About the Committee

The Committee on Community Economic Development (CED) provides a forum for lawyers to share their expertise and perspectives derived from working with (i) entrepreneurs and community-based organizations seeking to revitalize communities and (ii) the institutions that finance such initiatives. The Committee provides an opportunity to (i) share knowledge and develop policies on the emerging law of CED, (ii) support transactional lawyers involved in CED, and (iii) work with other committees of the Business Law Section, as well as other ABA entities. To join the Committee go to http://apps.americanbar.org/committee_join/ocj_action.cfm?comid=CL746000.

Message from the Chair

Welcome to the Committee on Community Economic Development's (CED) first eNewsletter of 2012. We hope that you find this information beneficial to your practice. In this eNewsletter, we have articles concerning (1) the Davis-Bacon Act and suggestions for how developers and contractors can comply with Davis-Bacon requirements, and (2) the potential for tax-evasion by Internal Revenue Code Section 501(c)(3) tax-exempt organizations and how to make these organizations more accountable to their donors.

We also have an interview with Heidi Alcock, Chief Executive Officer of Michigan Community Resources (MCR), a community economic development organization based in Detroit, Michigan. MCR supports and empowers nonprofit community organizations in Michigan by providing them with pro bono legal services and technical assistance.

The Committee on CED will be presenting a program at the 2012 Business Law Section Spring Meeting entitled "Innovative and Creative Community Economic Development Projects." The program will feature expert panelists discussing community economic development projects with significant affordable housing, nonprofit and federal and local financing components. Panelists will also discuss the challenging aspects of the projects and reasons for the ultimate success of the projects. We hope that you will be able to attend this program.

We welcome any suggestions to improve the Committee on CED's eNewsletter and other Committee programs. We also welcome any article submissions for the next eNewsletter. In addition, please take the time to visit the CED listserv and CED website.

If you are interested in becoming more involved in the Committee on CED, there are many opportunities available so feel free to contact me. See you at the Spring Meeting!

--Dana Thompson
Chair, Committee on Community Economic Development
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Interview with Heidi Alcock
Chief Executive Officer of Michigan Community Resources (MCR)

1. Tell me about Michigan Community Resources and your role in the organization.

Michigan Community Resources (MCR), formerly known as Community Legal Resources, supports and empowers nonprofit community organizations in Michigan that serve low income individuals and communities, with an emphasis on community economic development, by providing pro bono legal services and technical assistance. We hope to create an environment that helps nonprofits improve their services and the communities they serve.

MCR was formed in 1998 as a project of Michigan Legal Services and the ABA Business Section Pro Bono Committee. Formed to provide pro bono legal assistance to nonprofit organizations serving low-income communities, MCR is the only organization focusing on this type of work in Michigan.

I am the Chief Executive Officer, and my role is to ensure successful programs and strong internal operations that accomplish our mission. I oversee a team of 17 staff and a budget of $2.5 million. We have three separate programs (Legal & Policy, Planning & Technical, Education & Outreach) staffed by a diverse mix of professionals. We currently serve over 300 organizations annually.

2. Your organization offers an interesting mix of pro bono legal services, technical services and policy work. Tell me how the organization has evolved since it was first established.

Founded to meet the unfulfilled business and transactional legal needs of Michigan nonprofits, our transactional pro bono legal services referral program is the backbone of our organization and gets bigger and stronger each year. But we recognized early that achieving impact requires a varied approach.

The first stage of evolution diversified the pro bono legal services opportunities for business attorneys beyond traditional representations. We launched a legal education program that addresses important issues identified by our clients. We started our legal team approach to address specific systemic barriers to social justice. We also developed a policy program to inform policy decisions that affect our clients.

Our second stage of evolution occurred in 2007 when we became the lead organization of the Detroit Vacant Property Campaign (DVPC), a collaboration of local community leaders committed to turning vacant properties into assets and preventing vacancy. The DVPC develops vacant property plans in neighborhoods throughout Detroit, creates and disseminates vacant property publications that help communities combat blight and vacancy, and provides technical assistance to address specific threats and improve overall systems that affect Detroit's vacant property crisis.
Our third stage of evolution occurred in 2010 as a result of a strategic planning process and organizational restructuring. As a result, we have three defined programs that work collaboratively to achieve greater impact for our clients, not just in Detroit, but throughout Michigan. Though pro bono will always be the backbone of our organization, our multi-disciplinary approach allows us to leave no stone unturned as we work tirelessly to help our clients stabilize and ultimately transform their communities. To reflect this diversification, our name was changed to “Michigan Community Resources.”

