Economic Development Organizations, Trickle Down Charity and the Private Benefit Doctrine

By Matthew J. Rossman

The last fifteen years has seen a surge in charities that foster private sector job creation. Recent research I conducted indicates that each of the 50 largest metropolitan areas in the United States is now home to at least one nonprofit (usually a 501(c)(3) organization) that has a primary mission of providing direct aid to for-profit businesses in order to increase regional job opportunities. These organizations, which I term “regional economic development organizations” (REDOs), run venture capital funds, recruit companies to move to their regions, and provide low cost or no cost technical assistance and incubator space to business owners.

Although REDOs are making a significant impact on local and regional job growth in some areas, those that seek to operate as 501(c)(3) charities should raise at least one challenging question for their lawyers. That is, how to satisfy the “private benefit doctrine”? The private benefit doctrine provides that an organization is not organized or operated exclusively for charitable (or other) exempt purposes under Section 501(c)(3) “unless it serves a public rather than a private interest.”¹ Over time, the IRS has interpreted this doctrine as requiring that any benefit to private interests resulting from a 501(c)(3) organization’s activities must result only incidentally from its achieving public benefit.²

The basic operating model of a typical REDO presents a conundrum in this respect. Intrinsic to its work is direct aid to entrepreneurs and for-profit businesses so that they may generate private wealth (and hopefully lots of it). In theory, if enough of these businesses ultimately succeed, secondary public benefits like the creation of jobs or the revitalization of a distressed community will follow. This represents a reversal of what the private benefit doctrine permits – it is privately owned businesses which are the direct beneficiaries of the organization’s activities and the community’s residents who benefit incidentally. Even at its most altruistic, economic development is still “trickle down charity.”

So how does the IRS evaluate REDOs that apply for 501(c)(3) status? Short answer: It depends based on what type of underlying charitable purpose the organization claims to further. Many REDOs assert that they further charitable purposes by aiding economically distressed individuals and areas. In reviewing these organizations, the IRS relies principally on three revenue rulings from the 1970s that implicitly apply the private benefit doctrine.³ These rulings stand for the proposition that a charity may provide its services directly to businesses provided the businesses are merely the instruments by which the organization accomplishes its charitable purposes. For example, an organization that planned to make loans to and equity purchases in

¹ Treas. Reg. § 1.501(c)(3) – 1(d)(1)(ii).
businesses located in high density urban areas inhabited mainly by disadvantaged groups qualified as a 501(c)(3) because it prioritized businesses that provided training and employment opportunities for unemployed residents who lived in those areas. On the other hand, organizations that aid all businesses in an area, without regard to those that achieve the greatest potential community benefit, should in theory not qualify as charities because they “encourage private business development while only incidentally furthering social welfare purposes.”

A second common category of economic development organizations that seek to qualify under Section 501(c)(3) are those that claim to lessen governmental burdens. An organization that demonstrates that its activities accomplish those that a governmental agency would actually have had to perform and are subject to some measure of oversight or direction from that agency usually fits into this category. Although technically these organizations must also satisfy the private benefit doctrine, IRS private letter rulings suggest that the IRS typically expends little effort assuring itself that the relative balance of public and private benefit is appropriate in these cases.

In an article recently published in the Brooklyn Law Review, I argue that the current approach to evaluating economic development charities is outdated, inconsistent and insufficient. Satisfaction of the private benefit doctrine is a fundamental issue facing almost all REDOs seeking 501(c)(3) status, and it is unfair to lower and raise the bar based on which charitable purpose an organization cites. Furthermore, the types of economic development in which 21st century charities engage are far more ambitious and geographically broad than that carried out by organizations in the 1970s which worked principally in highly distressed urban neighborhoods and heavily impoverished rural areas. The IRS should adopt more nuanced standards for evaluating REDOs and require long-term accountability from these organizations via a specialized schedule to IRS Form 990. You can download my full article for free if you would like to read more about this topic and my proposals at: http://ssrn.com/abstract=2376470.

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4 Rev. Rul. 74-587.
6 There are a few other categories as well. Some REDOs, in particular those that are associated with university programs and research institutions, claim 501(c)(3) status for educational or scientific purposes. Counsel should review IRS rulings specifically addressing those organizations, as the rigor with which the IRS applies the private benefit doctrine to them also varies.
7 See, e.g., Robert Louthian & Amy Henchey, Lessening the Burdens of Government, 1993 EO CPE Text (1993), in which the IRS explicitly chides its own agents for neglecting to consider the private benefit doctrine with respect to groups claiming to lessen governmental burdens.
represent a wide range of nonprofit organizations, as well as for profit entities that seek to achieve a charitable purpose.