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CONTENTS

## ARTICLES



## STATUTES



## LEGISLATIVE DEVELOPMENTS

# COMMUNITY CAPITALISM AND THE COMMUNITY SELF-DETERMINATION ACT

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## *Introduction*

Ideologies built around the idea of community and the strength of capital have seldom found a common meeting place. The operative motive in capitalism is the pursuit of private gain, leaving the general welfare to the famous "invisible hand" of Adam Smith. Communal ideas have long been seen as antithetical to those of capital because of their association with ephemeral labor-intensive experiments or with anti-capitalist revolutions. Yet these two traditions are beginning to appear in tandem in America's ghettoes, where the idea of economic development is being adopted by grass-roots black community organizations.

"Community organizing" became a term of art after the sit-ins of the early '60's, when SNCC, NSM, SDS, and CORE began to demonstrate the power which could come from helping to articulate community discontents. The community was organized around the failures of the capitalist system vis à vis ghetto residents. Slumlord, cop, and social worker became symbols in the struggle to rally the community against the common enemy. The major organizational tool was the demonstration, and legitimacy depended primarily on effectiveness in advocating community demands.

Development of a conscious desire for economic power came different ways to different organizations. A tenant organization in Boston became a landlord when it realized that sit-ins were inefficient ways of combating the slumlord's economic power. The Woodlawn Organization, a group in Chicago which began organizing against urban renewal, now owns and manages a sizeable housing and shopping

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center complex. FIGHT in Rochester was born in a struggle against Eastman Kodak, and ended up negotiating an agreement for ownership of a factory.

Nationwide, new organizations are being formed around the idea of community economic development. A venture in Newark, called "Minority Economic Industrialization and Cultural Enterprises, Inc." plans to create "an instrumentality which will be in the business of making businesses," looking to the day when "the biggest business in the ghetto would be the community corporation owned, operated, and managed by the ghetto residents."[1] In Hough, a new development corporation seeks to

> attract and create industries that will train and employ Hough residents; attract and own commercial establishments to meet the consumer and service needs of area residents as well as the white community; and gain and use entrepreneurial and management abilities through improved employment opportunities.[2]

An organization that would turn Hough, Central Newark, Roxbury, or Bedford-Stuyvesant into a community which is no longer dependent politically or economically must inescapably combine the best features of business and politics. While the forms may be as familiar as the eighteenth century New England town meeting and the nineteenth century entrepreneurs' rugged capitalism, the *combination* is without American precedent. Such organizations, now springing up across the land, represent a radical and promising innovation in social action.

Many Congressmen have come to believe that government can play an important role in encouraging ghetto development through organizations of the type discussed above. But if such novel groups could be valuable agents of social change, it is nonetheless unclear what role the government might play. This article will discuss both past government attempts to intervene in the slum cycle and contemporary efforts by non-government groups to foster ghetto economic development. It will then analyze the Community Self-Determination Act, a much-discussed bill introduced in the last session of Congress, as a focus for consideration of how government might encourage black

1 *Narrative of Application for an E.D.A. Grant,* submitted by "Minority Economic Industrialization and Cultural Enterprises, Inc.," November, 1968, at 1.

2 *A Proposal for a Special Improvement Grant for Economic Development of the Hough Area,* submitted by Hough (Cleveland) Area Development Corp., June 10, 1968, at 19.

organizations working for community self-determination and economic strength. Finally it will consider the more important impacts of traditional business law on groups presently engaged in ghetto economic development.

## I. The Federal Role in Community Development

### A. *Past Government Interventions in the Slum Cycle*

Charity may alleviate the suffering of an individual, but it has not proven an effective way of intervening in the slum cycle. Traditional government poverty programs — welfare, job counseling, home services counseling, public housing — are a type of public charity much more harmful in its long-run effect on the ghetto than the private mission of mercy, precisely because of the greater resources at government's command. The traditional poverty programs perpetuated the dependence of the ghetto on white society while reinforcing a separate life style — a society within a society. Profits were generated for some white entrepreneurs, architects, lawyers, social workers. Income was created for those on welfare, but the money was used for survival, and nothing solid was left behind. Public housing built where a tenement used to be no longer signaled the "end of urban blight" but came rather to symbolize the absence of change. It seems evident now, that the problem of the ghetto is as much the *way* federal monies are being spent as the relatively small amount expended.

The community action programs (CAP's) administered by the Office of Economic Opportunity reflected government recognition of the fact that traditional services and income approaches to poverty were not changing ghetto realities. However, government acceptance of the techniques of community organizing also proved abortive. As Daniel Patrick Moynihan has recently said, "At the risk of oversimplification, it might be said that the CAP's most closely controlled by City Hall were disappointing, and that the ones most antagonistic were destroyed."[3]

The CAP's for the most part never answered the question: community action for what? They borrowed some of the techniques of the early '60's radical civil rights organizers, but the techniques never worked for the Kennedy and Johnson administrations the way they

3 D. P. Moynihan, Maximum Feasible Misunderstanding 131 (1969).

worked for, say, SDS. For one thing, students had organized around wringing concessions from a hostile society; rewards when they came were immediate and dramatic. When they did not, a person or institution, actually or symbolically responsible for the frustration could be found.

Government sponsored community organizing on the other hand could not tap the power which comes from giving form to the inchoate demands of an oppressed community. Nevertheless, one lesson which *should* have been drawn from successful community organizing projects of the past was that an organization cannot exist unless it produces results which are meaningful to a community. Since organizing against landlords and city hall was politically difficult for the government programs, some alternative means of fostering community power should have been sought, and economic development was an obvious candidate. Unfortunately, programs aimed at economic development such as they were, were administered by other segments of the bureaucracy, and no rapport was seen between the objectives of economic development and community organizing. Thus, community organizing was wrongly seen as an objective in itself, and the CAP's degenerated into lessons in town hall democracy, another form of the "services" approach to poverty which had the sole advantage of getting government salary money to some blacks instead of to white professionals.

The inadequacy of community organizing programs which merely give salary money to a few should be recognized. Community pride does not grow simply because some local people draw salaries from Washington. The riots emphasized that "integration" is not possible in the short-run, that the traditional "solution" of seeking out individuals worthy of upward mobility has been inadequate.[4] Since the ghetto has served notice that it will not cede to the onslaught of the war on poverty, training "qualified Negroes" skirts the real problem, which is how to deal with an alienated community as a community. Unless income-generating infrastructures are somehow created in ghetto communities, a feeling of powerlessness will continue to provide the stuff which violence is made of.

