# Critical Issues in Creating & Operating CED Ventures

Based on a presentation made to CED grantees by Eleanor Evans, Esq. from Community Action Program Legal Services, Inc.

This resource provides an overview of legal topics that affect CED grantee organizations.
*This resource does not provide legal advice or address state law. Grantees seeking additional information should seek legal counsel, tax advice, and accounting services regarding your organization's circumstances from qualified professionals.*

## Protecting your 501(c)(3) Status

Organizations must be organized and operated **exclusively** for one or more **exempt purposes**.

- Purposes related to Community Economic Development (CED) activities:
  - Relief of the poor and distressed or underprivileged
  - Promotion of social welfare by organizations designed to:
    - Combat community deterioration and juvenile delinquency
    - Lessen neighborhood tensions
    - Eliminate prejudice and discrimination
  - Lessen burdens of government (this may be hard to satisfy)
  - Advancement of education
- To be related, the activity must make an important non-financial contribution to 501(c)(3)'s exempt programs.
  - Activity is not related just because it generates funds that support exempt activities
  - Must further 501(c)(3)'s exempt purposes as stated in articles of incorporation
- Limited amount of unrelated activity is permitted, though too much can lead to unrelated business income tax or loss of exempt status.

501(c)(3)s must also:

- Serve a public benefit
- Not inure earnings of the 501(c)(3) to any private individual
- Be alert for conflicts of interest and follow IRS "intermediate sanctions" rules

## 501(c)(3)s are subject to tax on unrelated business income (UBI)

**Unrelated Business Income Tax (UBIT):** A 501(c)(3) is subject to tax on unrelated business income, such as income from a trade or business regularly carried on that is not substantially related to the organization's tax-exempt purpose.

- 501(c)(3)s must report annual amounts of UBI over $1,000 on Form 990-T
- **"Regularly Carried on"** means activity engaged in frequently or similarly comparable commercial business activity for as often and long as if it were operated by a non-exempt organization, and in the way a non-exempt organization would carry on (with an annual event exception).
- There are exceptions on passive income:
  - Dividends and interest from investments (not including interest, royalties, etc. from controlled entities)
  - Rent from real property not financed by debt, not rented to a controlled entity
  - Debt-financed property, if greater than 85% of activities related to the mission
  - Capital gains from sale of stock or property
- Activities NOT subject to UBIT include:
  - Conducted primarily by volunteers (more than 85%)
  - Sale of primarily donated goods (less than 85%)
  - Activities carried on for the convenience of employees, clients, and members
  - Qualified sponsorship payments
  - Sale of products resulting from performance of exempt function

- State/Local Taxes:
  - Check whether state UBIT is on unrelated business income (in some cases, the city or county may tax unrelated business income)
  - Possible impact on real and personal property tax exemption
  - If selling items or services, you may need to collect and remit state sales/use tax

## CED Grantees Working with For-Profits

When assisting for-profits using CED funds, grantees should set a criterion determining whether businesses are eligible for assistance, e.g.:

- In an economically depressed or blighted area
- Will benefit minorities, unemployed or underemployed
  - Where plan is for business to hire low-income people, require through contracts, loan terms etc.
- Have experienced difficulty getting financing

There are several legal structures 501(c)(3)s can use when working with for-profits:

- Program or division of 501(c)(3)
- Single-member limited liability company (LLC)
- Subsidiary
- Limited partnership
- L3C (Low-Profit Limited Liability Company)
- "Benefit" corporation
- Joint ventures

Grantees may consider working with for-profits in a **joint venture**. Joint ventures are two or more entities coming together to undertake an enterprise in which they will jointly share the distribution of profits and losses from the enterprise.

- IRS requires that 501(c)(3) must control the activities of the venture
- Consider possible private inurement/private benefit issues:
  - Furtherance of 501(c)(3)'s exempt purposes
  - Governance of joint venture
  - Distribution of earnings between the parties
- Seek tax and legal advice
- Adopt a joint venture policy

When working with a for-profit, grantees should keep the entities separate and follow these practices:

- Observe corporate formalities:
  - Separate articles (for corporation), LLC filing with the state
  - Adopt and follow bylaws (corporation) and/or operating agreement
  - Separate boards, board meetings, and minutes
  - Separate EINs, bank accounts, financial records, and IRS/state filings
  - For-profit subsidiary:
    - Must be adequately capitalized
    - Agreement for sale of stock
    - Issue shares of stock
- Separate websites
- Shared staff and facilities:
  - Maintain and follow agreements
  - Allocate expenses
  - Allocate time for staff
- Consequences of failure to keep separate:
  - Risk that debts, income, and liabilities of one entity will be attributed to another.
  - Tax issues
  - Problem with funding sources if grant funds and/or staff, equipment, or facilities paid for with grant funds used by the wrong entity.

## Federal Grant Rules

**Program income:** Federal funding sources may view revenue as program income. The grantee's gross income directly generated by a grant-supported activity or earned as a result of a grant award during the period of the performance. Includes, but is not limited to:

- Fees for services
- Income from use/rental of property acquired with grant funds
- Income from sale of commodities/items made under grant award
- Principal and interest on loans made with grant funds

Program income is subject to same rules as "regular" grant funds.

- Three alternatives for use:
  - Deducted from total allowable program costs to determine net allowable program costs on which federal share is based
  - Added to federal funds committed to program and used to further eligible program objectives
  - Used to finance some or all the program's non-federal share

**Shared Employees:** Grantees must track staff time and allocate salaries and benefits appropriately between grant-funded and other activities per Uniform Guidance (45 CFR § 75.430).