2009

More Private Equity, Less Government Subsidy, and More Tax Efficiency in Urban Revitalization

Roger M Groves, *Florida Coastal School of Law*

MORE PRIVATE EQUITY, LESS GOVERNMENT SUBSIDY, AND MORE TAX EFFICIENCY IN URBAN REVITALIZATION: Modeling Profitable Philanthropy and Investment Incentives

By Roger M Groves[1]

[1] Roger M. Groves is an assistant professor of law at Florida Coastal School of Law, former tax judge and equity partner at Howard & Howard, Attorneys, PC, and counsel to Lewis & Munday, PC.

TABLE OF CONTENTS

"The problem with the current income tax is that we are using it
to try and solve America's economic and social problems…and we know
that as a solution, it fails. Tax breaks are not working for these purposes."[2]

INTRODUCTION

The internal revenue code ("Code") is fundamentally designed to collect revenue.[3] But the Code's purposes have expanded and become complicated and voluminous.[4] This is due in large part to a Congressional appetite to use the Code to encourage certain behaviors from taxpayers by giving tax deductions or credits to reduce tax liability if the encouraged activities are undertaken.[5] One such encouraged behavior is charitable giving to those less fortunate within the country. Since 1917 tax deductions

---

[2] Michael Graetz, *Session 2: A Closer Look at tax Reform Options Within Fiscal Policy Restraints*, Taxes - The Magazine, Commerce Clearing House, 51, 54 (June, 2008). Mr. Graetz is a Justus S. Hotchkiss Professor of law, Yale Law School. This article was a reprinted part of a panel discussion with other tax experts, Hank Gutman, Douglas Holtz-Eakin, Jon Talisman and Kenneth Kiess.

[3] The origin of our current federal income tax statutes is the Sixteenth Amendment of the United States Constitution, which in 1913 provided in part: "Congress shall have the power to lay and collect taxes on incomes from whatever source derived…" See J. Martin Burke, Michael K. Friel, Understanding Federal Income Taxation, 17, Matthew Bender& Company, Inc, a member of LexisNexis Group (2001). The current internal revenue code codified that principle in its definition of gross income. I.R.C. § 61(a).

[4] One tax scholar opined: "We have a terrible tax system. The tax law is six times longer than War and Peace and not nearly as interesting, and much harder to parse." Michael Graetz, *Session 2: A Closer Look at tax Reform Options Within Fiscal Policy Restraints*, Taxes - The Magazine, Commerce Clearing House, 51, 54 (June, 2008). Mr. Graetz is a Justus S. Hotchkiss Professor of law, Yale Law School. This article was a reprinted part of a panel discussion with other tax experts, Hank Gutman, Douglas Holtz-Eakin, Jon Talisman and Kenneth Kiess.

4. As for tax credits as incentives, Congress encourages business investment in plant, machinery, and equipment through a substantial amounts of depreciation for exhaustion, wear, and tear of such property used in the business under Section 167 of the Code. I.R.C § 167. No such depreciation deduction is allowed for personal expenditures such as a lawn mower for the taxpayer's residence. As noted in a recent law review article: "Currently, biofuel production relies heavily on **tax** incentives to keep prices of biofuels competitive against petroleum products. FN[FN119] The largest federal government subsidy, the Volumetric Ethanol Excise Tax Credit ("VEETC"), rewards ethanol producers without limit and with no regard to the price of gasoline..." Amanda R. Wishin, *Soy And The City: The Protection Of Indiana's Agricultural Land In Light Of Biofuel Issues*, 42 VALULR 1017, 1040 (Valparaiso University Law Review), Spring 2008. Incentives for ethanol production may be controversial yet worthy of incentives. This article advocates incentives for private equity "production" as also viable if well designed. The one incentive is designed to cure our country's addiction to crude oil. The other seeks to cure our addiction to subsidies for undeserving projects for the wealthy while solving for the urban revitalization in a fiscally responsible manner – incentivize private tax exempt foundations to partner with private equity capital sources.

have been provided for individual taxpayers that contribute to certain authorized charities.[6] But while the general public may be well apprised of the routine potential deductions available for charitable giving, far less is known about certain emerging and evolving tax vehicles that facilitate transformative affects on the urban landscape.

And the need for the transformative affect in the urban environment is acute because major cities of America are in a crisis at their core. The infant mortality rate among all African Americans is more than twice the national average, and is much worse among the poor in the core of urban America.[7] In those core areas, there is a profound correlation between drop out rates, unemployment, and incarceration with no realistic reprieve in sight. Illustrating this trilogy of tragedy are the following facts: As of 2004, 72% of African American dropouts who are in their 20's are unemployed, up from 65% in 2000.[8] Incarceration levels are at historic highs and increasing, where by their mid-30's, 6 in 10 of these high school drop outs have spent time in prison.[9] That rate is *four times* higher than that of Black men in South Africa under the apartheid regime.[10]

In hopes of curing this recurring and pernicious malady, we use tax laws as incentives to those who chose to invest the depressed areas. Specifically, our tax policy

---

[6] For constitutional basis, see J. Martin Burke, Michael K. Friel, Understanding Federal Income Taxation, 351, (Matthew Bender& Company, Inc, a member of LexisNexis Group (2001). Charitable contributions are generally authorized as tax deductions for gifts to religious, charitable, scientific or educational organizations, *inter alia*. I.R.C. § 170(c).

[7] Center for Disease Control, http://www.cdc.gov/omh/AMH/factsheets/infant.htm (accessed June 13, 2006). The national average is 6.9 deaths per 1,000 live births, but 14.1 among African Americans. That is on par with the mortality of children from Bulgaria, Bosnia and Herzegovina, see study involving the World Health Organization and the World Bank (available at http://hdr.undp.org/reports/global/2003/indicator/indic_289.html) (accessed June 13, 2006).

[8] Eric Eckholm, *Plight Deepens for Black Men, Studies Warn*, N.Y. TIMES A1 (March 20, 2006). Eckholm was relying on data from a panel of experts at Columbia, Princeton, and Harvard, who opined that the rate of disconnectedness is "far" greater for these African American males than comparable white and Hispanic men. One factor of many is the reduced market for unskilled labor.

[9] Id.

[10] Dash T. Douglas, *A House Divided: The Social and Economic Underdevelopment of American's Inner Cities*, 10 U. FLA. J. L. & PUB. POL'Y 369, 381 (Spring 1999), citing Milton S. Eisenhower Foundation Report, *The Millennium Breach* 1(1998).

has been to use tax credits as a major incentive to those investors.[11] But those incentives given away to private investors come at a price to the public treasury. The tax credits are essentially a government subsidy that drains funds otherwise collected.[12] Tax credits – foregone tax collections - have been poured into city investors by the billions, over $820 million alone from the most recent initiative – New Markets Tax Credits ("NMTC").[13] Low Income Housing Tax Credits ("LIHTCs"), NMTC, *inter alia* are well intentioned, but without a major transformative impact.[14] But for a relatively few neighborhoods of gentrified projects where opera houses, convention centers, mixed use condominium-retail centers provide an enclave that only the wealthy can afford, most of the urban cores of today look much like they did in the 1960's – or worse.[15] Standing alone, such governmental tax subsidies are part of an urban strategy with vicissitudes that blow in political winds without being grounded in tax or economic principles that have changed the urban landscape. Urban decay has many causes and occurred over a long period of time. There is no short term fix for this long term problem. Governmental tax subsidies alone are short term gains through reduced taxes for a few investors (a tax credit for 7 years under the NMTC program, 10 years under the LIHTC program).[16] Whether the incentive takes the form of a tax deduction or tax credit, both are attempts to incentivize

---

[11] Tax credits are a dollar-for-dollar reduction in tax liability for the taxpayer, after taxable income and tax rates have been applied to arrive at a "tax liability". See Klein, Bankman, Shaviro, Federal Income Taxation, 24, (13th ed., Aspen Publishers, Inc. 2003.

[12] The tax credit is a "direct offset to the tax" otherwise collected and retained in the federal treasury. Id. at 24. Tax credits can provide a larger drain from treasury collections than deductions, because the later is not a dollar-for-dollar reduction in actual tax dollars paid, but rather a factor in reducing taxable income which is still multiplied by a tax rate. Id.

[13] Community Development Financial Institutions Fund, U.S. Dept of the Treasury, http://www.cdfifund.gov/who_we_/about_U.S.asp.

[14] LIHTCs are given to builders of low income housing. See I.R.C. § 42.

[15] Chicago data from Ethnivestor article.

[16] See I.R.C. § 45(a) (3) (A-B) for the 7-year credit period for the NMTC, and I.R.C. § 42 ___ for the 10-year LIHTC credit period.

investors into the urban areas through a year-by-year tax benefit of relatively minor amounts. That incentive for private investment has been historically inadequate.