It does not follow, however, that large capital transfers to community groups will prove any more successful than past programs. Absent

4 C. Hampden-Turner, *Black Power: A Blueprint for Psycho-Social Development?* in R. S. Rosenbloom and R. Morris, eds., SOCIAL INNOVATION IN THE CITY 63 (1969).

the skill to change capital into a stream of income such transfers will merely elongate the begging cycle. Any government program which hopes to effect meaningful change must therefore concentrate on how to encourage massive skill transfers which will end the powerlessness springing from economic dependence. Capital grants are a tactic incidental to this objective; the major emphasis must be upon formation of organizations with strong ties to the community. Outsiders must recognize that they no more know how to get something done in Harlem than the average ghetto dweller knows who to see at the Chase Manhattan. If, for example, it is determined that a textile plant would be economicaly viable and therefore a "good project for economic development of the ghetto," chances for economic success would be improved if a group with community legitimacy held equity in the operation. The serious tensions which are certain to build up as economic values begin to be generated could thus be minimized, and vandalism reduced. Finding and retaining talent could be facilitated, and knowledge of the community organization's participation in the business venture would mean immediate psychological "return" for the community.

Assuming that the government would choose to deal directly with organizations having grass-roots ties, how can it choose the "right" group in a given community? This is a central question for federal legislation which seriously contemplates capital transfers and other devices to build community institutions by fostering community economic power. If a certification mechanism could be set up to work automatically so that a group would be entitled to receive the federal benefits after it met certain objective criteria, city by city political struggles could be avoided.

But how could such a mechanism avoid backing groups which became despotic, unresponsive to the community? Is it *desirable* that such groups be "democratic" in the town meeting sense, or is the ability to throw out an oppressive elite enough? And is it possible procedurally to ensure even the latter objective? After all, the by-laws of many corporations afford but little solace to the dissatisfied shareholder; how realistic is it then to insist on democratic or corporate formalities in a society where the leaders never depended on electoral formalities for legitimization?

Even assuming some satisfactory answers are found to the problem

of "democracy", how is the government to choose one group over another? Anyone can claim to have power, allegiance of the community, and economic skill. If the wrong group is chosen, however, a local program may be torpedoed by an organization with the real power in a community. Alternatively, federal subsidies might create a "success" which does not benefit the community at all. When one gains some knowledge of a local community, it is possible to estimate the value of subsidizing one group over another. But if such broad personal discretion is built into a bill, the program could degenerate into a type of federal patronage.

### B. *Ghetto Realities*

Any attempt to deal legislatively with these problems must take account of the groups already engaging in ghetto economic development and of their experience to date. The approaches already tried illustrate possibilities, while the probable incidence of proposed federal legislation on already extant organizations is an important way of judging a bill's value.

In each city, organizations must face different realities. In some the "turf" is spatially well marked out; it is generally known that a given area "belongs" to a given organization. In others, a myriad of groups purport to speak for the entire community, and "turf" becomes defined either functionally (e.g., dope and prostitution, housing, manpower training, education) or in terms of ideological positions. In some cities the majority of the ghetto community consists of transients and new arrivals from the South, in others there is a more stable community. In some cities white organized crime is into the black community, in some there is a more autonomous black syndicate. In some cities, city hall uses the police to repress black organizations, in others not. In some cities blacks form a highly conscious substantial proportion of the electorate, in others they do not.

The fact that community development organizations operate in different environments, is reflected in both the organizational forms and the tactics they have adopted.[5] Many of the grass roots community

5 All comments about persons or organizations specifically named except those relating to the Hough Area Development Corporation are based on personal contact. General comments are based as well on many other groups which have been visited but not named. Comments on the Hough Group rely on unpublished studies of the Harvard Program on Technology and Society.

organizations were initially concerned with welfare organizing, tenant organizing, fighting urban renewal, picketing for jobs, or related activities. Expansion into business enterprises has taken various forms depending on local conditions, but almost universally such enterprises attempt to convert the rising black consciousness into economic power. In most cases community organizations can use the new consciousness as a business resource permitting access to a consumer market. In other instances this new resource may be used to reduce operating costs (from absenteeism, vandalism, etc.). In still one other case, it has opened up a producer dimension by permitting access to raw materials gathered from throughout the ghetto community.

While there are many exceptions, most of the new community businesses aim at the non-durable consumer goods market. Many groups have purchased franchises in order to obtain ownership, prestige of a national name, and some organizational guidelines. Those entering the producer dimension generally rely in the first instance on a "sheltered market" obtained through negotiation with government or private enterprise. Some of these groups attempt to encourage individuals to go into business, others run businesses themselves or through subsidiaries.

### 1. Existing Development Organizations

The community organizations we know of differ in:

1. the source and magnitude of their funds;
2. the time in their developmental process when funds became available;
3. the source of their legitimacy (election, organization against and outside enemy, organization for furthering economic interest, etc.);
4. tactical emphasis (violence, political dealings with city hall, mobilizing public opinion);
5. nature of leadership (male or female, many or few);
6. rewards for leadership (high visibility, economic return, etc.);
7. degree of continuing popular participation;
8. rewards for community participation.

It is impossible to know at this time which groups will maintain their legitimacy over time and produce economic successes. Community organizations as different as the West Side Organization

(WSO) in Chicago, Cleveland's Hough Area Development Corporation (HADC), and the Bedford-Stuyvesant Restoration Corporation (BSRC) in New York seem to have great potential for making a lasting impact on the ghetto. The Chicago group has not had access to large amounts of money during its four year existence and has not depended at all on technical assistance from outside advisors. It is run by a loose coalition of men in their 30's and does not rely on committees or functional groups to get a job done. Funds until recently came from small foundations. Its existence is barely tolerated by the city government and police force. After its initial successes in job and welfare organizing WSO turned to ownership of its own businesses; but fighting urban renewal and protecting community interests generally are continuing concerns.[6]

The Hough Area Development Corporation contrasts with WSO in almost every way except objectives. The Chicago group originally organized around job integration and welfare issues, only moving into business later in its developmental process, while HADC community leaders had economic development as their initial goal. The Hough group, incorporated in June 1967, received an OEO grant for $1.6 million a year later. HADC has strong grass roots ties, as does WSO, but relies much more on the charismatic leadership of one man. In HADC outside advisors are more frequently utilized than in WSO — and the group enjoys excellent relations with Cleveland's city government.

