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Community Action Program Legal Services, Inc.

Look Before You Leap: Critical Issues in Creating & Operating CED Ventures

OCS 2016 CED Grantee Conference

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Agenda

- Examples of community economic development (CED) ventures
- OCS CED funding
- Protecting your 501(c)(3) status
- Choosing a legal structure and keeping entities separate
- Federal grant law rules
- Additional legal considerations

CED Examples

- Real estate development and rental
- Purchase of equipment for use in businesses
- Operating for-profit businesses
- Loans to and equity investments in for-profits
- Business incubators
 - Space
 - Support services
 - Technical assistance and mentoring
 - Training
- Job creation and training for low-income individuals

OCS CED Grants

- Startup or expansion of businesses;
- Capital expenditures such as the purchase of equipment or real property;
- Allowable operating expenses; and
- Loans or equity investments
- Healthy Food Financing Initiative
- Yearly funding announcements; more info at:
<http://www.acf.hhs.gov/programs/ocs/programs/ced>

OCS CED Grants

- To be eligible for OCS CED grants must be a community development corporation (CDC) – i.e., an entity defined by federal law for purposes of CED grants from OCS (42 U.S.C. § 9921)
- Governed by board that consists of community residents and business and civic leaders
- A principal purpose is planning, developing, or managing low-income housing or community development projects

OCS CED Grants – Award Terms

- Service area
 - CED ventures must support a service area with unemployment and poverty rates that are at or above the state or national levels
 - HFFI ventures must be in a food desert or similar area
- Must create minimum number of new, full-time, full-year jobs that did not previously exist
 - Must recruit low-income individuals to fill 75% of those jobs
 - Must ensure that businesses and jobs created remain viable for at least one year after end of grant period

Protecting Your 501(c)(3) Status: Purposes

- Section 501(c)(3) organizations must be organized and operated **exclusively** for one or more **exempt purposes** described in IRC 501(c)(3)
- § 501(c)(3):
 - “...religious, **charitable**, scientific, testing for public safety, literary, or **educational** purposes, or to foster national or international amateur sports competition ... or for the prevention of cruelty to children or animals...”

501(c)(3) Purposes Related to 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, or
 - Eliminate prejudice and discrimination, or
- Lessening burdens of government
 - May be hard to satisfy
- Advancement of education

501(c)(3) Purposes

- To be related, the activity must **make 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
 - Too much can lead to **unrelated business income tax** or **loss of exempt status**

Other 501(c)(3) Rules

- Must serve **public**, rather than private, benefit
- Earnings of the 501(c)(3) **may not inure to any private individual** (i.e. insider)
 - Compensation paid to insiders for services must be reasonable
 - Transactions with insiders must be at arm's length, fair market value (FMV)
- Be alert for conflicts of interest (especially with insiders) and follow IRS “intermediate sanctions” rules (26 U.S.C. § 4958)

IRS Criteria for CED Assistance To For-Profits

- Aids economically depressed or blighted area;
- Benefits a disadvantaged group, such as minorities, the unemployed or underemployed; and
- Aids businesses that either:
 - Have experienced difficulty in obtaining conventional financing, or
 - Would locate or remain in economically depressed area and provide jobs and training for unemployed or underemployed individuals only if the assistance was available

What These Rules Mean for You

- Check purposes language in your organization's articles of incorporation
 - Amend if necessary
- Set criteria for determining whether businesses are eligible for assistance, e.g.:
 - In depressed 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

Joint Ventures

- What is a joint venture?
 - 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
 - Joint ventures may be created in various ways – e.g., contract, LLC, limited partnership
- IRS requires that 501(c)(3) must **control the activities** of the venture

Joint Ventures

- 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

Unrelated Business Income Tax

- 501(c)(3) subject to tax on **unrelated business income**
 - Income from a trade or business regularly carried on that is not substantially related to the organization's tax-exempt purpose
- Must report annual amounts of UBI over \$1,000 on Form 990-T
- Tax assessed on gross income, minus allowable deductions
- Too much unrelated activity can jeopardize tax-exempt status

UBIT – “Regularly Carried On”

- Activity engaged in frequently or continuously similar to comparable commercial business activity
 - For as often and as long as if operated by non-exempt organization and in the way a non-exempt organization would carry on
 - Annual event exception



UBIT Exceptions – Passive Income

- Dividends and interest from investments
 - But not interest, royalties etc. from controlled entities (dividends are OK)
- Rent from real property not financed by debt, not rented to controlled entity
 - Services provided must be minimal
- Debt-financed property, if $> 85\%$ of activities related to mission
- Capital gains from sale of stock or property

Exclusions from UBIT

- Activities NOT subject to UBIT:
 - Conducted primarily (> 85%) by **volunteers**
 - Sale of primarily **donated goods** (< 85%)
 - Activities carried on for the **convenience** of employees, clients, members
 - Qualified **sponsorship payments** (sponsor will not receive any substantial benefit other than use or acknowledgment of business name or logo)
 - Sale of products resulting from **performance of exempt function**

State/Local Taxes

- Check whether state UBIT on unrelated business income
 - In some cases (e.g., Columbus) city or county may tax unrelated business income
- Possible impact on real and personal property tax exemption
- If selling items or services, may need to collect and remit state sales/use tax