On the sidelines of the urban battleground has been a large pool of previously underutilized private equity investors. They are motivated by both a social cause and reasonable profitability, (i.e. a willingness to subrogate the *maximization* of financial returns).[17] The result is a "double bottom line".[18] This author terms that theory "profitable philanthropy". This group comprises a potentially broadened base of equity investors. [19]

One underlying premise of this article is that high octane urban revitalization is more likely accomplished through investors who are more motivated by a return on investments than small tax deductions. As one tax expert opined when assessing the long view of tax deductions and other subsidies as social tools, "Congress today uses the income tax the way my other used chicken soup – as a cure for anything that ails you – and it doesn't work."[20]

---

[17] For these investors, certain non profit vehicles can meet their needs. They invest what would otherwise be private equity funds into tax exempt vehicles in joint venture with profit entities. The equation can increase private equity into not-for-profit projects, like construction of affordable housing and urban health care clinics. For definitions of these social entrepreneurs, see Roger M. Groves, Roger M. Groves, Time to Step Up: Modeling the African American Ethnivestor for Self-Help Entrepreneurship in Urban America, 111-113, Vol. 13, Issue 1, Fall 2007.

[18] See Priv. Ltr. Rul. 200709065 (2007), p. 1. See also Gail A. Lasprogata & Marya N. Cotton, *Contemplating 'Enterprise': The Business and Legal Challenges of Social Entrepreneurship*. 41 Am. Bus. L. J. 67, 69 (2003).

[19] We also need a refinement of filters on tax subsidies. Tax subsidies should be allocated to those with long term interests in the low income residents and projects that make them the primary beneficiaries of their equity investments. This is premised on the notion that urban core community is far larger than a gentrified few blocks and entire core area cannot be healthy unless the majority of those who live within it are economically healthy. See Roger M. Groves, Time to Step Up: Modeling the African American Ethnivestor for Self-Help Entrepreneurship in Urban America, 111-113, Vol. 13, Issue 1, Fall 2007. Small business modeling is recommended but beyond the scope of this article. Id, at 138-139.

[20] Michael Graetz, *Session 2: A Closer Look at tax Reform Options Within Fiscal Policy Restraints*, Taxes - The Magazine, Commerce Clearing House, 51, 56 (June, 2008).

Such an observation leads to the radical tax policy notion that is unremarkable in logic: Instead of trying to force a market-based investor into a tax-return based incentive, why not make the tax incentive more market based? For the philanthropic urban investor, the short term incentive of an annual tax benefit (credits from the annual tax returns) is singularly inadequate to cause a major shift in equity investments for the urban core. A preferred method of increasing that investor's participation is to increase the return on investments through joint ventures with tax exempt entities.[21]

There are vehicles for tax-favored treatment, even tax exempt treatment of equity-driven ventures. Yet such ventures have gained seemingly reluctant acceptance by the Internal Revenue Service ("IRS"), and have been obscurely tucked away within the Code, private letter rulings and regulations.[22] This article seeks to bring more public adoration and utilization to such vehicles while also increasing long term efficiencies through subsidy restructuring and downsizing over time.

The thesis of this article is that a greater contribution from private equity investors in capital and acumen should lead to a lesser dependence over the long term on governmental subsidy programs. How to significantly increase the private equity sector contribution to this cause is the billion dollar subsidy question. The proposed answer is the above-referenced paradigm shift in how we use tax subsidies: Allow these investors to actually have a near-market return on the investment (i.e. profitable philanthropy) *and* codify the allowances in statutes to add stability, clarity, and notice to those potential broadened equity investors.

[21] This method of increased investment does not also imply the total elimination of tax credits. It would unrealistic to assert that investors consider tax breaks to be irrelevant. And once a benefit is given, it is politically difficult to retract the benefit without significant gnashing of teeth.
[22] See the discussion of private letter rulings in Part III of this article.

Part 1 of this article examines the tax vehicles that profitable philanthropist can employ to aid in the urban revitalization. Part II identifies and analyzes the hurdles to the use a private equity- tax exempt entity joint venture. Part III offers statutory amendments and expansion of private letter rulings as solutions to the predominant private benefit hurdles to the joint venture models. Part IV summarizes tax policy implications from this subsidy paradigm shift to investment-enhanced and joint venture models.

Part I: The Target Philanthropic Investor Choice of Entities

There are various ways a socially conscious taxpayer may choose to "make a difference" in a community of interest and receive tax benefits. One route is to simply donate funds to a tax exempt entity, and receive a deduction for the charitable contribution.[23] The deduction for these contributions is capped annually and is inadequate as a stand-alone incentive for a movement of social entrepreneurs to make transformative revitalization as advocated in this article.[24] Because the focus of this article is on making a difference in the lives of whole communities, a major marshalling of resources is required. So the alternative method advocated in this article is a joint venture between tax exempt entities and groups of private equity investors. This vehicle is preferred for primarily three inter-related reasons:

(1) Due to the magnitude of the problem, tax exempt entities alone are under-resourced to have the desired transformative affect on urban areas so that tax subsidies can be reduced and quality of life increased for the target low income urban residents.

---

[23] I.R.C. § 170(c). Under this subsection a gift or contribution is deductible if made to organizations organized and operated exclusively for religious, charitable, educational purposes, *inter alia*, where no net earning benefit private owners or individuals.

[24] The charitable deduction has an annual cap determined by the taxpayer's contribution base. The contribution base is essentially adjusted gross income, and the deduction is a percentage of that base. I.R.C. § 170(b). So if a taxpayer is looking for major tax shelter as an incentive to invest in urban projects, this is not it.

(2) Private equity investors can infuse capital, expertise, and construction resources to assist the tax exempt entities fulfill their charitable missions.[25]

(3) Only the private infusion can exponentially increase the target population's self sufficiency to a point that reduces subsidy dependence for economic growth and thereby increase the tax collection base over the long term.

The model's equation is therefore: Tax Exempt Entity + Private Equity Socially Motivated Entity = Revitalization Project. The players of interest are the middle class, high net worth individuals and private entities capable of multi-million dollar contributions. So the issue becomes what entities are preferred for both ends of the equation. Tax exempt entities must analyze the profit entity carefully since a structure that prioritizes only profit motives may destroy the tax exempt status.[26] Similarly, the investor engaged in profitable philanthropy may choose to invest funds solely into a private entity and partner with the tax-exempt entity, but must still be careful about which type of tax exempt entity to do business.

<u>The Tax Exempt Entity of Choice: The Private Foundation</u>

Sophisticated donors may funnel contributions through any of three types of charitable entities: public charities, private foundations, or a lesser known category – donor advised funds. A discussion of the essential elements of these three choices can aid the decision making process. For both public charities and private foundations, qualification under the Code as a tax exempt entity is a threshold requirement, tied of

[25] See the discussion infra at ____, where the IRS has authorized continued tax exempt status when such joint ventures have been proposed.

[26] As will be discussed in greater detail below, tax exempt status is retained only if the activities are primarily charitable, so private benefits to individuals in the private partner could be deemed "private inurement" and a cause for disqualification of the entity attempting to retain exempt status. I.R.C. § 501(c)(3)

course to charitable purposes and the lack of private benefit (i.e. inurement) to individuals or entity owners.[27]

The distinction between public charities and private foundations is found most significantly in whom the funds are raised from. Public charities are just what they sound like, charities supported primarily by the general public and the government.[28] More specifically, the funding sources for public charities requires a receipt of more than one-third of its support each year from "gifts, grants, membership fees", and less than one-third of its support from investment income.[29] Private foundations are 501(c) (3) exempt organizations that fall outside of the public charity definition.[30]

Donor-advised funds are a breed apart – a fund that is often referred to as a public-charity alternative to a private foundation.[31] It is only a "fund", a "segregated account" for various charities and cannot be used to make a distribution to a single identified organization, like a private foundation.[32] True to the entitlement the donor is only advising the fund managers on how funds shall be distributed and to whom.[33] A separate tax exempt entity actually has the legal decision making authority on the

---

[27] The primary criteria are that the entity (1) is organized exclusively for charitable, educational, religious, or scientific purposes. Other authorized purposes are religious, literary, fostering amateur sports competition, or prevention of cruelty to animals, (2) no part of the net earnings benefit any private shareholder or individual, and (3) no substantial part of its activities involve lobbying for legislation or on behalf of a candidate for public office. I.R.C. 501(c) (3).

[28] I.R.C. § 170(b) (a) (A) (i)-(iv). Public charities also include churches, schools, hospitals, and governmental units under that section. Other qualifications of public charities include organizations that

[29] I.R.C. § 509(a) (2).

[30] I.R.C. § 509.

[31] See Victoria B. Bjorklund, Current Developments in Giving to Donor-Advised Funds Supporting Organizations and Private Foundations, 97, The American law Institute, (2007)

[32] I.R.C. § 4966 (d) (2).

[33] Id.

distribution.[34] And grants from the fund must be on an objective and non-discriminatory basis after approval of that separate governing board.[35]

Generally, the tax exempt vehicle choice is made not just on the entity types, but on a more comprehensive list of four factors: donor control, deductibility, distribution penalties, and excise taxes.[36] For the profitable philanthropist profile, “control” is accorded far greater weight.[37] This type of donor is typically using his or her own funds and wants to designate and control where and to whom the funds are donated. Since solicitations from the general public are not primary, public charities are a rare choice and not modeled here. The private foundation is therefore widely regarded as the preferred vehicle over public charities.[38]

For that same reason, the donor advised fund is also less desirable. The profiled donor would not want to abdicate the legal authority to determine the fund recipients on an objective basis to fund managers. Thus the private foundation is regarded here as the vehicle of choice for the tax exempt side of the equation.