Least like WSO, the archetypically successful issues-oriented community organization, is the Bedford-Stuyvesant Restoration Corporation, the establishment of which was announced in a speech by Senator Robert Kennedy in December 1966. Senator Kennedy chose Judge Frank Thomas, a Bedford-Stuyvesant resident, to head the non-profit corporation, and the other members of the corporation have been chosen by Mr. Thomas. The sister Bedford-Stuyvesant Development and Services Corporation is manned by some of New York City's top business leaders. In June of 1967, the Department of Labor allocated $7 million to the two corporations and grants for $750,000 and $1 million from the Ford and Simpson J. Astor Foundations, re-

6 Cf. Kenneth H. Miller, *Community Organizations in the Ghetto, in* SOCIAL INNOVATION IN THE CITY, *supra* note 4, at 97.

spectively, followed. Of the ten man full-time staff, eight have graduate degrees and top consulting talent is freely utilized.

In terms of physical accomplishments, BSRC has been the most productive of the three groups. It has undertaken an ambitious housing rehabilitation program which generated six black-owned construction organizations. It is completing in May the construction of a two million dollar neighborhood center, and is running an ambitious manpower training program and home mortgage pool. It has both persuaded businesses to locate in Bedford-Stuyvesant and generated black-owned firms through its business development program. WSO with infinitely fewer financial resources, has been operating successfully a large Shell gas station, is negotiating several other franchises, and is closing a deal for a manufacturing operation. Plans include a housing rehabilitation program, a supermarket, and expansion of the community newspaper.

It would be bootless to point to one of these groups as the "model" for community development. One might have suspected that WSO, with its loosely organized grass-roots directors would have been least capable of doing successful economic development. Conversely, the Bedford-Stuyvesant Restoration Corporation especially in light of an earlier community split might have been thought incapable of involving the hard-core unemployed in its programs. At this early date, however, guarded optimism is possible with regard to all three groups discussed herein and many others not mentioned.[7]

### 2. Individual Entrepreneurs

The diverse possibilities for community development become even greater when one considers individual black entrepreneurs who have also begun to find economic opportunities in the ghetto. Archie Williams in Boston purchased three ghetto-based supermarkets from Purity Supreme in a series of highly leveraged transactions which laid the basis for Freedom Industries. Having sold contracts to certain electronics firms in the Boston area, Williams was also able to establish a components manufacturing firm. Graphics 34, a designing and advertising affiliate, and Freedom Manpower, a manpower training corporation, now form part of Williams' expanding network of businesses. All are located in the ghetto, and the overwhelming majority

7 *See supra* note 5.

of employees are ghetto residents. The Freedom Foods advertising campaign has placed heavy emphasis on the theme "build your future by buying at a black business". A major effort was undertaken to demonstrate that the stores really were purchased and that Freedom Industries was not just fronting for Purity Supreme. Freedom Industries is closely held, but Williams is interested in having stock widely owned in the black community. He pays top wages and spends an extraordinary amount of time and money on employee welfare.

Like Williams, Floyd McKissick, former national director of CORE, sees black capitalism as a means of ghetto transformation. Though McKissick has begun consulting and advertising operations and has purchased a publishing house, his projects are in the planning stages and cannot now be discussed. In general, however, like "Soul City," the new town being planned in North Carolina, McKissick's projects are more grandiose than those with which Williams began. The McKissick organization is much more personal and had access to more substantial sums of money from the beginning due to its relationship with Corn Products Inc.

### 3. "Community Benefit" Corporations

There exists also a myriad of new black businessmen who hope to put their successful business at the service of the black community. Harold Mars, president of Camura, Inc., and Frank McElrath, president of PA Plastics, two of a number of black entrepreneurs launched through the financial backing of the Rochester Business Opportunities Commission, espouse social as well as economic objectives. These for-profit enterprises arguably represent a new organizational form which might be called a community benefit corporation. Such corporations are unlike traditional Negro businesses which were either very small scale or a means of escape for the participants (who could then become concerned with what to do about the slums). Many new black entrepreneurs who are locating in the ghetto recognize that they are benefiting from a community spirit to which they will have access only as long as they can distinguish themselves from traditional white operators. Being black, however, gives one a certain time lag before he is put to the test, and it is no more possible to say at this time whether black entrepreneurs will succeed on the social dimension than

it is to predict economic success for business-minded community organizations.

### C. *Community Self-Determination Act: A Framework For Federal Legislation***

The differences in types of black economic development entities as well as the extreme variations in urban environment must be considered by the draftsmen of federal legislation aimed at ghetto economic development. A bill known as the Community Self-Determination Act introduced during the last Congress which would in fact have created a program for government sponsorship of community development corporations received broad bipartisan support, and will serve as a useful vehicle to illustrate some of the possibilities for federal relationships with community groups.[8]

It has been re-introduced during this congressional session. The bill represents a giant step forward from past poverty programs. Unlike the community action programs, this bill does not aim at funding federal community organizers, but attempts instead to encourage true ghetto-based organizations. No salary money at all is provided by the bill. Moreover, unlike the past community organization programs, this bill assumes a reason for organizing which transcends political and social education: namely, economic development which would create a new source of funding for community service activities. People of slum communities would be assisted "in their efforts to achieve gainful employment and the ownership and control of the resources of their community including businesses, housing, and financial institutions."[9] The bill's major weakness is that it consistently makes detailed decisions governing organizational form and strategy which reduce the possibility of flexible response to local conditions by community development entities.

The bill prescribes a procedure whereby an organization in urban or rural poverty areas can qualify as a National Community Development Corporation (NCDC). It establishes guidelines for organization and operation; it creates tax incentives and grants for the NCDC's

**Analysis of the bill is based in part on work with the business group of the Harvard Program on Technology and Society.

8 H.R. 18715, 90th Cong., 2d Sess. (1968), S. 3875, 90th Cong., 2nd Sess. (1968). In the following discussion, the bill will be referred to only by section.

9 Sec. 2(c).

themselves and for outside businesses which undertake certain projects in conjunction with NCDC's. (The bill also sets up a system of national community development banks to provide the financial services required by NCDC's and independent businesses in NCDC areas, but only the parts of the bill dealing directly with the urban NCDC will be discussed here.)