3. What kinds of matters do participating attorneys typically handle?

Pro bono attorneys help our clients with their basic business and transactional legal needs that benefit the organization and its community projects. Our pro bono legal services include:

- Draft/ review simple contracts/agreements/leases
- Intellectual property
- Computer law
- Legal compliance review
- Corporate advice, including strengthening advice and ensuring corporate compliance
- Review, draft and/or advise on partnership agreements (not with for-profits)
- IRS/Tax advice/Charitable giving
- Loan document review and advice
- Employment and benefits advice
- Health care advice
- Fiscal sponsorship
- Insurance/Liability Advice
- Advice and guidance on CHDO qualifications
- Bankruptcy assistance
- Administrative law/Civil Infractions/Regulatory Assistance
- Environmental law, including assistance with environmental assessments, EJ and NEPA
- Real estate advice, including advice on clearing title or help preparing for closings
- Community Land Trust advice
- Advice on joint ventures and partnerships with for-profit entities
- Strategic restructuring (including dissolution)
- Community partnership (i.e., establishing a one-year, corporate counsel relationship with a firm)

4. Describe some of the community development clients you serve and the common issues they encounter.

Our legal services are limited to nonprofit organizations working in low-income communities that can demonstrate inability to pay for the legal work. Our other programs serve a wider range of clients from block clubs to municipal departments. Our work helps different clients use information (legal and otherwise) to strengthen their organizations and increase their impact given decreasing resources. In our vacant property work, we help our clients better understand what is happening with properties in their area in order to hold owners accountable.

5. What are some of the pressing issues facing community development practitioners in Detroit, statewide and nationally?

Foreclosure, vacancy, and a weak economy have changed the community development environment in a significant way over the past six years. In the 1990’s, there was a push to create affordable housing opportunities for families and at the same time target the housing investment in communities that needed an economic boost. During that time, there were ample resources to fund affordable housing construction.
Things are different today. The weak economy and housing and foreclosure crisis has changed the funding environment and supply of and demand for single-family housing. Many communities are now faced with surplus housing stock, insufficient demand for housing units, and inadequate sources of funding to otherwise kick-start weak housing markets.

Community development organizations are challenged with creating and implementing new business models for this environment. They have to determine what interventions can effectively improve neighborhood conditions and then learn how to deliver them with diminishing resources.

Moreover, now that housing is more affordable in regional neighborhoods of choice, many communities are facing increased competition for fewer buyers. Particularly weak market cities have to overcome unfriendly tax structures, poor quality schools and city services, lack of access to viable employment, and other disincentives and find creative ways to retain and attract jobs and residents.

6. Describe some of the innovative approaches you are using to revitalize Detroit and other economically distressed areas.

**Nuisance Abatement**

- MCR is piloting a Nuisance Abatement program that will work with community partners to utilize private nuisance court actions as a tool to eradicate nuisance properties.
- Limited government resources and the growing prevalence of vacant and/or blighted properties in Michigan communities have made it necessary to identify creative solutions.
- In 2010, through the use of volunteer attorney services and the assistance of a local community group, MCR initiated its first private nuisance action. The action is designed to compel the property owner to abate the existing nuisance, thereby positively impacting the immediate neighborhood.
- Building on this work, MCR proposes to initiate ten (10) private nuisance actions in 2012. MCR staff will partner with volunteer attorneys to develop a standard process for initiating private nuisance actions that will be transferable to communities throughout the state.

**Planning & Technical Assistance**

Our innovative approach to providing planning and technical services is rooted in the following four characteristics:

- **Community-Driven:** We see community organizations as the lead planners and implementing entities and it is our role to develop services to support their work.
- **Data-Driven:** We join data and analysis with decision makers to improve their ability to create effective responses to destabilizing factors.
- **Market-and Asset-Based:** Our services are informed by the market conditions in a neighborhood and focus on reinforcing and generating community assets.
- **Actionable:** In order to respond effectively to vacant properties, any plan must employ the use of many layered strategies that take into consideration variables such as ownership, property condition, and location.

**Code Enforcement**

- MCR supports communities in reporting properties that require boarding. We coordinate the community-driven initiative of the Boarding Coalition by leveraging our relationship with the Department of Building Safety & Engineering (BS&E).
- Over 1,500 properties have been reported to BS&E for boarding - most of which have been boarded. This relationship between the Boarding Coalition and BS&E is a successful
model for community-based code enforcement, community partnerships with municipalities and community-led, action-based advocacy.