Private Equity Socially Motivated Entity of Choice: The LLC

An underlying theme of this article is that tax policy is well served by infusing factors that motivate the private sector into the tax subsidy paradigm. For various business and tax reasons, the private sector is motivated to make the limited liability

---

[34] Id.
[35] I.R.C. § 4966 (d) (2) (B).
[36] See Victoria B. Bjorklund, Current Developments in Giving to Donor-Advised Funds Supporting Organizations and Private Foundations, 116, The American law Institute, (2007) for a detailing of these factors.
[37] Id.
[38] See Victoria B. Bjorklund, Current Developments in Giving to Donor-Advised Funds Supporting Organizations and Private Foundations, 116, The American law Institute, (2007).

company ("LLC") the entity of choice.[39] The advantages include the ability to gain the best of both worlds in that LLCs receive full corporate-like liability protection for all its members, while also receiving a "pass through" tax advantage of having income and expense items flow directly to the tax return of individual members without the double tax on both the entity and the individual.[40]

Particularly relevant to this article is the characteristic that LLCs are statutorily given the discretion to be creatures of contracts between members without the statutory restrictions as to finance and management that historically restrict corporations.[41] LLC statutes generally permit greater ability of the LLC to negotiate and contract the relative liability rights between partners than the more rigid requirements of corporations. There is no need to create special "surplus" accounts for dividends and no special requirement for management by a board of directors or equivalent body.[42] And saliently, LLCs can be operated for nonprofit purposes as well as profit purposes.[43]

These characteristics are advantageous to profitable philanthropists that seek to joint venture with a nonprofit entity. The relationship between entities can be more easily customized for the myriad of circumstances. For example, an LLC investor may not have a major financial stake in that entity. But in light of a commitment to the cause and relationship with the nonprofit, she may greater management or voting power than evidenced by a pure percentage of ownership interests. If one member or a group of

---

[39] See Nicholas G. Karambelas, The Revised Uniform Limited Liability Company Act, 33, Washington Lawyer, Vol. 22, No. 6 (February 2008) Journal of the District of Columbia;
[40] See Robert W. Hamilton, Jonathan R. Macey, Corporations , including Partnerships and Limited Liability Companies, 165 (9th ed.,Thomsom-West,2005), Note 1.
[41] See Robert W. Hamilton, Jonathan R. Macey, Corporations , including Partnerships and Limited Liability Companies, 165 (9th ed.,Thomsom-West,2005), Note 1.
[42] Robert R. Keating, et al., The limited Liability Company: A study of the Emerging Entity, 47 **Bus. Law**. 378, 385 (1992).
[43] See the Delaware Limited Liability Company Act, § 18-201.

members have the primary capital contributions to the LLC, they may still want to allocate power to other less financial members of the LLC. This flexibility is particularly helpful under this article's model, where the profitable philanthropist includes not only the financially well healed, but also the middle class citizenry that still wants to be part of "making a difference".

Among this middle class citizenry may be a carefully configured pool of the African American middle class termed "Ethnivestors" where among the more than $631 billion of earnings per year of total African Americans, they too can make a greater contribution to this private equity base.[44] As lack of exposure and access to capital has been a historic hurdle for these investors, the flexibility to allocate rights apart from capital contribution affords them a seat at the entity table that is more difficult or impossible to negotiate in the corporate entity form.[45] The end game includes adding these Ethnivestors to the private equity base. The benefits should be not only the tangible facilities, brick and mortar of the health care clinic, school, grocery stores, affordable housing, but also the self-help mentality that builds a community from within its own talent and resources.

Part II: Private Benefit Hurdles to Philanthropic Joint Ventures with Private Entities

[44] See Roger M. Groves, Time to Step Up: Modeling the African American Ethnivestor for Self-Help Entrepreneurship in Urban America, 113, Michigan Journal of Race & Law, Vol. 13, Issue 1, Fall, 2007, where it is noted that "census data reveals a 46% increase in African American owned firms between 1987 and 1992 compared to a 26% increase in the larger society." As posited in that article, with more African Americans in the US than there are people in Canada, the careful configuration of this group is based on a risk analysis and a presumptive self interest in the community beyond that of the general public, but confined to only those who are defined as "economically searching" and ethnically motivated, not those who are ethnically uncommitted and are economically self-saturated through individualism, economically stunted through subrogation, or economically satisfied through structural success. Hence the term "Ethnivestors". Id, at 133-124.

[45] See Isaac C. Hunt, *A Message on Investing*, 42 How. L. J. 387,388 (1999).

Under the joint venture model, the tax exempt entity must enter into this partnership vigilant regarding agreements or activities that may threaten its tax exempt status. In addition to the above statutory mandates for exempt status, there are two additional general requirements – satisfying an organizational test and an operational test.[46] The organizational test is met if the organization is organized exclusively for exempt purposes, and the articles of incorporation do not empower activities that do not further those exempt purposes, apart from any insubstantial amount of its activities.[47] The operational test requires the entity to operate public, rather than private purposes.[48] No part of the net earnings of the organization may "inure" to the benefit of any shareholder or other individual.[49] The organizational is easiest to satisfy since the articles of incorporation can simply provide the appropriate language to limit the organization to a particular set of charitable activities. But to in fact operate without an impermissible private benefit to the shareholders is a more fact specific inquiry and drawing the line can be more difficult.[50]

The plethora of cases in this area suggests the bright line of exemption-destroying private benefit is blurred.[51] The extent to which there is an impermissible amount of

[46] I.R.C. 501(c)(3) or (4).
[47] Reg. § 1.501(c)(4)-1(b)1(i) and Reg. § 1.501(c)(3)-1(c).
[48] Reg. § 1.501(c)(4)-1(d)1(ii).
[49] I.R.C. 501(c)(3) or (4).
[50] See for example I.R.C. § 507(b)(2) and Reg. § 1.507(b)(7) and 1.507-3(d) that allow a private foundation to transfer assets to a non-exempt entity with some return on the transfer without termination the exempt private foundation status. The difficulty is in knowing where to draw the line is more basically shown by the following example. A Red Cross executive repeatedly uses 50% of the entity's donations dedicated to a flood-ravaged area for a down payment and subsequent payments on his personal residence, with board authorization. Clearly, there is an impermissible private benefit that could jeopardize the exempt status of the organization. But what the Red Cross executive just receives honorariums from speeches (in addition to a reasonable salary)? When does the size of the honorarium become private inurement as opposed to a mere "incidental" part of a predominately charitable and permissible activity?
[51] See Housing Pioneers, Inc. 58 F3d 401(1995).

private benefit to shareholders of the tax exempt entity as opposed to only incidental enhancement in order to carry out the charitable objective is a matter of degree.[52]

More to the point of this article, it is that prohibition from private profiteering in tax exempt entities that has restricted the joint venture partnering of private and profit entities. And thus a hurdle exists to pooling resources in efforts to transform the urban landscape. This difficulty in drawing the charitable – private benefit line is often born from the appetite of tax exempt entities to invest funds jointly with profit entities, with a return on the investment flowing to the tax exempt entity.

An example of the attempted bright line to prohibit charitable and profitable entity joint ventures is found in *Housing Pioneers, Inc. v Commissioner*.[53] In that case, a nonprofit public benefit corporation under California law was formed with articles of incorporation stating that its sole purpose was "to provide innovative and affordable housing to low income and handicapped persons, [and]…pre-release and post-release persons who are or have been incarcerated in prisons."[54]

The nonprofit ("Pioneers") entered into a joint management agreement with a limited partnership ("Grant Square").[55] Under the agreement, Grant Square loaned funds to Pioneers. Pioneers used the loan to purchase a 1% interest in Grant Square and become a general partner in Grant Square. Pioneer, due to its nonprofit status would be able to

[52] Unfair competition is also a fundamental rationale for that private versus public benefit distinction. A charity does not pay federal taxes. For-profit entities pay those taxes. If they are both engaged in the same activities, with the same amount of benefit to the shareholders of the organizations, they both receive a return, but the profit entity has the disadvantage of paying taxes which reduces its net economic benefit. The so-called charitable entity does not pay the taxes and therefore gains a greater return though providing the same activity (if allowed to receive the same personal profit). Congress deemed that circumstance unfair. The so-called charity entity could have exempt status denied or revoked, or be taxed on income unrelated to their exempt purposes under the unrelated business income tax. See I.R.C. § 511.
[53] Housing Pioneers, Inc. v Commissioner, 58 F3d 401(1995).
[54] Id. at 401.
[55] Id. at 402.

receive state property tax exemption. To receive the full exemption benefit Pioneer needed, and applied for federal tax exemption as a charitable organization.[56] The tax savings were to be split between Pioneer and the limited partners.[57] Although Pioneers was a co-general partner, its partnership duties were restricted to assuring that the tax savings were applied to reduce the rents charged by the partnership so low income residents could afford the rental units.[58] The only Pioneer duty as a general partner was to maintain its exempt status for the low income credit federally and California state law. [59] Several of the Grant Square limited partners were blood relatives of the owners of Pioneer.