### 1. Formation of a Development Corporation

Procedure for initial formation of an NCDC is quite complex. The NCDC may be formed in any community whose "development index" is below a certain level as measured by comparing its unemployment rates and median income to the national average.[10] A national community corporation certification board (NCCCB) consisting of five persons appointed by the President is in charge of overseeing the certification procedure.[11] Any five or more individuals who would form an NCDC have to submit to the NCCCB a letter of intent describing the geographic area of the proposed community, articles of incorporation, and an organization certificate which contains statistics to indicate whether the development index is sufficiently low.[12] At the same time, the incorporators submit agreements to purchase five-dollar shares in the NCDC signed by five percent or more of community residents over sixteen years old.[13] Upon receipt of the necessary materials the NCCCB issues a conditional charter.[14] If the group can then obtain additional pledges to bring its total up to ten percent of the residents and collect $5,000 from at least 500 residents, a referendum is held to determine whether the majority of the community favors the establishment of an NCDC.[15] If the majority of those voting approves, the NCDC is eligible for a final charter and a grant from the NCCCB equal to the amount invested by shareholders.[16]

However, if more than one group is claiming to represent the same territory, a referendum is first held in the "potential community" which includes the contested territory as well as all additional areas claimed

10 Sec. 138.
11 Sec. 101-105.
12 Sec. 131-133.
13 Sec. 133 (c).
14 Sec. 135 (e).
15 Sec. 136 (a), 137 (a).
16 Sec. 137 (a), Sec. 140.

by competing groups.[17] Before any group can obtain a final charter, a majority of those voting in the potential community must favor the establishment of a CDC.[18] If such majority exists, the group with the largest vote becomes eligible for final certification, but if the majority does not vote in favor of the NCDC, a new referendum is held in the next largest geographical area described by an eligible groups' letter of intent, and the procedure is continued until a majority favoring the establishment of an NCDC is obtained, or the final proposal is rejected.[19]

Though the bill would have an impact on poor communities throughout the nation, its influence would be particularly strong in black slums. The formation procedure must therefore be judged in part by the response it would be likely to evoke from ghetto groups. In highly politicized and well-organized communities, militant groups (sometimes the only legitimate ones) might refuse to participate in a white-sponsored contest among the natives. The bill's provision (Section 135A) for branch offices in the ghetto to administer the referenda, would lend force to that view. When organizations strong enough to get 5% of the population to buy shares did participate, the referenda might create the bitterness that sometimes results from a formal public battle for the right to represent the community. It is not unimaginable that the referendum procedure could become a catalyst for violence.

In those communities where strong organizations were not yet in existence, there would also be some dangers. The bill seems to hypothesize the existence of a group of founders who are far-sighted enough to see what they could do with the seed money and tax advantages to be discussed below. The group would have to sell shares in a nonexistent venture to 10% of the community. And it would have to undertake a referendum campaign which is not valid unless 15% or more of the eligible residents vote[20] (a percentage above the average for Model City's elections where the federal carrot is even more in evidence). Moreover, the ghetto's real leaders have traditionally spurned public office. While the formation procedure does not exclude an entrepreneur with a business idea who hopes to gain a community

17 Sec. 137(b), Sec. 135(a).
18 Sec. 137(b).
19 *Id.*
20 Sec. 142(c).

following, it does force a tactic on him. He must win the community *before* he can try his business ideas.

The bill allows the possibility that subsequent CDC's may be formed in an overlapping area, but only three years after the formation of a pre-existing NCDC.[21] Even then the rival group must obtain pledge cards from 20% of the community and win the vote of 70% of the residents in a campaign for final certification.[22] The bill's careful time-consuming procedure (perhaps a year or more if there were contested referenda) follows necessarily from the decision to favor one NCDC per community.

### 2. Operation of the Development Corporation

The bill's provisions regulating corporate operations are as rigid as its formation procedures because the draftsman has in many instances taken the decision to resolve the tension between economic and social purposes, one way or the other. For example, the bill does not rely on economic return to stimulate the ghetto dweller's participation. Generally, no dividends may be paid on shares in the CDC, and shares may only be resold to the corporation, which repurchases them for the original five dollars.[23] No matter how many shares a man purchases, he gets but one vote.[24] Participation is to be encouraged through an interest in NCDC affairs stemming from the NCDC's hoped-for effect on the ghetto environment and possibly through preferential access for shareholders to NCDC services and facilities.[25] Since these $5 shares are the only class permitted to be sold,[26] a rigid capital structure, which may or may not be suited to its needs is imposed on the NCDC.[27] A community corporation which would rely on dividends for incentives (like Rev. Leon Sullivan's OIC program in Philadelphia) cannot qualify as an NCDC, although anomalously the bill applies state law relating to "business corporations".[28]

21 Sec. 143.
22 *Id.*
23 Sec. 120, Sec. 118. Dividends may be paid if after five or more consecutive years at a development index above 100 the corporation elects to be treated as a normal business corporation for tax purposes. Upon dissolution dividends may be paid proportionate to the length of time distributee was a shareholder.
24 Sec. 111 (e).
25 Sec. 116 (c).
26 Sec. 132 (a) 5.
27 *See* text preceding note 40, *infra.*
28 Sec. 110 (c).

A crucial question is the extent to which the NCDC will be able to go outside its own community for markets and resources. One critic of the bill has argued that the draftsmen intended to restrict the NCDC's business activity to the community it has defined for itself,[29] while one of the draftsmen has disclaimed any such intention.[30] The bill's language, though it could be cured by legislative history, favors the critic's interpretation. The NCDC is to have the power to own property wherever situated if such property is reasonably required for the operation of an individual proprietorship located in the community or for the operation of other named traditional type business entities within or without the community.[31] It also has the power to

> conduct its business, carry on its operations, have offices, and exercise the powers granted by this title throughout the community and elsewhere to the extent consistent with this title; . . .[32]

Initially, at least, it appears that it would be improper for an NCDC to conduct activities outside its community since the articles of its corporation must contain

> the precise boundaries of the geographic area within which the corporation intends to conduct its activities and a statement that the corporation shall be authorized and empowered to make such efforts within, but only within, the community so described, unless the boundaries of the community are enlarged or diminished by amendment to the article as provided by this title; . . .[33]

The articles may be amended by the traditional two-thirds vote of the shareholders, but only pursuant to procedures of general applicability prescribed by the NCCCB and only if the amended articles contain such provisions as might lawfully be contained in the original article at the time of making the amendment.[34] It is clear that no NCDC could lawfully define its community as the nation or the metropolitan area since in any event an NCDC is limited to a community of no more than 300,000 residents of 16 years of age or older.[35]

29 F. D. Sturdivant, *The Limits of Black Capitalism*, 47 HARV. BUS. REV. 122 (1969).
30 Macloughery, Letter to 47 HARV. BUS. REV. 43, 45 (1969).
31 Sec. 110(a) (4).
32 Sec. 110(a) (11).
33 Sec. 132(a) (3).
34 Sec. 122(a).
35 Sec. 110(b).