SAFE Mini-grant Program

- MCR administers a mini-grant program in Detroit to provide grants of up to $5,000 to community-based organizations that support neighborhood-led projects.
- The SAFE mini-grant program is an innovative approach to addressing factors that affect neighborhood security and insecurity. It sets a precedent for funding neighborhood-led actions to mitigate the effects of vacant and abandoned properties. It is also designed to increase neighborhood stabilization and improve quality of life by investing in neighborhood-initiated activities that make neighborhoods safer.
- This year, we received over 130 applications and awarded seventy-five (75) SAFE grants.
- This is the only funding source of this kind in Detroit. This program has been shown to have a positive impact on particular properties. Most importantly, it has been shown to incentivize and strengthen community mobilization and action.

Education and Training

- In 2010, MCR created and implemented the Vacant Property Education Series (VPES). The VPES was developed to augment the technical assistance provided under the Detroit Vacant Property Campaign (DVPC).
- The VPES is providing a comprehensive approach to vacant property education by fostering a peer-to-peer and community-to-community learning model.
- Topics for the VPES include, but are not limited to: Nuisance Abatement, Code Enforcement, Web-Based Resources, Squatters Information, Code Enforcement, Creative Strategies in Vacant Property Mitigation, and Community Organizing and Mobilizing Strategies. The series will include an annual Vacant Property Best Practices Seminar.

7. How could these approaches be duplicated in other cities?

We believe in an approach that tailors solutions to the unique needs, conditions and capacities of each community. We also believe in a comprehensive approach to community development that integrates the perspectives of all stakeholders. We believe that the most important part of our model is to equip the community with information and resources to make strategic and impactful decisions about its fate and then connect those community decisions directly to policy-making and resource allocation. After all, nobody knows a community's challenges and opportunities better than that community.

8. How do you share information about your work to practitioners in the community economic development field?

Our staff attorneys are active in the private bar. All of our staff participates and is frequently asked to present at professional conferences and trainings. We are also asked to submit and/or contribute to articles and other publications. Last, we regularly disseminate information about our work to our contact list, which includes thousands of practitioners in Detroit, across Michigan and throughout the country.

9. How do community economic development attorneys play a role in implementing these innovative approaches?
Community economic development attorneys provide top-notch legal representation to our clients and actively contribute to our educational publications, workshops and trainings, policy work, and legal teams projects. The private bar also contributes financially in support of our legal programs through the Access to Justice Fund administered by the Michigan State Bar Foundation. Our board and its committees are also led by members of the private bar.

## Featured Articles

### Deciphering Davis-Bacon: Suggestions for Developers and Contractors on How to Avoid a Larger Than Anticipated Construction Budget

**Jared Kelly**

Developers of community development projects and their legal counsel should be aware of the requirements of the Davis-Bacon Act ("the Act" or "Davis-Bacon") because the consequences of not complying with Davis-Bacon could challenge the viability and completion of these projects. Davis-Bacon was passed by Congress in 1931 to ensure federal construction contracts paid laborers a fair wage. The Act applies whenever federal funds are used to enter into contracts over $2,000 for the construction, alteration, or repair of public buildings or public works. Contractors and subcontractors are required to pay their workers a minimum prevailing wage rate based on the local rate as determined by the Department of Labor ("DOL"). DOL issues wage rate schedules for thousands of areas across the country and will periodically revise wage rates to account for inflation and cost of living adjustments. Many public housing funding sources, such as HOPE VI funds, trigger Davis-Bacon when used to fund construction work. Therefore, developers and contractors must pay close attention to the applicable Davis-Bacon rates when entering into construction contracts assisted by federal funds. This article will discuss the importance of the applicable law and regulations for developers and contractors entering into public development contracts and will give practical advice regarding ways to maintain compliance with the strict Davis-Bacon rules.

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### Accountability in the Non-Profit Community: A Look at the Potential for 501(c)(3) Tax Evasion and Misused Donations

**April Fabregat-LeBlanc**

Currently, there are millions of Internal Revenue Code Section ("Section") 501(c)(3) tax-exempt public charities in the United States. A substantial number of these charities are committed to what would be classified as community economic development ("CED") work. A growing concern among government regulators is the potential for tax evasion schemes involving Section 501(c)(3)’s that take advantage of their tax-exempt status and unfairly compete with private, tax-paying corporations. The Internal Revenue Service ("IRS") has generated a list of frequent tax-evasion scams. Included on the IRS tax-scam list is the practice of non-profit organizations erroneously invoking the unrelated business income tax provisions to avoid paying taxes on certain income. Due to the IRS tax-scam list, individual donors should also be concerned about whether or not their donations to a Section 501(c)(3) organization are being spent on the Section 501(c)(3) organization’s stated exempt purpose.

