87. *See also In re* San Francisco Bay Exposition, 50 F. Supp. 344 (N.D. Cal. 1943). *See generally* Note, *Tax and Other Legal Aspects of Business Involvement in Ghetto Development Programs*, 20 CASE W. RES. L. REV. 825, at 848 n. 69.

effect on the marketability of its property might be a likely candidate for a contribution. Equally likely, and maybe more desirable in terms of the amount of the contribution, might be a large corporation which, because of its location in an economically depressed neighborhood, is finding it increasingly difficult to attract a skilled labor force, or one, again because of its location, which is fearful of the results of civil disorder and therefore willing to purchase, by its contribution, a certain amount of good will.

Moreover, the private foundation still remains a potential source of funds. In order to ensure that the grant will be treated as a qualifying distribution, it must be used for charitable purposes, but it need not necessarily be granted to a charitable organization.[164] The grantor is required to exercise expenditure responsibility but this does not mean that he is required to ensure that the grant will in fact be expended for charitable purposes. It only means that the grantor must exercise certain defined precautions to assure that result.[165]

It is not contended here that the suggested approaches to acquiring capital funds will minimize the practical difficulties which will be faced by a social welfare organization. Indeed, it would be folly to assert that the same capital-attracting potential exists for a social welfare organization as for a charitable organization, but clearly a potential is there. It is equal folly, however, to ignore the destructive potential of the private foundation provisions on a small community development corporation. Whether a social welfare exemption is a good trade for a lesser amount of venture capital is a question impossible of immediate resolution. Nevertheless, it is a question deserving of thoughtful consideration.

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164 I.R.C. § 4942(g)(1)(A).

165 I.R.C. § 4945(d)(4). Proposed Treas. Reg. § 53.4945-5(b), 36 Fed. Reg. (1971).