The Ninth Circuit upheld the Tax Court ruling that Pioneer was not a tax exempt organization on two grounds.[60] According to the Court, allowing the profit-organized partnership (and limited partners) to benefit from the tax exemption was a non-exempt purpose because the property tax split was not itself charitable and the benefit to the profit partnership was "substantial in nature." [61] Second, the Court determined that the benefits of the joint venture inured in part to private individuals-those blood relatives that were in both the nonprofit Pioneers and the profit partnership.

So even though the entity seeking charitable exempt status had the sole purpose of offering affordable housing to low income residents, and even if the tax savings from achieving tax exempt status was to be used to allow a profit joint venturer to offer low

---

[56] 501(c)(3).
[57] Id. at 401.
[58] Id. at 402.
[59] Id. at 402. See I.R.C § 42 for the federal low income housing tax credit which also required charitable exempt status under I.R.C. § 501(c)(3) of the Code. See California Revenue and Taxation Code § 214(g) for the state exemption.
[60] Id. at 402.
[61] Id. at 402. This non-exempt purpose was to provide the benefit to profit entity owners from both the California § 214 exemption and the federal § 42 credit to partnerships that were not exclusively charitable.

rents to those low income residents, the fact that the profit partnership was "relieved of the necessity of maintaining rents at a level sufficient to cover operating expenses which would otherwise have to be paid out of partnership capital…the forbidden purpose and the private benefits were 'inextricably' meshed."[62] The sharing of the tax exemption benefit with the partnership was apparently a sufficient ground as an impermissible purpose and as private inurement.

Under that holding, *any* benefit of exemption flowing to a profit entity joint venture partner would destroy the exemption of the nonprofit, *even if that arrangement furthered the exempt purpose of providing a charitable goal like affordable housing*. If therefore the nonprofit entity had no management expertise, but wanted to pursue the charitable goal, it could not gain the exempt status if it shared the tax savings with profit partners. *Housing Pioneers* therefore, standing alone as precedent, would significantly chill joint venture efforts because the proposed charitable entity could easily lose the very status that gives it value to the joint venture – charitable tax exempt status.

As applied to this article, *Housing Pioneers* could have a chilling effect on charitable and profit joint ventures with unintended consequences of reduced long term tax efficiency. Social entrepreneurs may want to establish charitable organizations, but may not have the resources, or the will, to contribute the total resources required to complete a charitable project. If, like in *Housing Pioneers*, the entity was not bringing significant assets, the primary contribution to the venture would be the tax savings from tax exemption. Under *Housing Pioneers*, the entity would be at risk of losing its primary leverage and basis of attraction to the profit joint venturer -exempt status. If exempt

[62] Id at 402, 403. (Italics added).

status is denied, the federal treasury would presumably gain a relatively few tax dollars by taxing the earned income of the person or entity that was denied exempt status.[63]

But if the nonprofit entity were allowed to joint venture with profit entities that can supply whatever is missing from the project to make it a reality, the project could better serve the need of those needing services – services that otherwise may have to borne partially by the public treasury through tax credit subsidies. And more sustainable projects brought on line should cause fewer people to use public assistance for those purposes in the future. Thus, the indirect and long term tax efficiency is the reduction in the number of projects that are *only* undertaken by tax exempt entities or entities that are heavily subsidized. The increase in start ups of projects otherwise forgone by ill-equipped charitable entities through joint ventures should reduce the public drain of resources.

To illustrate the point, consider a hypothetical entity that applies for exempt status to provide health care facilities in an area that lacks adequate prenatal assistance. The nonprofit does not have the expertise or resources to build a facility. But if the charitable entity is allowed to share part of its tax savings to entice a profit builder to make the project a reality, prenatal care and preventive education is advanced beyond what it would have been without the joint venture. The resulting benefit includes lower health care costs and a lesser drain on the federal and state treasury. More importantly, the amount of federal subsidies used for such projects would be reduced if the builder is allowed to participate through the inducement and collaborative contribution by the nonprofit entity.

Assume the above facility costs $1 million in governmental subsidies if no joint venture is allowed. If because of the joint venture, a profit partner agrees to contribute

[63] This of course assumes donor frustration of purpose and no contribution to another exempt entity.

one-half of the subsidy amount, the subsidy is reduced by 50%. If exempt status is maintained for the nonprofit joint venturer, the profit entity is more likely to join the cause and bring a future tax benefit that would not occur if the tax exempt status was denied to the charitable partner and the project never became a reality.

Viewed differently, if a portion of the incentive to the profit entity is the tax benefit given to the charitable entity, the splitting of benefit between both entities spreads the benefit and provides a greater bang for the subsidy buck. Instead of only the charitable entity receiving 100% of the tax savings, that savings is used to induce contributions, financial and otherwise by the profit entity. That is an overall tax savings because more benefit is gained from the same tax exemption, i.e. project expertise and financial contributions.

The above remedy could be an amendment to the Code essentially stating:

> "Qualification under Section 501(c) (3) shall not be denied due solely to an arrangement between the exempt entity and a non-exempt entity whereby the tax savings due to exemption for the exempt entity is shared with the profit entity or those with primary ownership interest in either entity. This provision does not alter the requirement of primacy of charitable purposes in the joint venture."

This would in effect be an exception to the private inurement prohibition. The justification for the exception is that the overall public policy good exceeds the detriment associated with the exemption. Code regulations, with examples, would need drafting to close unintended loopholes and reduce the administrative burden on the IRS. As has been done with other regulations, percentage restrictions could be imposed so, for example, the split of exemption benefit to the profit entity cannot exceed a set amount. Presumably an amount less than 50% is preferable to be consistent with the principle that the charitable activity is substantial and primary, and the profit purposes are incidental and insubstantial.[64]

Part III: Specific Joint Venture Modeling and Outcomes

This article therefore urges that the prohibition on private inurement, though a bedrock principle, is not absolute. Indeed, the very fact that statutory language permits *incidental* private benefit is congressional acceptance of something less than an absolute prohibition on all forms of private benefit.[65] And a carefully constructed provision can avoid opening the floodgates to abuse. Then an overriding benefit can occur because each tax subsidy should, in this author's view, be measured against the overall tax objectives that gave rise to the subsidy. If an exception to the private inurement prohibition serves the greater good of providing more qualitative incentives then just cause exists for ameliorating the prohibition.

Perhaps the principle becomes clearer through illustration. Assume nonprofit corporation X applies for federal tax exemption to build a health care facility to combat infant mortality among low income residents and epidemic-scale kidney failure among African Americans, who are disproportionately affected by kidney disease.[66] Assume further that if exemption is denied, X has taxable income as a corporation of $200,000. At 2007 marginal rates, the amount of tax is $61,250.[67] The LLC arrangement is not consumed therefore and no tax credits are provided.

---

[64] See Better Business Bureau of Washington DC v United States, 326 US 279 (1945); KJ's Fundraisers, Inc. v Commissioner, 166 F.3d 1200 (2nd Cir. 1998).
[65] An insubstantial amount of nonexempt business activity does not destroy the exemption. Treas. Reg. § 1.501(c)(3) – 1(b)(1)(iii), (c)(1). Better Business Bureau of Washington DC. See I.R.C
[66] The project could just as easily be lung screening for coal mining communities in West Virginia.
[67] The tax table in a profit corporation's Form 1120 reveals a tax of $22,250 when taxable income is between $100 and $335,000, with a 39% marginal rate on any amount over $100,000.

But if a federal exemption is granted the exemption facilitates the joint venture with Y, a for-profit builder, because X splits the tax savings with Y. Y will contribute its expertise, and the first $100,000 cash in Year 1 to commence construction of the facility. The tax consequences are that the $61,250 attributable to X is not taxed due to the exemption. The equity investment of $100,000 in Year 1 amounts to a tax credit of $5,000 in Year 1, and a total credit subsidy of $39,000 over the aggregate of 7 years.[68] Then assume a county health study concludes that the combined savings for adequate pre-natal screening and adequate dialysis intervention, and preventive education in both areas within this low income community could save governmental health care costs of $800,000 over the same 7 year period covered by the tax credit.

Under the above facts, granting the charitable exemption reveals a greater tax benefit for allowing the private benefit to Y. If the federal exemption is denied due to the sharing of the exemption benefit, the federal treasury gains the $61,250 taxable to X. But if the exemption is granted, the immediate cost to the treasury is the forgone tax collection of $61,250 annually plus the NMTC subsidy of $39,000 over 7 years. In Year 1 the added cost of the exemption is $66,250 (61,250 + 5,000 of tax credit). Over 7 years the treasury cost is $467,750 (7 years of the X tax plus the full tax credit). The countervailing benefit is at least the difference between that forgone tax/subsidy and the $800,000 of health care savings from operating the facilities (i.e. $800,000 – 467,750 = $332,250).[69]

---

[68] See I.R.C. § 45D(a)(1)-(3). This provision gives a graduated percentage increase in the tax credit over the 7 years until the 39% of the equity investment is captured.