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Submit Articles for the Community Economic Development Newsletter

The Committee on CED invites you to submit an article for possible publication in future issues. The articles do not need to be long. Submitting an article is a great way to share your perspective and/or expertise with fellow practitioners and to participate in Committee activities. If interested, please email your article for consideration by clicking on the name of any of the newsletter editors listed above. Thanks.
Deciphering Davis-Bacon: Suggestions for Developers and Contractors on How to Avoid a Larger Than Anticipated Construction Budget

By Jared Kelly

Introduction

Developers of community development projects and their legal counsel should be aware of the requirements of the Davis-Bacon Act ("the Act" or "Davis-Bacon") because the consequences of not complying with Davis-Bacon could challenge the viability and completion of these projects. Davis-Bacon was passed by Congress in 1931 to ensure federal construction contracts paid laborers a fair wage. The Act applies whenever federal funds are used to enter into contracts over $2,000 for the construction, alteration, or repair of public buildings or public works. Contractors and subcontractors are required to pay their workers a minimum prevailing wage rate based on the local rate as determined by the Department of Labor ("DOL"). DOL issues wage rate schedules for thousands of areas across the country and will periodically revise wage rates to account for inflation and cost of living adjustments. Many public housing funding sources, such as HOPE VI funds, trigger Davis-Bacon when used to fund construction work. Therefore, developers and contractors must pay close attention to the applicable Davis-Bacon rates when entering into construction contracts assisted by federal funds. This article will discuss the importance of the applicable law and regulations for developers and contractors entering into public development contracts and will give practical advice regarding ways to maintain compliance with the strict Davis-Bacon rules.

Discussion

Davis-Bacon and the issue of timing can be crucial to community development projects. Typically, a developer or general contractor will be responsible for including the proper wage rate schedule in the bid solicitation or contractual terms. This process, although second nature to experienced developers and contractors, can be difficult for novice parties to navigate. DOL continuously publishes updated rates, so developers and contractors should check for updated rates.

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1 Jared Kelly is a third year law student at Georgetown University Law Center and was a law clerk with the Washington, DC based law firm Reno & Cavanaugh PLLC. He has worked on multiple affordable housing projects.
before soliciting bids or entering into construction contracts. For example, assume a project is privately bid in August 2011 and a contract is signed that includes a schedule of wage rates published in July 2011. Construction does not begin until December 2011 and DOL issues an updated general wage rate in September 2011 for the metropolitan area in which the project is located. Regardless of any other contracts or budgets that have been created in reliance on the July 2011 rate, the September 2011 rate will generally be considered the prevailing wage rate.

**Incorporation of Proper Wage Rates**

Developers are typically required to incorporate general wage rate schedules into federally assisted construction contracts. General rates are published for virtually every county or large metropolitan area in the United States and can be found online through DOL’s Wage and Hour Division. General wage rates do not expire but DOL can revise the rates either by issuing supersedeas wage rates or specific modifications. Supersedeas rates replace the entire wage rate schedule while modifications alter specific terms of a wage rate schedule for a particular position, such as the minimum rate a welder will receive in a certain locality. DOL has the authority to modify or replace rates at any time and developers or contractors are generally required to incorporate the new rates into existing construction contracts.

In some instances, developers or contractors may choose to request project specific wage rates that will apply only to the specific contract attached to the project. These rates will remain valid for 180 days from the date DOL issues the specific determination. Developers or contractors use project specific wage determinations when contracts are being publicly bid. This ensures the proper wage rate is being incorporated into the project’s construction contract and allows bidders to properly estimate costs. If the wage rate expires between the time of bid opening and contract award, contractors or developers will need to request a new wage rate from DOL. Under limited circumstances, project specific wage rates can be extended by the administrator of the Wage and Hour Division ("the

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6 29 C.F.R. § 1.6(a)(2), (c)(1) (2009).
7 29 C.F.R. § 1.6(c)(1) (2009).
8 29 C.F.R. § 1.6(c)(2), (3), (d), (e), (f) (2009).
9 29 C.F.R. § 1.6(a)(1) (2009).
10 Id.
Administrator”) for good cause when unavoidable situations arise. An example is when construction on a public building needs to begin immediately for climate reasons such as a forthcoming winter season that will not allow for efficient construction.