Choosing a Legal Structure

- Program or division of 501(c)(3)
- Single-member limited liability company (LLC)
- Subsidiary
 - Non-profit corporate subsidiary or affiliate
 - For-profit corporate subsidiary or affiliate
- Other possible structures:
 - Joint ventures (e.g., multiple-member LLC)
 - Limited partnership (e.g., for investment fund)
 - L3C (Low-Profit Limited Liability Company)
 - “Benefit” corporation

Keeping Entities Separate

- Observe corporate formalities:
 - Separate articles (for corporation), LLC filing with state
 - Adopt and follow bylaws (corporation) and/or operating agreement (LLC)
 - Separate boards, board meetings, minutes
 - Separate EINs, bank accounts, financial records, IRS/state filings
 - For for-profit subsidiary:
 - Must be adequately capitalized
 - Agreement for sale of stock
 - Issue shares of stock
- Separate websites

Keeping Entities Separate

- Shared staff and facilities
 - Maintain and follow agreements
 - Allocate expenses
 - For staff, allocate time
- Consequences of failure to keep separate:
 - Risk that debts, income, liabilities of one entity will be attributed to other
 - Tax issues
 - Problem with funding sources if grant funds and/or staff, equipment or facilities paid for with grant funds used by wrong entity

Federal Grant Rules

- Program income
 - Federal funding sources may view revenue as program income
- Restrictions on use of equipment, facilities purchased with federal grants

Program Income

- Program income = grantee's gross income directly generated by a grant-supported activity or earned as a result of grant award during the period of performance
- Includes (but 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

See Uniform Guidance (45 CFR § 75.307)

Use of Program Income

- Program income subject to same rules as “regular” (i.e., appropriated) 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/all of program’s non-federal share

See Uniform Guidance (45 CFR § 75.307)

Federal Interest

- Federal interest – created when federal grant funds used for acquisition or improvement of certain types of property
- Reversionary interest
 - Part of federal interest
 - Comes into play when property no longer needed by grantee for its funded use, or grantee defaults

Federal Interest

- Applies to certain types of property acquired or improved with federal funds:
 - Real property
 - Equipment (unit cost of \$5,000 or more)
 - Supplies
 - Intangible property (e.g., loans, notes, debt instruments, stock) and copyrights

See Uniform Guidance (45 CFR §§ 75.318, 75.320, 75.321, 75.322)

Federal Interest

- Real property, equipment, and intangible property must be held in trust by grantee as trustee for the beneficiaries of the project or program under which the property was acquired or improved
- Property shall not be encumbered without the approval of the federal awarding agency

See Uniform Guidance (45 CFR § 75.323)

Use of Federally Funded Equipment

- If using equipment acquired with federal funds to provide services to outside organizations, must generally charge FMV – i.e., what private companies charge for equivalent services – as long as fed. gov't continues to have an interest
 - See Uniform Guidance (45 CFR § 75.320(c)(3))
- While equipment is used for project for which it was acquired, "user charges" for use on other federally funded projects are treated as program income
 - See Uniform Guidance (45 CFR §§ 75.320(c)(2) and 75.307)

Encumbering Federally Funded Equipment

- Obtain approval of federal awarding agency before encumbering (i.e., granting a security interest in) equipment purchased with federal grant funds

See Uniform Guidance (45 CFR § 75.320)

Equipment Disposition

- Seek disposition instructions from awarding agency when disposing of equipment purchased with federal grant funds that has a current per unit FMV of more than \$5,000
 - Items of equipment with a per unit FMV of \$5,000 or less may be retained, sold or otherwise disposed of with no further obligation to the HHS awarding agency

See other rules in Uniform Guidance (45 CFR § 75.320)

Disposition of Supplies

- If there is a residual inventory of unused supplies exceeding \$5,000 in total aggregate value upon termination or completion of the project and the supplies are not needed for any other federal award, must retain the supplies for use on other activities or sell them
- Either way, must compensate the Federal Government for its share. The amount of compensation must be computed in the same manner as for equipment (see 45 CFR § 75.320(e)(2))

See Uniform Guidance 45 CFR § 75.321

Use of Federally-Funded Facilities

- Must account to federal government for use of facilities for purposes other than those funded under grant
 - See Uniform Guidance (45 CFR § 75.311(b))
 - See Uniform Guidance (45 CFR Part 75, Subpart E)
- Allocate costs

Real Property – Notice of Federal Interest

- Must record notice of federal interest and send a copy to federal awarding agency
 - Specifies conditions on use and disposition of the property for the useful life of the property
 - Including funding source approval before property sold, leased, transferred or encumbered

See Uniform Guidance (45 CFR § 75.318)

Disposition of Real Property

- When property no longer needed for original project
 - Get approval from awarding agency before using real property for another federal project or similar use
 - Get disposition instructions before using for a non-federal project or unrelated use or before selling etc.

See Uniform Guidance (45 CFR § 75.318)

Shared Employees

- Must track staff time and allocate salaries and benefits appropriately between grant-funded and other activities

See Uniform Guidance (45 CFR § 75.430)

Securities Laws

- If planning to seek investors in for-profit business or investment fund, seek legal advice on securities law compliance

Don't Go It Alone!

- This presentation is a general overview, not legal advice and doesn't address state law
- Seek legal counsel, tax advice and accounting services regarding your organization's particular circumstances from qualified professionals

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