[69] This hypothetical assumes constant taxable income over the 7 years, and does not attempt to adjust for inflation or the present value of future income.

This cost-benefit analysis does not include several other benefits. There are residual benefits of any ongoing better health beyond the 7-year tax credit period, including forgone opportunity costs to the government and the public. Also not quantified to the benefit side of the equation is the increased utility of the split subsidy. If X received all the tax savings due to the exemption ($5,000 in Year 1), X still could not have built the health care facility with its own resources. If X enlisted public funds from the city, state, or federal government, those funds are still taken out of a pool of otherwise collectible tax dollars. If instead the tax savings are split, the 50% that was used an incentive to the builder (a mere $2,500) provides a greater return from that subsidy. The return on the tax savings invested in the builder was at least the expertise and start up of construction for the facility. And without the facility, the much greater benefit of the $800,000 of subsidy savings would not have occurred.

The present value of the long term benefits of the split exemption is a matter of sophisticated income capitalization techniques, beyond the scope of this article. But the point remains that a narrow private inurement allowance as part of a joint venture for philanthropic purposes can have sufficient benefits to accomplish the goals of the subsidy, and can make fiscal sense in the context of tax policy. [70] And the amount of contribution by the nonprofit entity is not necessarily confined to splitting tax savings. A charity may have political influence, goodwill with the target customers of the profit entity (e.g. a profit entity that sells what the community buys may be more likely to invest in a nonprofit that has goodwill with that target customer base). [1] Admittedly, the

---

It is also realistic to posit that there is some level of influence and commitment by a nonprofit entity that can entice a socially conscious profit entity to participate in a venture. That the profit entity may not have invested at all or at a much lesser level but for the nonprofit's influence and contribution. And various real life examples of such LLCs with profit and nonprofit members evidences the transactions are more than hypothetical. See the PLRs discussion below.

cost and savings figures are purely hypothetical, but perhaps not unrealistic if one assumes some profit entities are not entirely driven by maximizing profits. It is realistic to surmise that purely profit motives did not guide Google to pledge approximately 1% of its stock and profit to charitable causes, estimated at $1 billion.[71] So entrepreneurial realism exists for a hypothetical fact pattern that at least factors the motivations of the charity and the socially conscious profit entity.[72]

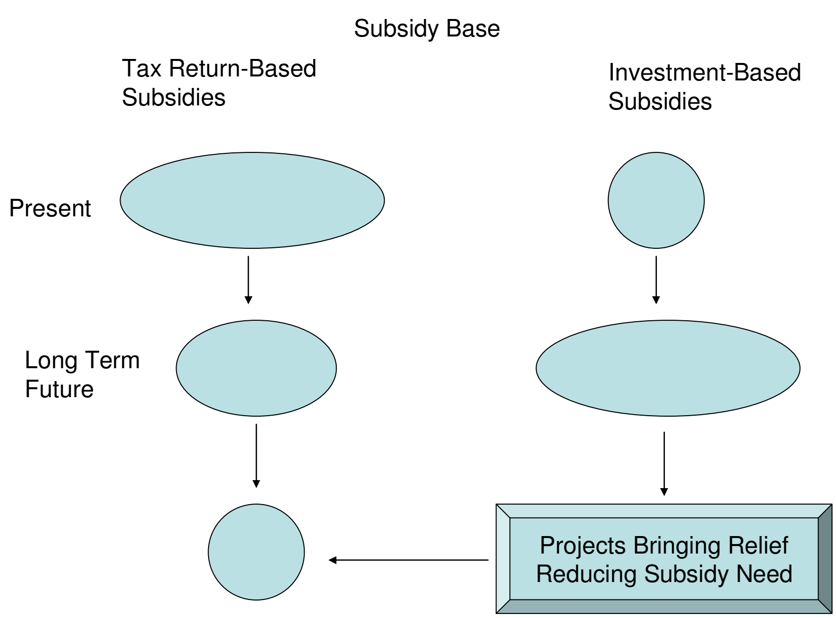
A graphic depiction of the model is below. The goal is to reduce long term dependence on tax subsidies by increasing the incentive to private equity investors. Those private investors have been using the tax incentives for projects that purport to help people succeed who are in greatest need. This model does not change the goal, only the incentives. Instead of a minor tax return adjustment due to a tax credit, a greater incentive should come from providing an investment benefit. Allowing carefully constructed private inurement is one way to create near-market level financial participation by that private equity investor. Other methods are described below, particularly joint venture arrangements where near-market rates of return are part of the structure of the relationship and transactions.[73]

This model starts with the notion that there is a subsidy base, much like a tax base. And that it is wise tax policy to configure a way to reduce the subsidy base over time and supplant it with the private equity base. The viability of the model depends on

---

[71] Christopher Lim, Google.Org, For-Profit Charitable Entity: Another Smart Decision By Google, Kan. J. L. & Pub. Pol'y 28, 30, (2007).
[72] It is also realistic to posit that there is some level of influence and commitment by a nonprofit entity that can entice a socially conscious profit entity to participate in a venture. That the profit entity may not have invested at all or at a much lesser level but for the nonprofit's influence and contribution. And various real life examples of such LLCs with profit and nonprofit members evidences the transactions are more than hypothetical. See the PLRs discussion below.
[73] See particularly the section regarding increasing the rate of return on joint venture projects between tax exempt foundations and profit entities.

the premise that the projects undertaken in the future through increased private equity participation will actually assist those who have been current recipients of governmental subsidies. So there is a correlation between the projects and the reduction in the government subsidies. The government would provide less in tax subsidies if the projects that involve increased private equity are successful. Success can be measured, for example, by providing affordable housing. The private equity investors commit funds and expertise and generate more projects on an accelerated basis than if the joint venture had not occurred. More affordable housing with private equity contributions could correspondingly reduce the dependence on governmentally subsidized contributions to those projects. As the model below illustrates, the size of the tax subsidy decreases over time, while the private equity contribution increases. If the private equity contribution brings an acceleration of projects that meet the needs of the targeted citizenry, the tax credit subsidies can decrease.



Fortunately for social entrepreneurial purposes, *Housing Pioneers* is not the stand alone authority for determining the extent of joint ventures between charitable and profit enterprises. Favorable decisions exist, but only through more obscure revenue rulings and private letter rulings – neither of which have statutory force. This article asserts that the benefits of a limited inurement exception warrant a statutory amendment. Only by that action is there likely to be a sort of consumer confidence that creates a large scale movement in social entrepreneurship. Without the infusion of a group of not-yet-millionaire entrepreneurs no large scale affects on the urban landscape is likely and no tax policy fruition of reduced subsidization and increased private equity. Yet hope lives in a body of non-statutory authorities known at least to the small niche of exempt tax practitioners. Those authorities are discussed below.

Hope Springs from Obscure Places

Three years after *Housing Pioneers* the IRS issued Revenue Ruling 98-15.[74] The IRS framed the issue they faced as follows: "whether nonprofit hospitals that participate in joint ventures with for-profit entities continue to qualify for exemption as organizations described in Section 501(c) (3)." Two scenarios were presented. In the first, a nonprofit tax exempt hospital receives financing from a profit entity that owns hospitals.[75] The profit entity seeks a "reasonable rate of return" on the loan.[76] Both the nonprofit and the profit contribute assets to the LLC, including the nonprofit's contribution of its hospital. In return, both the nonprofit and the profit companies receive

[74] Rev. Rul. 98-15, 1998-1 CB 718.
[75] Id.
[76] Id.

ownership interests in the LLC equal in value to their respective contributions.[77] The LLC also engaged a firm to manage the entity consistent with its charitable purposes, which received reasonable market compensation for its performed services.[78] No person within the management firm was related, personally or professionally, to either of the entities that comprised the LLC.

The more precise issue in scenario 1 is whether such an arrangement disqualifies the nonprofit from tax exempt status. The IRS articulated a four-pronged rule statement:

- A 501(c) (3) organization may form and participate in an LLC and can continue to meet the operational test if still furthering its exempt purpose.[79]
- The arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.
- The exempt organization may enter into a management contract with a private party as long as the exempt organization retains the ultimate authority over those assets managed, and the private entity's compensation is reasonable, and
- If the private management firm uses the assets to primarily benefit a private party, the nonprofit member of the LLC may lose its exemption.

The IRS applied these rule to hold that under this arrangement, the nonprofit does not lose its exempt 501(c) (3) charitable status. In reaching that conclusion the IRS emphasized several control factors between the nonprofit and the profit. The governing

[77] Id.
[78] Id.
[79] Id. This ruling of course assumes the governing documents and operation in fact allows the continuation of charitable purposes. Also significant, the IRS noted the LLC can be treated as a partnership for federal tax purposes. And thus it follows that if the new entity was a partnership or a limited partnership rather than an LLC, the same allowance would exist.

documents provide (1) the nonprofit had a majority of the votes on the board of directors and that the nonprofit intends to appoint community persons to responsible positions (2) the nonprofit board members must approve major decisions of the LLC and (3) if a conflict arose between the community benefit and any "duty" to maximize profits, the community benefit standard must be satisfied "without regard to the consequences for maximizing profitability."[80] The IRS further stated that any private benefit was merely incidental, including the management functions carried on by the private entity.