**Changes to Prevailing Wage Rates**

Changes to wage rates during the initial stages of a development can have a significant impact on a project’s financial feasibility. Projects requiring large and skilled construction teams can include millions of dollars budgeted for laborers. Many times, the changes in Davis-Bacon rate schedules will increase labor and construction costs by hundreds of thousands of dollars. For non-profit developers, this could mean the temporary or permanent delay of the entire project. For-profit developers may be better able to adjust for increased expenses by taking on more debt or seeking greater private investment. Still, the increased costs are not easy to absorb given the limited capital funds most community development projects maintain. To avoid a potentially crippling budget increase, developers and general contractors should continuously check for updates on applicable wage rates at the DOL website until construction has begun, or the construction contract has been awarded.

Contracting agencies are responsible for ensuring the correct wage rates are included in any construction contracts. Although regulations and guidance do not precisely define the term ‘contracting agencies,’ the term at least includes federal agencies, but both developers and contractors may share responsibility for incorporating the proper wage rates into construction contracts. Federal agencies that receive federal funds and award construction contracts will be responsible for enforcing compliance with prevailing wage rates. General contractors working on public housing projects may have the general obligation to ensure compliance with the Davis-Bacon wage rate schedules based on guidance from the Department of Housing and Urban Development. The applicable section states that the principal contractor “[is] responsible for the full compliance of all employers . . . with the labor standards provisions applicable to the project.” To be safe, construction contracts should define parties’ roles to ensure responsibility for inclusion of the proper rates. If developers include improper

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11 Id.
12 GPO Access website, supra note 4.
13 29 C.F.R. § 1.6(b) (2009).
14 See, e.g., ICA Constr. Corp. v. Reich, 60 F.3d 1495, 1948 (11th Cir. 1995) (holding the developer and contractor liable for the increased wages due to the inclusion of improper wage rates).
16 Id.
rates in construction contracts, DOL has the authority to provide written notice to the agency requiring the incorporation of the proper rates.\textsuperscript{17}

\textit{Remedies for Inclusion of Improper Wage Rates}

To correct the inclusion of an improper wage rate into a construction contract, DOL can either: rescind the contract and require the contracting agency to solicit a new bid with the proper wage rate, or incorporate the proper rate retroactively to the beginning of construction.\textsuperscript{18} If DOL takes either of these steps, the contractor must be compensated for the increased wage rates. Regulations and Department of Housing and Urban Development (‘HUD”) guidance do not fully define the term ‘contractor’ in this instance, but case law suggests the term means general contractor or subcontractor.\textsuperscript{19} It is unclear what party or agency would bear the responsibility of paying the additional wage rate costs in specific projects.\textsuperscript{20} This is an issue that would likely be negotiated by developers, contractors, and relevant agencies such as HUD and DOL in the event additional costs are incurred because a contract includes an improper wage rate determination.

There are few legal remedies for developers or contractors who include the wrong wage rates in construction contracts. First, parties can ask for a determination from the Administrator for a prevailing wage rate based on the facts of the development.\textsuperscript{21} This request can be made at any time. If the Administrator determines that the wrong rates were included, then parties are allowed to appeal the decision to the Wage Determination Board. If an adverse decision is made at the administrative appeals level, then parties can seek judicial review in federal court.\textsuperscript{22} The judicial review process is extremely costly and has a low probability of success. For example, the Eleventh Circuit Court of Appeals has firmly upheld the strict regulatory framework regarding applicability of prevailing wage rates. In one case, the court dismissed an argument by a contractor that claimed it had relied on the wrong rates in determining its budget.\textsuperscript{23} The contractor faced significant budget shortages because DOL modified its general rates before construction began on the project. The construction contract included rates in effect when the project’s costs were established. However, because DOL altered its rates and gave proper

\begin{itemize}
\item[\textsuperscript{17}] 29 C.F.R. § 1.6(e), (f) (2009).
\item[\textsuperscript{18}] 29 C.F.R. § 1.6(f) (2009).
\item[\textsuperscript{19}] Universities Research Association, Inc. v. Coutu, 450 U.S. 754 (1981).
\item[\textsuperscript{20}] The law does not define who would pay the contractor for the increased costs. This issue has not been litigated because usually the interested parties work together to supplement any budget shortages.
\item[\textsuperscript{21}] Requests can be made by submitting DOL Standard Form 308 to DOL, which can be found at http://www.dol.gov/whd/programs/dbra/sf308.htm (last visited Oct. 31, 2011).
\item[\textsuperscript{22}] See 29 C.F.R. § 7 (2009).
\item[\textsuperscript{23}] ICA Constr. Corp. v. Reich, 60 F.3d 1495 (11th Cir. 1995).
\end{itemize}
notice (published the wage rates online or in the Federal Register) before construction on the project began, the contractor was required to incorporate the new, increased rates into the construction contract. Ultimately, the holding enforces the importance of ensuring the correct wage rates are included in any construction contract because judicial relief may not be available.