Even if the NCDC itself is not empowered to conduct activities outside its community, it could be argued that activities of its subsidiaries, wholly owned or otherwise, are not attributable to the NCDC.[36] Against the expanding notions of corporate "presence" this interpretation seems particularly strained and the spirit of the bill as a whole favors the more restricted interpretation. If the legislature does adopt the view that subsidiaries can operate freely outside the community, the rationale for the elaborate definition of a community to which the activities of the NCDC itself are confined and the reasons for confining the NCDC to drawing resources from that community are both undercut. Under the bill's present form, a non-resident may not buy shares unless he owns or operates a business in the community and then only after a two-thirds vote of the shareholders.[37] Thus sources of NCDC equity capital are restricted; an officer of an NCDC subsidiary operating outside the community would not be able to own shares in the parent unless he lived in the community. And if a shareholder moves out of the community and does not operate an enterprise located in the community, he will lose his voting rights.[38] The bill sets up a nine-member business management board (BMB) to direct the economic development activity, and all nine BMB members as well as NCDC officers must be residents of the community.[39] There is no good reason to impose this restriction on the source of the personnel. Many of the black community organizers and entrepreneurs operating in the ghetto, like WSO's full-time chairman or Boston's individual entrepreneur Archie Williams, have large grass-roots followings and work in the slums but reside elsewhere. And it is conceivable that community organizations might want to have non-residents on their boards in minority positions.

Through the use of subsidiaries, an NCDC might achieve some flexibility both in sources of capital and in ability to use financial return as an incentive. An NCDC subsidiary is permitted to pay federal income tax at a lower rate according to the degree of development of its area, as measured by its "development index."[40] In the most underdeveloped areas, an NCDC subsidiary would pay no tax on the first

36 Apparently Sturdivant does not consider this possibility.
37 Sec. 117 (a).
38 Sec. 118.
39 Sec. 113 (b), Sec. 114 (a).
40 Sec. 402 (b).

$50,000 income and could claim a surtax exemption of $200,000.[41] Since dividends from an NCDC subsidiary to the parent are 100% deductible,[42] this tax abatement would be of great value to a profit-making NCDC with a low development index. But in order for an NCDC subsidiary to qualify for the bill's tax benefits, all the subsidiary's shares must be held either by the NCDC or by the employees' pension, profit-sharing, or staff-bonus trusts qualified under section 401 of the Internal Revenue Code.[43] And if the NCDC were to forego the tax benefits, either by running the for-profit activities as part of the parent's operations, or by having the subsidiary stock held throughout the community, it would not have available the option of using financial incentive as a means to encourage participation in the NCDC's own activities. (In any event though shares in parent NCDC would presumably be exempt from the 1933 Act,[44] the subsidiary would encounter the same securities regulations problems as are discussed *infra.*)[45] Since the NCDC is a for-profit corporation, there could be no argument that any of its income is exempt under section 501 of the Code, so that a Type II or III CDC, described *infra*,[46] could be in a better tax position than an NCDC whether or not the NCDC relied on outside capital. Of course all the tax savings techniques available to a for-profit enterprise discussed *infra*,[47] would be available to the NCDC subsidiary.

In its requirement that the Business Management Board must allocate twenty to eighty percent of the after-tax income to social programs each year,[48] the bill has again made a decision which local realities might disapprove. For example, where existing government social programs are responsive to community pressure, it might be desirable to plow back 100% of profits into business expansion. Conversely, where a corporation desired to expand the number of shareholders in its community, it might want to spend the first several years'

41 *Id.*
42 Sec. 403.
43 Sec. 402(b).
44 Such shares might fall under Sec. 3(a)(2) of the Act which exempts securities issued by any person "supervised by and acting as an instrumentality of the Government of the United States" . . . or perhaps under the Sec. 3(a)(4) exemptions for non-profits.
45 *See* text accompanying notes 117-132 *infra.*
46 *See* text accompanying notes 76-110 *infra.*
47 *See* text accompanying notes 133-155 *infra.*
48 Sec. 119(a).

profits on social programs. Such a tactic in the initial period might lead to more after tax "income" in the form of share subscriptions than pure economic development could generate.

The bill's decisions regulating the board of directors afford another example of excessive detail. It is provided that a majority of the shareholders may remove the entire board of directors with or without cause[49] and where there is only one CDC per community chosen through the prescribed formation procedure, this provision may indeed afford a necessary prophylaxis; it would not do to saddle a community with a federally sanctioned despotism. But the organizations which take advantage of the federal procedure will have legitimated themselves in many different ways, with the result that procedural democracy will be more (or less) central to the parties concerned than to the draftsman. Some groups, for example, would be seriously inconvenienced by a procedure replacing a highly informal method of getting feedback — like drinking in local bars — by a responsibility to a formalized and changed constituency. Others might find it necessary to insure a minority — through cumulative voting, classification of shares, or more casual methods — that it would in all circumstances continue to have representation on the board. The bill further provides that the *size* of the board must vary directly with the size of community. The largest communities are to have a board with a mandatory minimum of 63 directors.[50] Such a large board would probably develop informal ways of accomplishing business, but such top-heavy management could hamstring operations.

The bill's decision in favor of broad citizen participation in one comprehensive community group brought the draftsmen dangerously close to attempting to make the ghetto safe for democracy. The bill sets up a procedure for federal examination of corporate records and requires filing of annual financial reports with the NCCCB;[51] so that even after the NCCCB branch leaves the community, the federal presence will continue to be felt. This is doubly unfortunate, because the traditional antipathy of businessmen for federal regulation will be reinforced by black suspicion of outside control. It is further provided that any aggrieved person may appeal to the NCCCB for failure of the corporation to distribute benefits in accordance with objective,

49 Sec. 112(g).
50 Sec. 112(b).
51 Sec. 126(c).

non-discriminatory, and equitable criteria described in the corporations by-laws.[52]

Given the bill's detailed regulation of corporate form and operation, possibilities for financial advantage should be the key factor for a group considering whether to attempt qualification as an NCDC. The four-pronged approach to subsidization is tax abatement, seed grants, turnkey programs, and planning funds. As the following discussion of possibilities for community capitalism under present law will suggest, a group may have a better tax position under existing code provisions than that afforded by the bill's tax abatement provisions. Initial seed money granted to a newly certified NCDC is to equal the amount paid for share subscriptions at the time of certification.[53] Even in the largest communities of 300,000, if ten percent of the community subscribes, the NCDC will only receive $150,000 — most of which will be required to pay organizational and administrative expenses previously incurred.