This conclusion is significant for several reasons. First, the IRS authorizes a nonprofit joint venture with a profit entity, albeit through the formation of an LLC without the loss of exempt status. Chief among requirements is that the charitable purposes must by primary. That was evidenced in this scenario by the nonprofit retaining a majority of the board positions and the commitment of that board to involve the community. Second, the ability to receive loans from a profit partner is significant because the nonprofit is not always in the position to finance its projects. The obvious condition being that the loan was gained only to facilitate health care services to the community, not primarily for the financial benefit of the profit entity. Third, the authorization to contract with a private, (i.e. non-exempt profit-based) management firm does not cause a loss of exemption. The significance of achieving management expertise is vital to project fruition, as good ideas poorly managed still often fail. Last, it is factually significant that the nonprofit contributed *all* of its assets into the LLC.[81] That means, without losing exempt status, a nonprofit can fully integrate its mission and resources with those with greater expertise, financing and management, avoiding any

[80] Id.
[81] Id.

undue functional disconnects between the mission and the operation. This flexibility can enhance the achievement of the primary goal – having the necessary resources to make the charitable project operational.

The flexibility to partner with profit entities that may finance and manage projects is particularly important to the fulfillment of this article's thesis because of the type of private equity partner profile contemplated herein. As discussed below, the pool of socially conscious private equity investors can be greatly expanded. That strategy is much like federal tax strategies employed historically where one method of raising additional revenue is to broaden the tax base.[82] Here, it is the private equity base that is to be broadened. To target investors that broaden that equity pool are not a minuscule percentage of the already super wealthy. They are the expanding upper middle class that are socially conscious. They are likely board members in an LLC, like those discussed in Rev. Rul. 98-15 that would agree to prioritize the community benefit standard "without regard to the consequences for maximizing profitability." [83]

In the second scenario examined in Rev. Rul. 98-15, a nonprofit health care entity also jointly formed an LLC with a profit health care entity, and hired a management company through the LLC. The IRS denied the continuation of charitable 501(c) (3) status for the nonprofit because, unlike scenario 1, the nonprofit did not control the board decision making.[84] The board could make decisions irrespective of the charitable purposes of the nonprofit member, as could the management company which was a

[82] Reducing those exempt from tax increases the taxpayer base and thereby broadens the tax base (i.e. the pool of people and entities that pay tax upon application of a tax rate and collection based on tax liability). For example, From the Thomas Jefferson administration until the Civil War, the backbone of the federal tax system was a tariff, imposed primarily on the wealthy. To pay for the Civil War the tax base was broadened on the larger populace. See Klein, Bankman, Shaviro, Federal Income Taxation, 3, (13th ed., Aspen Publishers, Inc. 2003.

[83] Rev. Rul. 98-15, at 10.

[84] Id. at 10.

subsidiary of the for-profit LLC member.[85] On that basis, the IRS determined that the benefit to the LLC from the nonprofit's activities were not incidental to the furtherance of the nonprofit's charitable purposes. Accordingly, the nonprofit failed the operational test and lost exempt status when it formed the LLC and contributed its assets under an arrangement that did not further its exempt operation.[86]

It is also an important cautionary note that while a nonprofit's control is an important factor in the partnering with profit entities, a private foundation has statutory restrictions on the amount of control it may have through the voting stock or ownership interests of the profit enterprise.[87]

The overriding lesson from Rev. Rul. 98-15 is that forming an LLC with a profit entity, and hiring a profit-based management team, does not automatically destroy exempt status for the nonprofit. Exempt status can be maintained if the nonprofit can control major decisions of the LLC through its board of director participation, and the management company is not so related or affiliated with the LLC or the for-profit partner that the charitable purposes are subrogated to profit-making purposes of the LLC.

Yet tax scholars have cautioned that Rev. Rul. 98-15 is responsive to only two highly related fact situations. There are many unanswered questions. Is exempt status lost if the nonprofit has only equal representation on the governing board? Similarly, is a nonprofit's veto power is still sufficient control absent a board majority?[88] An open issue also remains as to whether the LLC formed in part by the nonprofit entity has a greater

---

[85] Id. at 11.
[86] Id. at 11.
[87] See I.R.C. § 4943, which in most cases limits the foundation control to 20% of the voting stock, and may rise to 35% if the enterprise is owned by a third party (separate from both the nonprofit and for-profit entity).
[88] Susan Kalinka, *Individuals and Passthrough Entities,* Taxes – The Tax Magazine, CCH 2006, p. 30.

fiduciary duty to the LLC (and its profit members) than to just the philanthropic purposes of the nonprofit member.[89]

Statutorization

Despite the existence of Rev. Rul. 98-15, an additional step is necessary to bring this expanded private equity investor group to projects that may truly impact the urban core areas. In a word, "statutorization." By that term, this author means a process whereby Congress incorporates non-statutory rulings and pronouncements from the IRS, otherwise obscure to the general public, into statutory law on a fast-track basis to aid policy direction to congressional actions.[90] The core reason is no different than the rationale often used to justify a statute – to add clarity and certainty in an otherwise amorphous area.[91] Thereby counsel to the intended beneficiaries will have greater certainty as to the state of the law and their clients should have greater certainty that such ventures are doable. The process and statutory mandate should also include extraordinary public notice to those who meet the profile of the private equity pool. That pool includes the tens of thousands of applicants for small business loans from the Small Business Administration, and the small businesses known to the various lending

---

[89] This author advocates an analysis that starts with the purposes of the LLC. If the dominant purposes are to further the charitable objectives of the nonprofit members, and the board authorization supports the prioritization of those purposes in operation, then the duty should run with the purposes. In this instance then, the duty to the charitable purposes trumps the profit motives of the other members or LLC.

[90] Below will be a discussion of investment strategies for philanthropic-profit entity joint ventures that are codified in private letter rulings. These private rulings are IRS responses to specific taxpayer requests concerning their own fact situations. As such, the IRS is not bound to follow the legal position it took in that letter and other taxpayers, even if they discovered it, cannot use it as precedent for their circumstance. See Klein, Bankman, Shaviro, Federal Income Taxation, 35-36, (13th ed., Aspen Publishers, Inc. 2003.

[91] See Robert W. Hamilton, Jonathan R. Macey, Corporations, including Partnerships and Limited Liability Companies, 196-197 (9th ed., Thomsom-West, 2005), where the excerpt from a proxy statement from Dole Food Company, Inc. notified the stockholders of the desire to reincorporate in Delaware as opposed to Hawaii because the statutory corporate law provides "a greater measure of predictability" and proposed statutory amendments help "meet changing business needs."

institutions across the country. An example of statutorization is the above proposed statutory amendment to provide an exception to the private inurement prohibition.

Statutorization is recommended because, unlike private letter rulings and revenue rulings, the statute is uniform and more readily accessible to the general public. Moreover, the process of statutory enactment necessarily requires lobbying and inertia from within Congress. The process allows an opportunity to mobilize like-thinkers not only in Congress, but the constituencies of the Congress members. The risk of failure is no worse than current ineffective subsidy remedies.[92]

[92] Ineffective remedies include the various loopholes in existing law that allow new markets tax credits (which are essentially tax subsidies) to be used for wealthy development groups to build opera houses, convention centers, and luxury condominiums that have little affect on the low income residents the subsidy was designed to assist. See Roger M. Groves, *The De-Gentrification of New Markets Tax Credits*, 8 Fla. Tax Rev. 23, 40 (2008).

Joint Venture Investment Strategies Without Jeopardizing Exempt Status

An underlying premise of this article is that social entrepreneurs are likely more motivated by investment return than deductions and tax credits, and that if private equity interests can partner with nonprofits and still approximate the investment return of the private marketplace, more private equity investors may move into philanthropic ventures at a rate sufficient to have a transformative affect on the urban core.[93]

In order to achieve near market investment returns, a joint venture between the exempt and non-exempt private equity philanthropist must navigate a few Code provisions. One of the models for the joint venture includes a private foundation as the charitable entity in the venture.[94] Code section 4944 provides potentially severe penalties on a private foundation, in the form of an excise tax, on any investment that "jeopardize[s] the carrying out of any of [the entity's] exempt purposes".[95] Since the tax is imposed on "any" amount there is no threshold below which an investment is essentially exempt.[96] Taxes can be imposed separately on both the foundation and the management (foundation manger).[97] The tax is 10% of the amount of the jeopardizing investment on both the foundation and the manager (20% total), plus another 25% of the

---

[93] The thesis continues that to continue a tax subsidy paradigm of appealing to deductions and relatively minor amounts of tax liability reduction will remain a dribble of projects. The dribble only prolongs the drain on the federal treasury. Near-market investment strategies can bring projects to fruition sooner with more involvement of private equity funds, reducing the subsidy if the projects are effective at increasing health care, employment, affordable housing and the like.