There is an important final distinction regarding the manner in which construction contracts are procured that changes the applicability of wage rate determinations under Davis-Bacon regulations. If a contract is publicly bid, the wage rate schedule in effect when the contract was awarded is the prevailing wage rate that should be included in any related construction contracts. Also, a statutory exemption allows the Administrator to determine whether there was enough time to properly notify bidders in a specific project. If the Administrator determines that there was insufficient time, the Administrator then files a report in the project file supporting the inclusion of the improper rate for the project.\(^\text{24}\) Moreover, when a contract is not awarded within 90 days of bid opening, any wage rate modification that is published before contract award will be deemed proper.\(^\text{25}\) In contrast, when a construction contract is privately negotiated, the applicable wage rate is generally the rate published at the time construction begins.\(^\text{26}\) This timing also applies to projects receiving funds under the National Housing Act of 1934 or Section 8 of the U.S. Housing Act of 1937.\(^\text{27}\)

**Conclusion**

Davis-Bacon is an important component of any federally funded construction contract. For community development entities, having the wrong wage rates can mean delaying or permanently foregoing development of much needed public development projects. Parties should be mindful of the DOL’s published wage rates and be sure to include the correct rates in any contract or bid solicitation. Including incorrect rates in a contract is not easy to correct when construction budgets have little flexibility. Appealing to DOL or a federal court for lenience of relief will be costly and likely yield unfavorable results for parties who have been ordered to update wage rates that increase construction costs. To be sure, developers and contractors should double check construction contracts to ensure the prevailing wage rate schedule is properly included in any legal documents.

\(^{24}\) 29 C.F.R. § 1.6(c)(3)(i) (2009).

\(^{25}\) 29 C.F.R. § 1.6(c)(3)(iv) (2009).

\(^{26}\) 29 C.F.R. § 1.6(c)(2)(ii) (2009). Public wage rates are those that are published by the DOL and incorporated by projects generally whereas private wage rates are applicable only to a specific project upon developer or contractor request.

\(^{27}\) 29 C.F.R. § 1.6(c)(2)(i), (c)(3)(ii), (iii) (2009).
Accountability in the Non-Profit Community: A Look at the Potential for 501(c)(3) Tax Evasion and Misused Donations

By April Fabregat-LeBlanc

Currently, there are millions of Internal Revenue Code Section ("Section") 501(c)(3) tax-exempt public charities in the United States. A substantial number of these charities are committed to what would be classified as community economic development ("CED") work. A growing concern among government regulators is the potential for tax evasion schemes involving Section 501(c)(3)’s that take advantage of their tax-exempt status and unfairly compete with private, tax-paying corporations. The Internal Revenue Service (“IRS”) has generated a list of frequent tax-evasion scams.2 Included on the IRS tax-scam list is the practice of non-profit organizations erroneously invoking the unrelated business income tax provisions to avoid paying taxes on certain income.3 Due to the IRS tax-scam list, individual donors should also be concerned about whether or not their donations to a Section 501(c)(3) organization are being spent on the Section 501(c)(3) organization’s stated exempt purpose.

501(c)(3) TAX EVASION: THE UNRELATED BUSINESS INCOME TAX

Given that state and federal tax agencies, such as the IRS, do not have sufficient resources to effectively enforce tax laws, including § 501 of the Internal Revenue Code, and given the growing number of tax-exempt organizations, there is a great potential for tax evasion.

A tax-exempt organization, such as a CED organization, is subject to unrelated business income taxes ("UBIT") when the activity that is generating income (1) is not substantially related to the organization’s charitable purpose, (2) is regularly carried on, both in frequency and continuity, in a manner similar to that of comparable commercial activities of non-exempt organizations, and (3) constitutes a trade or business.4 All three prongs must be met in order for the organization to be taxed.