The turnkey program provides tax benefits to industry for building facilities and turning them over to NCDC's. Any firm which enters into a contractual relationship with an NCDC to build a turnkey facility benefits from:

1. A ten percent tax credit for wages and salaries of shareholder employees in turnkey facilities.
2. A tax credit equal to 15% of profits generated by the turnkey facility for five years after its sale.
3. Rapid amortization of turnkey facilities.
4. Exemption from recapture of investment tax credit for machinery and equipment in turnkey facilities.
5. Non-recognition of capital gains on sale of turnkey facility to the CDC if proceeds are reinvested in a new turnkey facility or in Class B stock of a community development bank.
6. Exemption from recapture of depreciation if the proceeds are reinvested in a new turnkey facility.[54]

By themselves, turnkey programs beg important social and economic questions; they can only work where a community vehicle capable of entering the turnkey partnership exists. Only the first two tax benefits depend on the continued success of the turnkey operaton, so that

52 Sec. 116(c).
53 Sec. 140(b).
54 Secs. 404-409.

a contractor who preferred to avoid arduous continued dealings with local groups could take a quick profit while leaving the community with no long-range economic potential.[55] Furthermore, reliance on such programs assumes that the desirable strategy will be construction of plant whereas in many instances the correct approach to the market is renting space while making expenditures for soft-ware such as advertising or a sales force.

The bill's major attraction for a community development organization is the amendment to Title IV of the Economic Opportunity Act of 1964 providing Small Business Administration grants to NCDC's for identification and development of new business opportunities, market surveys and feasibility studies, organizational planning and research, plant or facility design layout and operation, marketing and promotional assistance, and business counselling.[56] Such grants to an NCDC would allow it to pay a technical staff which would be responsive to its requirements. And the funds might provide an opportunity to train the NCDC's own staff in business skills. The NCDC might for example commission a marketing firm to do a study and hire a community nominee to supervise it.

### 3. A Preliminary Conclusion

It is by no means clear that the federal government has any role to play in coordinating the diverse approaches to ghetto institution-building being undertaken across the land. If, however, it is determined that federal assistance is dependent on the existence of a certified local group, it is nevertheless possible to achieve greater flexibility than is afforded by the Community Self-Determination Act. One way of doing so would be to abandon the concept of one CDC per community in favor of a pluralist model which relies much more on institutions tailored to meet local needs. An NCCCB would still have to certify any organization before it could become entitled to the benefits of being a National CDC. Any ghetto corporation could submit to the board a type of simplified prospectus on the basis of which it would sell shares at five dollars or more to the community, and specially streamlined federal conditions would offer the CDC an alternative to meeting its state's blue sky laws.

55 Note, *Community Development Corporations: A New Approach to the Poverty Problem*, 82 HARV. L. REV. 663 (1969).

56 Sec. 503.

If broadly-based community ownership were deemed important, the number of shareholders the prospective CDC would have to obtain could be different for every metropolitan area — a percentage of the total population of those areas having a low "development index." Perhaps only a schedule for ownership distribution over time should be required. Any group which obtained the requisite number of shareholders could qualify for certification if it were "controlled" by people in underdeveloped areas. Control could be defined so as to permit flexibility in financing. The CDC could organize as a for-profit or not-for-profit corporation, and the government would make seed money grants on the basis of $20 to 1 with safeguards in the case of for-profit enterprises to prevent profiteering by a few. The CDC could have as many classes of shares as seemed desireable. There would be no constraints on its internal organization. There might be five CDC's based in one community all of which were marketing products throughout the city. One might pay dividends, another would not.

There would be no federal presence in the ghetto since private sector auditing and bonding facilities would be relied on. The issuing group would be guaranteed its CDC status for two years with the right during certification to be given special priority in federal poverty programs. After two years the group would have to resolicit the purchase of shares and would continue to qualify as a CDC if:

a. the subscription drive resulted in the sales of securities to a number of persons equal to a given percentage of those who purchased prior to initial certification,
b. control was still retained by people in areas with a given "development index."

After the resolicitation, a CDC would continue to qualify as long as it retained a certain percentage of its second year shareholders and met the community control criteria.[57]

Whatever the government may do to encourage the development of community capitalism, decisions on what kind of ghetto institutions will develop and what directions they will follow will ultimately be made at the grass roots level. A decision by Washington in favor

57 Despite its thorough procedural safeguards, the Community Self Determination Act as presently written does not provide any criteria for determining when a CDC has failed, so that a group could continue to qualify for the benefits of NCDC status although its impact on the community was negligible or negative.

of one organizational form could only produce a series of attempted transplants which do not take root locally. While it seems premature to be putting forth a national model for ghetto development, federal legislation could doubtless affect the possibilities for ghetto economic growth by changing the legal environment.

## II. PRESENT LEGAL CONTEXT

A prerequisite to determination of what legislation might facilitate the progress of the kinds of community development entities discussed above is a consideration of possibilites and constraints under present law. Many of the possibilities have never been tested, since the advent of an entity interested both in business and in social welfare is recent —a fact reflected in the traditional dichotomy between "poverty lawyers" and "business lawyers". The following discussion will investigate the impact of tax, corporate, and securities law on both non-profit and business corporations doing community development.

### A. *Not-For-Profit Community Development Corporations (CDC's): Tax aspects*

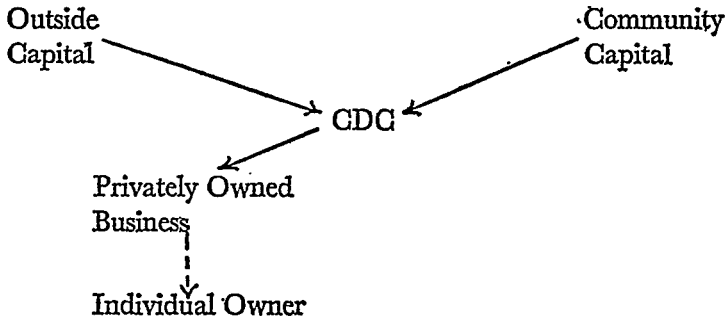
To illustrate the possibilities for flexibility in attaining corporate purposes through the non-profit form, three types of CDC will be discussed against the background of the tax code. A "type I CDC" generates privately-owned enterprises through grants, loans and financial counselling. None of the income of the individually owned businesses is returned to the CDC. A "type II CDC" generates business enterprises in which it retains the ownership interest. The income earned by the business it funds is returned to the CDC for further social and economic development. A "type III CDC" generates businesses in which it retains part of the ownership interest. Part of the business income returns to the CDC for economic and social development, and part returns to community investors.