[94] As noted above, the private foundation is typically used by individuals of substantial wealth, who donate his or her own income that is otherwise taxable into his or her own tax exempt charity that qualifies as a 501(c)(3) entity. See I.R.C. § 509 for further definitions and qualifications.

[95] I.R.C. § 4944.

[96] I.R.C. § 4944(a).

[97] I.R.C. § 4944(a)(1)(2). The tax on the foundation manager is only imposed for a knowingly jeopardizing investment, not if the manager's participation in the investment was "not willful and is due to reasonable cause." I.R.C. § 4944(a)(2). The Regulations provide that the manager needs to exercise "ordinary business care and prudence". 1. Reg. § 4944-1(a)(2).

invested amount if the investment is not "removed from jeopardy" within the "taxable period".[98] So the total tax could be 45% of the investment - clearly an incentive to avoid investments could be construed as beyond charitable objectives or to the benefit of private individuals within or outside the foundation.

<u>The Safe Harbor: Program-Related Investments</u>

So with the potential of a tax that could wipe out nearly half of an investment, the foundation that attempts to joint venture with a profit entity is looking directly into the teeth of the excise tax. To navigate around that tax, the foundation has a safe harbor exemption. Under subsection (c) of this section, the tax is inapplicable to "program-related investments".[99] That term is defined as those investments that (1) have a primary purpose of accomplishing charitable purposes, and (2) have no "significant purpose" to produce income or appreciation of property." [100] At first blush, the implicit rule is that the investment is jeopardizing if it appears that a major motivation of the investment is to produce income or to invest in property that will be held for its increased value later. That would seem to rule out stock purchases, purchases of any property that could be rented, or property that is intended to be held for over a year and then sold.[101] But private letter

---

[98] I.R.C. § 4944(a)(1)(2) and I.R.C. § 4944 (b)(1). The taxable period starts from the date of the investment through the earliest of (1) the date of the IRS notice of deficiency, (2) the date of assessment, or (3) the date the investment is removed from jeopardy. I.R.C. § 4944(e)(1)(A)(B)(C) and I.R.C. § 4944(e)(2).
[99] I.R.C. § 4944 (c).
[100] I.R.C. § 4944 (c). The charitable purposes for program-related investments are specifically those found in section 170(c)(2)(B). That provision refers to entities organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.
[101] The one year-plus period is only this author's opinion because an intent to hold for that long is more than coincidentally what allows long term capital gains treatment and customary for those who indeed hold property for its appreciation or profit-based income potential. See I.R.C. § 1222.

rulings ("PLRs") and a few examples in Revenue Rulings provide additional guidance and glimpses of creative, yet accepted, joint venture strategies.[102]

<u>Subsidiaries for Comprehensive Programmatic Solutions</u>

I suspect many social scientists claim that the ills of urban America have not one cause, but many, necessitating therefore multi-faceted solutions. One such multi-faceted project was instituted by a nonprofit that is discussed in PLR 200709065. The entity ("X") makes grants to organizations that help low-income individuals create wealth and take control of their lives.[103] These organizations advance home ownership, support enterprise development, provide quality child care and/or increase access to capital in rural and urban communities.[104] X also makes investments that provide the aforementioned double bottom line - a return while also helping underserved populations in the distressed communities.[105]

X sought IRS acceptance of a plan to expand its operations even further. Through creating a wholly-owned subsidiary, X proposed to encourage other private foundations to also invest in the development of minority and underserved communities. Specifically, the subsidiary would provide advice for a fee (consulting services). Important to this article is the fact that the target clients were not only other private foundations and exempt organizations, but also the "*socially motivated investor*."[106] The subsidiary would

[102] As noted previously, *supra*____, the private letter ruling is a request from an entity for an IRS interpretation of the law as applied to the entity's particular facts. The IRS does not have to follow the ruling in other cases, and thus is not precedent for other entities.
[103] Priv. Ltr. Rul. 200709065 (2007), p. 1
[104] Id.
[105] Id. As discussed
[106] Id.

also be a fundraiser or "placement agent" to connect other profit philanthropists to what they termed "community development venture capital funds." [107]

This effort is significant because one of the historical impediments to economic growth among small business entrepreneurs in distressed urban core areas is the lack of access to capital.[108] The X subsidiary was focusing on that issue and targeted those who were without federal or other matching funds to support investments.[109] Additionally, the X subsidiary would provide asset management services and establish and maintain a public mutual fund.

The IRS allowed the subsidiary to be X's program-related investment without imposition of the excise tax and other potential taxes.[110] If this ruling rose from PLR status to statutory law, it could be stable authority for profitable philanthropists to be subsidiaries of private foundations, and *for a fee* connect other exempt entities to community-based venture capital funds, public mutual funds, and an array of financial services needed to overcome the access to capital hurdle.[111] Such an allowance increases the investment incentive of profit partners to the philanthropic cause. It may well be true that many of the middle class socially motivated investors have not had historical access to the savvy and expertise of sophisticated capital markets. This type of exempt entity-profit subsidiary arrangement can be plasma for growing the small business community

[107] Id. The consulting services also sought out Rural Business Investment Companies.

[108] See Groves, "Time to Step Up" supra, note ___ at 108, for a discussion of inordinate consumer spending and a lack of wealth building among African Americans.

[109] Priv. Ltr. Rul. 200709065 (2007).

[110] Id. The IRS also declared the subsidiary qualified as a "functionally related business" per I.R.C. § 4942(j)(4) because it would advance X's exempt purpose. Therefore the subsidiary would not cause X to be liable for the tax imposed on "excess business holdings" of a private foundation engaged in a "business enterprise" under I.R.C. § 4943.

[111] Of course, the fee received by the subsidiary would be taxable income to the subsidiary. See Rev. .Rul. 69-528, 1969-2 C.B. 127.

from within the urban areas that subsidies have sought to benefit. Therein lays the justification and potential part-solution to the urban distress. And therein lays rationale for statutorization for this PLR. The public mobilization and lobbying and specialized public notice is part of wiser tax policy than the continuation of the current tax subsidy paradigm.

Real Estate Management Collaborations

As gentrification has highlighted, real estate can be precious even within a currently distressed urban area. The proximity to work, sports and entertainment venues, and avoidance of traffic congestion from long commutes and increasingly high fuel costs have spurred a movement that finds new value in downtowns across the country. Hence, a multi-billion dollar tax subsidy program termed “New Markets Tax Credits” (“NMTC”) was created by Congress to lure private equity investors to revitalize those distressed urban cores.[112] A very significant portion of those authorized projects involved commercial real estate – building an infrastructure for those who could afford and enjoyed opera houses, high priced condominiums, and convention centers.[113] Not nearly as much real estate was dedicated to the low income residents of the very area sought to be revitalized. So one subsidy program with costs to American taxpayers approaching a billion dollars designed for urban revitalization has not fulfilled the need.

With this backdrop, enter PLR 200637041.[114] A private foundation was established to receive and administer assets donated from its founder. Those assets were primarily gifts of commercial and residential real estate. The foundation was obligated to

---

[112] The NMTC statute is codified at I.R.C. § 45D.

[113] See Groves, supra, note ___ at 221. [The De-Gentrification of New Markets Tax Credits, Fla Tax Review, Vol.8:2, 214 (2008)]

[114] Priv. Ltr. Rul. 200637041(2006).

distribute earnings solely for charitable purposes. The foundation formed various LLCs to manage those real estate investments. The IRS authorized such an arrangement to exist without imposing the jeopardizing investment tax or a tax on excess business holdings.[115] The IRS also ruled that the rental income generated from real estate was not business taxable income to the foundation.[116] Nor was that income taxable as unrelated taxable income.[117] The sale or exchange of the properties was also excluded from the unrelated business income tax (UBIT). As most LLC statutes authorize, the foundation was the sole member of each of the LLCs.[118] Yet contracts between the foundation and the LLC were not "self dealing" though the same person that was involved with the foundation was involved in the LLC.[119]

As applied to subsidy-sensitive urban revitalization, if this PLR was allowed to be precedent, foundations could gain confidence that private equity firms that specialize in real estate could manage their properties without losing its tax exempt status. The founder of the foundation could as easily be a present or future Bill Gates, Warren Buffet, or someone drawn from the myriad of athletes and entertainers who now or will someday "remember where they came from" and elect to become profitable philanthropists.[120] The properties at issue could as easily be qualitative health care facilities specializing in the

---

[115] Id.
[116] Priv. Ltr. Rul. 200637041 (2006).
[117] Id.
[118] See Caroline R. Broderick, Arthur B. Page, 22, Choice of Entity and Incorporation, Massachusetts Continuing Legal Education, Inc, 2007. As noted above, LLC statutes give organizers great organizational flexibility, including also the ability to be not-for-profit entities. See the Delaware Limited Liability Company Act, § 18-201 which allows an LLC to operate for both for-profit and nonprofit purposes.
[119] Priv. Ltr. Rul. 200637041(200_).
[120] The 25 highest paid professional basketball players in the National Basketball Association have an annual salary of over $ 400million. USA Today Salaries Database, http://www.usatoday.com/sports/basketball/nba/salaries/top25.aspx?year=2006-07.
At least 16 of those 25 players have foundations designed for charitable giving. Id. The potentiality of joint projects among such a pool of players is the subject of a work in process article by this author. Their agents may be unaware of these PLRs but the possibilities are limited only by our imagination and lack of exposure.

areas of greatest need to the low income residents, or schools, grocery stores, affordable housing for the elderly and the soon-to-be-displaced due to rent or property tax escalation. The foundation has therefore a better opportunity to succeed with qualitative management even if with private LLC members, while the foundation maintains the mission of community prioritization.