A tax-exempt non-profit must pay tax on income only if the income-generating activity is not substantially related to its charitable purpose.5 An activity is not substantially related to the non-profit’s purpose when the money itself, being earned from the activity, is the motivation for the activity. In other words, the end goal of the income-generating activity must be to support the charitable purpose or mission that is specified in the CED organization’s incorporating documents. If the charity does not spend the donated funds on its charitable purpose, the income...
must be taxed for obvious reasons. This also raises questions for donors about how they can make sure that their donations are going to a charitable cause.

This requirement is demonstrated in *St. Luke’s Hospital of Kansas City v. U.S.* St. Luke’s Hospital, a 501(c)(3) non-profit, provided pathology tests for local doctors in exchange for a fee. St. Luke’s mission was to train new doctors. St. Luke’s argued that it needed the collected cell samples from the pathology tests, specifically the cancer cells, in order to properly train the new doctors in the classroom. The U.S. District Court ruled that by producing the needed samples, the hospital was promoting its tax-exempt mission and therefore the service revenue received was not taxable.

In the event that multiple activities are being undertaken by the CED organization, each income-generating activity is treated separately and all activities, or the funds derived therefrom, must contribute importantly to the CED organization’s purpose in order to be exempt from UBIT.

Second, a CED organization is subject to UBIT only if the income-generating activity is regularly carried on, both in frequency and continuity, in a manner similar to that of comparable commercial activities of non-exempt organizations. In the landmark case, *National Collegiate Athletic Association v. Commissioner of Internal Revenue*, the IRS argued that the NCAA March Madness Basketball Tournament was a regularly carried on business and was therefore subject to unrelated business income taxes. The NCAA successfully argued that the tournament was only produced and marketed for a few weeks each year, as opposed to the for-profit activities of the similar organization ESPN, which works year-round to produce its product.

Third and finally, a non-profit, tax-exempt organization must pay UBIT only if the income-generating activity constitutes an unrelated trade or business. An unrelated trade or business is characterized as one in which (1) there is a profit motive, (2) substantially all of the work is performed with compensation, (3) the sold goods or services were not goods received as a gift or donation to the organization, and (4) a substantial amount of participation is performed by the non-profit directly or indirectly through control of another organization.

In *Portland Golf Club v. Commissioner of Internal Revenue*, a Golf Club had participated in two activities (investing capital for profit and food sales to non-members). The Golf Club was successful in earning income from investing, but incurred a net loss in food sales to non-members. The Golf Club’s investment gains were subject to UBIT because it was regularly
and actively carried on by the Golf Club’s members, unrelated to its purpose, the income was not received as a gift, and there was a profit motive. The Golf Club claimed that the food sales were also taxable because the customers were non-members and therefore, the activity was not substantially related to its purpose. The Golf Club wanted the net loss in food sales to be taxable so they could deduct the loss against the investment gains, claiming both as taxable income. The Supreme Court ruled in favor of the IRS’ argument which stated that because the Golf Club was selling the food below the wholesale variable cost paid for the food, it had to be assumed that the Golf Club did not have a profit motive. Without a profit motive, the food sale activity did not constitute a trade or business and therefore, it was not taxable.

If income is generated in a passive manner, the income is not taxed because the non-profit is not actively engaging in the alleged trade or business. The recognized forms of passive income are interest earnings, dividends, royalty payments, rents from real property, and revenues from the sale of property. For example, in Sierra Club Inc. v. Commissioner of Internal Revenue, the Sierra Club was paid by a credit card company for use of its mailing list. The IRS unsuccessfully argued that the credit card marketing transactions constituted a regularly carried on business and, therefore, were taxable. The court sided with Sierra Club, holding that the payments it received constituted royalty payments, as defined by Black’s Law dictionary, were therefore passively earned by Sierra Club, and not taxable.

**INDIVIDUAL TAX EVASION THROUGH A 501(c)(3)**

In recent years, the IRS has caught on to a very specific type of tax-evasion. According to the IRS, in its 2010 Dirty Dozen Tax Scams list, one of the most common methods of tax evasion is through a Type III supporting organization, which is donor advised and therefore not controlled by the charity that it supports. The donor organization or individual gives money to a tax-exempt organization (created by the donor) and then gets the supposed donation back, tax-free, through offshore investments or interest-free loans to family, who eventually return the funds to the original donor. Effectively, an individual’s taxable income is laundered through the tax-exempt charity so that the donor can evade paying taxes on personal income. The funds may also simply be used by the donor as a board member of the charity. For example, a person may set up a Section 501(c)(3) tax-exempt charity in the U.S. and open a bank account for the charity. The person may then donate large amounts of personal income to the charity that he or she created and deduct the donations on personal income taxes. The money is then used by the
person, who is of course authorized to use the *charity funds*, for personal purposes, but reported as being used for charitable purposes on the Section 501(c)(3)’s 990 tax form. The I.R.S. does not provide information regarding specific organizations that have been caught during audits.\(^{28}\) Private inurement can cost a non-profit, tax-exempt organization its tax-exempt status, but only if the organization is caught. There are a number of organizations engaging in this type of illegal activity however, as previously mentioned, there are not enough state and federal tax enforcement resources to catch and punish organizations engaging in these types of illegal activities.