#### 1. "Type I CDC"

Let us first assume that a community based group is interested only in generating enterprises privately owned by community people through the provision of grants, loans, and financial counselling. The input would come from contributions by civic minded individuals within and without the community while the only take-out would be by

owners of the privately run businesses. None of the income generated would be ploughed back into the CDC for community development.

FIGURE 1: *CDC Type I — Generating Privately Owned Enterprises*




This type of CDC is the easiest to fit into the charitable exemption provisions of the code. The definition of "charitable" includes *inter alia:*

1. Relief of the poor and distressed or of the underprivileged.
2. Lessening of the burdens of government.
3. Promotion of social welfare by organizations designed.
   a. to lessen neighborhood tensions
   b. to eliminate prejudice and discrimination
   c. to combat community deterioration and juvenile delinquency.[58]

Contributions to section 501(c)3 "charitable" organizations are deductible up to a certain percent of the contributor's adjusted gross income,[59] and income from activities substantially related to the corporation's exempt purpose is not taxed.[60] Such organizations may not engage in political activities,[61] nor may any part of their net earnings inure "to the benefit of any private stockholder or individual."[62] Read literally, this latter limitation might be held to preclude exemption for a CDC which benefitted some individual ghetto residents, but the statutory proscription has usually been taken to forbid only indirect

58 Treas. Reg. Sec. 1.501 (c) (3) -1 (d) (2) (1959).
59 INT. REV. CODE OF 1954, § 170 (c) (2) and § 170 (b).
60 *But see,* discussion of provisions taxing unrelated income (Sec. 502, 511-513), text accompanying notes , *infra.*
61 *See,* Treas. Reg. Sec. 1.501 (c) (3) -1 (c) (3) (iii) (1959).
62 Treas. Reg. Sec. 1.501 (c) (3) -1 (c) (2) (1959).

benefits to member-contributors[63] and direct dividends to them on amounts contributed.

Although charitable organizations traditionally tax-exempt ministered to the immediate needs of the individual, there is no *statutory* reason for denying tax exemption to organizations aimed at lending an individual enough to start a business. It has never been a pre-requisite to exemption that the recipient of the benefits be totally impoverished.[64] Moreover, while the Congress has been concerned with the danger of unfair competition to existing businesses through the use of the charitable exemption, it dealt with the problem in 1950 by taxing unrelated business income of charitable exempt organizations[65] in a way not intended to affect the original question of eligibility for exempt status.[66] Of course, if the organization were to lend money to entities which would otherwise have sought and obtained conventional financing, exemption could be denied, not on some unfair competition theory, but rather because the organization's primary purpose would not be charitable — i.e. its funds would be used to duplicate a function adequately fulfilled by private enterprise.[67]

While there have been no cases or public rulings holding tax-exempt a business development CDC of the kind under discussion, there is a line of cases and rulings exempting organizations which attempt to place disadvantaged people in jobs through counselling and individual financial assistance.[68] And CDC's which offer more extensive financial aid in order to encourage business development have recently succeeded in obtaining exemption through private rulings.

A June, 1968 ruling, for example, granted exemption under section 501(c)3 to the Boston Urban Foundation, a trust organized to solicit public and private contributions which are to be distributed by loan

63 *E.g.*, Spokane Motorcycle Club 222 F. Supp. 151 E.D. Wash. (1963) holding that refreshments, goods, and services furnished to members of charitable nonprofit corporations from business enterprise net profits, constituted benefits inuring to individual members, and therefore corporation was not tax exempt.

64 Scofield v. Rio Farms, Inc. 205 F.2d 68, (5th Cir. 1953).

65 INT. REV. CODE OF 1954, §§ 511-13.

66 *Sen. Rep. No.* 2375, 81st Cong., 2nd Sess. 29 (1950).

67 *See, e.g.*, Veteran's Foundation v. U.S. 178 F. Supp. 234 (D.C. Utah 1959) aff'd. 281 F.2d 912.

68 *E.g.*, Rev. Rul. 67-150, 1967-1 CUM. BULL. 133, superseding IT 2088, III-2 CUM. BULL. 220 (1924). An organization dedicated to rehabilitation of convicted criminals obtained all its funding from contributions. It gave counselling and financial assistance, helped to secure employment, disseminated information. *Also* Rev. Rul. 56-304.

or grant to individuals and corporations to start new businesses in economically depressed areas of Boston. The exemption letter permits grants and loans to needy individuals who are unable to obtain needed funds through any conventional source, but it specifically reserves the question of whether grants or loans to firms, corporations, financial institutions and other entities are permissible.[69]

In January 1969, a similar New York group known as "Coalition Venture Corporation" obtained a slightly more liberal private ruling which permits the organization to aid corporations as well as individuals. The ruling is ambiguous on the question of whether grants as well as loans are to be permitted.[70] In any case only individuals or corporations unable to obtain funds through conventional financing may be considered.

How valuable are these section 501(c)3 exemptions to a CDC interested in ghetto economic development? To date almost all recipients of such rulings have been associations of concerned businessmen. Thus a major difficulty is that such rulings encourage a selection of "qualified negroes" by white outsiders who distribute funds raised and controlled by them. This dramatic manifestation of outside power operating directly on individuals may have the effect of fragmenting the community and weakening internal attempts by a grass roots CDC to organize. Of course where strong community organizations already exist, the intervention might be met with such resistance that some way of working through the local organizations will be found. A Boston group known as FUND which obtained a ruling similar to that of the Boston Urban Foundation discussed above, confronts the problem by turning over the bulk of the money it raises to the United Front, a coalition of most significant Roxbury community organizations.[71] Also there is no apparent reason why a community based

69 I.R.S. exemption letter to Boston Urban Foundation, June 24, 1968.

70 The letter seems to assume throughout that loans and not grants are to be employed. For example if "a business that you financially assist cease(s) to be compatible with your purposes in that it will primarily serve some private interest, you will withdraw your financial assistance either by exercising a buy-out privilege or by arranging for refinancing." But elsewhere the letter explicitly allows: "You will make your loans and grants available to all qualified individuals on a non-discriminatory basis."