Based on this PLR, the ability to form multiple LLCs for multiple properties only enhances the advocated process of accelerating subsidy-reducing projects. That acceleration should again, infuse private equity and expertise at a higher level, and increase the opportunities for operational success. And that success should translate into qualitative transitions for the beneficiaries of those projects. Fewer governmental subsidies should also result from the expanded well managed, real estate community portfolio. This PLR, if subject to statutorization, is another enabling authority for that process.

Adequacy of Investment Return

If indeed near-market investment return is a greater catalyst for private equity contributions than the relatively small amounts of tax liability reduction from tax credits, then the advancement of the model needs legal authority upon which to justify those returns. Over two decades ago a PLR broke ground on that notion. In PLR 83-011-10, a tax exempt private foundation was organized to combat urban deterioration, alleviate poverty and provide relief to the poor.[121] In furtherance of those purposes, the foundation provided long term financing to a limited partnership ("LP") to assist the LP build a hotel in a blighted downtown area.[122] Local banks and corporations were also part of the

[121] Priv. Ltr. Rul. 83-011-10 (1982).
[122] Id.

financing pool, and received the same interest rate on the loans as the foundation, except for an additional amount based on room rental rates that exceeded a certain threshold. The rate of return received by the private foundation considerably exceeded the current "prime" rate and beyond a normal returns on similar portfolio investments by foundations. Yet the IRS found this investment return was within the program-related investment exception to jeopardizing investments under subsection (c) of Section 4944.[123] As noted above, that exception only applies if the investment is deemed *not* to be for the production of income or asset appreciation.

The significance of this PLR was concisely stated as follows:

> "What is of particular interest is that the interest rate (15.0%)...considerably over the then-current 'prime' rate and normal return on foundations' portfolio investments… helps show that even though the rate of return for a domestic investment may appear high on its face, 'other factors' are relevant in determining whether a significant purpose of the investment is the production of income or appreciation."[124]

Of particular relevance to this article, the foundation's investment return was only lower than the corporate and bank investment return by a premium based on hotel rental rates that exceeded a particular benchmark. That relatively minor return differential may well encourage, rather than deter, socially motivated private equity investors to build laudable projects.

Even more aggressive investment incentives are possible. While economic redevelopment is clearly established as a traditional charitable cause in Treasury Regulations, the Regs have not authorized a tax exempt foundation to make a loan to a profit LLC at *market* interest rates, even if "some other terms of the loan will be below or

[123] Id.
[124] John A. Edie, Private Foundations and the IRS: Under the Microscope? 39, 64-65, The American law Institute (2002).

not as attractive as commercial lenders [receive] …under like circumstances.[125] Why not allow such techniques as credit enhancements and favorable equity "kickers" on loan transactions. [126] They are already in play in the private marketplace. An equity kicker is an additional amount paid to an investor to compensate that investor for an increased risk for holding certain investments.[127] This feature is particularly relevant since many investments in currently distressed areas designed to assist the small businesses and low income residents may be considered a higher risk by private equity investors.

Finally, more dynamic nontraditional theories can be explored. Desperate problems sometimes demand desperate remedies. The tax code is not, and has never been uniform for all of the country's citizenry. Historically, Congress has always given tax breaks to some, not shared by the general citizenry. [128] It has been a matter of Congressional priorities. The lost resources of urban residents is desperate when less than half of the young African Americans in public high schools do not graduate, and thereafter seek an underground "employment" that often leads to incarceration and adverse consequences to the system that pays for the imprisonment and the victims of the desperation – often community residents. That circumstance should be a sufficient cause for desperate incentives to break that cycle. Could the treasury afford to do something as radical as actually allow exempt entities a market-level investment return *and* a premium for taking the additional risk? The private marketplace employs such vehicles – called

[125] Id. at 68-69. The hypothetical was based on Priv. Ltr. Rul. 2001-24-022 (2001) where a loan from a public charity helped finance a parking garage needed as part of the revitalization. The charity provided a loan at below-market interest rates without any collateral to secure the loan. The IRS granted program-related investment status to the loan. That conclusion is not surprising since the lack of collateral and below market terms do not approach the terms that may indicate a profit investment return.
[126] Id. at 65-67. A typical credit enhancement is a letter of credit used to guarantee payment as an additional part of a loan portfolio. See Id, at 65
[127] Id. at 66.
[128] As noted above, from the inception of our tax system, the Jeffersonian theory was the tax burden falls most heavily on the wealthy.

equity kickers. The same is advocated herein for the subsidy market. Such suggestions have not been headed to date and no clear statutory authority, or Regulations of similar octane have been established.

Part IV: Tax Policy Implications

A fair question can be presented: Even if we assume a broadened equity investor base, and accelerated qualitative projects through joint ventures, what makes that good *tax* policy? This article asserts there can be higher long term tax collections if the tax credits are downsized. To clarify priorities, the overarching tax policy goal should be to improve the quality of life of those sought to be benefited from the subsidies. But in pursuit of that goal, our federal tax system can become more efficient in its collections. First and most directly, a joint venture arrangement allows a private equity entity to pay a percentage of the amount otherwise subsidized, in exchange for other benefits from the nonprofit.

Second and indirectly, more equity participation should accelerate the timing and volume of qualitative economically sustainable projects. Increased private sector contributions to health care centers, quality grocery stores, affordable housing, unconventional and micro financing for minority and small businesses and the like, can increase self sufficiency, improve health and employment, and thereby reduce governmental subsidies for Medicaid, unemployment benefits, and other low-income subsidies.[129]

[129] For example, tax credits are also provided to the elderly and permanently and totally disabled. I.R.C. § 22.

One such direct payment to low income residents is the earned income tax credit, which amounted to $26 billion in 2002 alone.[130] A credit is also provided for the permanently disabled elderly.[131]If private equity and expertise gains results in a higher number of effective health care facilities to those most in need, presumably fewer of the elderly will be permanently and totally disabled. Fewer subsidies should occur in proportion to the increased health of the target individuals. Thus greater tax collections undiminished by the subsidy should result. It is naïve to believe Congress will suddenly discontinue using the Code for reward incentives. If Congress has reduced use of subsidies in this area, the collected tax revenue can be placed in other areas of need.[132] Thus a three-pronged benefit accrues to this shift in the tax policy paradigm.

Conclusion

Many Americans have the heart to contribute to alleviate the disparate suffering in our urban and rural environs. Yet no diagnosis has cured the patient. This article has the audacity to assert that one catalyst for that transformative treatment is from the most unlikely of sources – the internal revenue code ("Code"). But neither the IRS nor any other government agency is a wholly curative remedy. Yet there are dynamic and evolving tax vehicles that provide an incentive and opportunity for private sector partnerships with philanthropic goals to invest, return a reasonable profit, and truly make a difference.

More specifically, this article's subsidy model advocates a changed incentive formula. The current subsidy paradigm produces a relatively anemic stimulus package

[130] Klein, supra, at 385. The EITC is a direct subsidy that not only offsets tax liability, but results in direct payments from the government to the individual. See I.R.C. § 32.
[131] I.R.C. § 22.
[132] Certainly, this paradigm takes a risk that it will be taken as an excuse for those less well-intentioned to siphon funds for the wealthy without having fixed or prioritized the less fortunate among us.

producing minor amounts of tax liability reduction per investor. To continue down that path will likely only perpetuate a dribble of those projects that truly assist the low income residents. The dribble only prolongs the drain on the federal treasury. The tax policy paradigm advocated herein increases investment return as incentive, and decreases of tax return-based subsidy incentives.

The result should be a broadened base for philanthropy, increasing private equity contributions for the financing and expertise needed to get the deal done, increasing therefore the number of operational qualitative projects. Through the private letter rulings, the IRS has allowed a few joint ventures (via LLCs and limited partnerships) between private equity firms and tax exempt entities with near-market rates of return. This article advocates even more aggressive encouragement of private equity participation with nonprofit foundations and mirroring market-based investment returns. Making such PLRs part of the statutory law is a start. This tax policy paradigm also increases the immediate return on the subsidy dollar by sharing its use with the profit entity (even if it means some private benefit

The net affect of the proliferation of this profitable philanthropy over the long term should be a reduction in dependence on tax subsidies. Projects that provide effective micro financing may lead to more employment and entrepreneurship and less outlays of unemployment benefits. Better health care facilities can lead to lower Medicaid subsidies. The changed tax subsidy paradigm can be part of the initiative that brings those socio-economic goals to reality.