**MISAPPROPRIATED PUBLIC DONATIONS**

The second major concern for regulators and donors is that, as the public is donating to CED charities, there is no one checking to make sure that these organizations are really spending the donations on their purported charitable purposes or any charitable purpose at all.

Two years ago, a public charity called Ahava Kids, whose purpose was to help child victims of human trafficking and AIDS by operating a hotline and safe houses, was sued by Connecticut Attorney General Richard Blumenthal.\(^{29}\) Blumenthal claimed that Ahava Kids’ founder used roughly $100,000 in public donations for personal or inexplicable expenses at restaurants, department stores, grocery stores and sporting goods stores.\(^{30}\) An investigation revealed a safe house did exist, but that it was rarely used.\(^{31}\) In another example, the Gloria Wise Community Center (“GWCC”) received $875,000 from New York City’s Department of Youth and Community Development, Department for the Aging, and Department of Education, to be used for services for children and the elderly. Instead, GWCC improperly loaned the money to Air America Radio for non-exempt purposes. GWCC must now return $625,000 to the city.\(^{32}\)

**SOLUTIONS**

One possibility for accomplishing an accountability check to alleviate both of the aforementioned concerns is the creation of a formal accreditation body, similar to a legal advisory and certification board that can provide non-profit, tax-exempt organizations with a legal compliance and financial audit review as well as a certificate of transparency to better protect donors and to curb tax evasion.

Accreditation bodies such as the National Collegiate Athletic Association, the American Bar Association, and Commission on the Accreditation of Rehabilitation Facilities, were all created by willing participants, volunteers, and government organizations that saw a need for
organization and standards within each respective sector. The non-profit community also has such a need for accreditation standards that will increase financial transparency and enforce ethical and legal standards. Community economic development may be best served by an accreditation process that will act as both a marketing vehicle for non-profits who want to attract donors and assurance for donors.

Another similar, but potentially more feasible, solution may already be underway. Guidestar, a non-profit resource website founded in 1994, has opted for a less formal, but still potentially effective, approach. It has launched a program called the Guidestar Exchange Program and is in the process of encouraging its 2 million plus charities to participate. This free, optional program requires participating non-profits, including community economic development organizations, to provide an independent financial audit along with other general information. A charity who receives a Guidestar Exchange Seal by successfully completing the program increases its chances of receiving donations through the Guidestar website and acts as an incentive for other non-profits who have not achieved the higher starred status. Donors who regularly visit the website will now be able to screen out charities that have not opted for transparency and accountability.

The potential for tax evasion and misappropriation by Section 501(c)(3) organizations will grow as the number of these organizations grows if a solution is not implemented. All affected parties (regulators, donors, and competing private businesses) should be aware of the lenient reporting standards to which Section 501(c)(3) organizations are currently held. As donors become more aware of this problem, more accountability and transparency will be demanded of Section 501(c)(3) organizations and, in return, provide more piece of mind to donors.

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3 Id.


5 Id. All 3 prongs of the test must be met.


7 Id. at 86.

8 Id.

9 Id. at 86, 88.
10 Id. at 89.
11 Nat’l Collegiate Athletic Ass’n v. Comm’r of Internal Revenue, 914 F.2d 1417 (1990).
12 Id. at 1421.
13 Id. at 1422.
14 Treas. Reg. § 1.513-1(e)(1-3).
16 Id. at 157.
17 Id. at 158.
18 Id.
19 Id.
20 Id. at 171.
21 Id.
22 I.R.C. § 512(b)(13).
23 I.R.C. § 512(b)(1) – (3).
24 Sierra Club Inc. v. Comm’r of Internal Revenue, 86 F.3d 1526 (1996). See also Arkansas State Police Ass’n, Inc. v. Comm’r of Internal Revenue, 282 F.3d 556 (2002).
25 Id. at 1530.
26 Id. at 1527, 1529.
28 Id.
30 Id.
31 Id.