71 While the Boston ruling provides that "The screening of applicants will be conducted *under the direction* of your organization," the New York letter requires that "The screening of applicants and the determination of the recipients of loans will be conducted *by* your Board of Directors." (Emphasis added.)

group could not itself qualify for section 501(c)3 exemption.[72]

A problem with the Boston rulings is their limitation to needy individuals. Admittedly, the ability to get its supporters started in business could enhance the strength of a community organization, but many black groups are interested in projects, which are on a much larger scale than the individual proprietorship, and which offer opportunity for broad scale community participation. The adverse effect of the "needy individual" restriction can be mitigated somewhat by the individual's incorporation after receipt of the grant.[73] In any case, the limitation seems to be absent from the more recent rulings.

To be sure, a section 501(c)3 exemption could be quite valuable to a community-based CDC which had access to funding through contributions. Though almost any community organization will be highly political, it should not be too difficult to avoid running afoul of the prohibition against exemption for "action" organizations.[74] Funding for political campaigns and the like could be handled through a separate organization, and community organizers when acting politically would do so in their private capacity.[75] Nevertheless community groups dedicated to economic independence would by definition seek to end reliance on outside contributors as soon as practicable.

### 2. "Type II CDC"

While funding of privately owned businesses does offer some hope of eventual economic independence, it is evident that the developmental process would be greatly speeded if profits from CDC-funded businesses were available for community purposes. One way to insure the return of profits would be for the CDC to own the businesses it funds either as subsidiaries or as integral parts of one multipurpose corporation. Such a CDC might look like this:

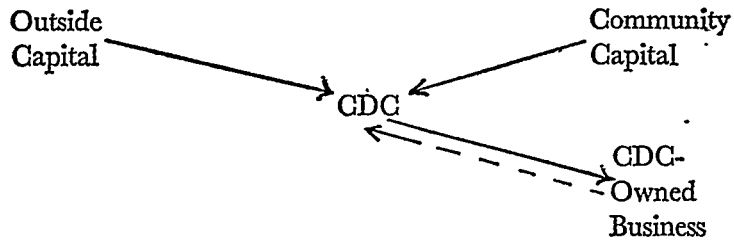
72 Detroit's Inner City Business Improvement (ICBIF), although not engaged in grass roots community organizing is an all black group which possesses a § 501(c)3 exemption. The United Front itself has submitted an exemption application.

73 Telephone interview with Ralph Hoagland, a founder of FUND.

74 Treas. Reg. § 1.501(c)(3)-1(c)(3).

75 The exemption in § 501(c)4 for "civic" organizations places even fewer restrictions on political activity but has not been discussed here because contributions to a civic organization are not deductible (Sec. 170).

FIGURE 2: *Type II—Ploughing back "unrelated" income*




This type of CDC has great advantages over the previously discussed form. Not only is a greater degree of independence built in, but also, community owned projects offer opportunities for stimulating community pride and mobilizing community support for incipient economic ventures

a.) *The § 501(c)(3) Exemption*

The probable tax treatment of the "type II CDC" can be discussed only after a closer examination of the statutory environment. Prior to 1950, many organizations were involved in income-generating business activities unrelated to their exempt purpose. A series of cases in which the IRS attempted to challenge this practice had held that the determinitive test of the availability of the exemption was the destination of the income, and not its source.[76] In 1950, however, responding to well publicized abuses, Congress enacted amendments to the code which aim at taxation of "unrelated business income". (The present secs. 511-514.)

The amendments impose a normal tax and surtax on the gross income of any unrelated trade or business regularly carried on by the exempt organization. And the trade or business is deemed unrelated if it is

> not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis of its exemption under sec. 501. . . .[77]

76 *See, e.g.*, Trinidand v. Sagrada Orden, 263 U.S. 578 (1924).
77 INT. REV. CODE of 1954, § 513.

But in no case is a trade or business to be deemed unrelated where substantially all the work in carrying on the trade or business is performed for the organization without compensation, where certain types of organizations carry on business primarily for the convenience of their members, or where an organization sells merchandise substantially all of which has been received as gifts or contributions.[78] Even where the income is from an "unrelated trade or business", it is not seen as "unrelated business taxable income", and therefore not subject to tax if it is "passive" income from dividends, interest, annuities, royalties, certain rents from real property (including personal property leased with real property) or gains from the sale of capital assets.[79]

The 1950 amendments also foreclosed the possibility of channelling business profits to charities through the device of "feeder" subsidiaries. Thus, an organization operated for the primary purpose of carrying on a trade or business for profit is not itself exempt under section 501 on the ground that all its profits are payable to a section 501 exempt organization. For a CDC which is interested in economic rehabilitation of a community, these sections dealing with unrelated business income and feeder organizations are of particular importance.

b.) *The § 501(c)(4) exemption*

An alternative for a Type II CDC is the possibility of exemption under 501(c)4 of the code as a "civic" organization. Although a (c)4 exemption would probably be available for a Type I CDC,[80] the exemption would be of little value to it since contributions to an exempt civic organization are not deductible under sec. 170. Here, however, the CDC hopes to plough back income, and the unrelated business income provisions do not apply to (c)4 organizations. Thus, it might be argued that a Type II CDC has a trade-off between deductibility of contributions with taxation of unrelated income under 501(c)3 or non-deductibility of contributions and exemption of unrelated income under 501(c)4. Unfortunately, there is no reason to believe that a CDC could so easily escape taxation of business income by choosing the second alternative, since the IRS would be able to argue: first, that the CDC is *both* a (c)3 and a (c)4 organization and thus subject

78 *Id.*

79 *Id.*, § 512(b). *See*, U.S. v. Myra Foundation, 382 F.2d 107 (8th Cir. 1967), holding that these terms are to be defined by state law.

80 Rev. Rul. 67-294, 1967-2 CUM. BULL. 193.

to sec. 511-514, or second, that the CDC loses its exemption because it is organized for profit and not *exclusively* for the 501(c)4 exempt purposes of promotitng social welfare and the like. The latter argument is particularly strong since the failure of Congress to include (c)4 organizations within the business income provisions might suggest that unrelated business income is more noxious to a 501(c)4 exemption than to the 501(c)3 status. It will therefore be assumed in the discussion below that risks to a CDC engaging in reinvestment of business profits are at least as great under 501(c)4 as under 501(c)3.

If it is an exempt purpose to create job opportunities and upward mobility in the ghetto through the funding of black businesses (as in the case of a Type I CDC) a Type I CDC converting to Type II CDC activities might argue that businesses owned and operated by the CDC are not unrelated to its exempt purposes — that is, that there is a substantial causal relationship between the *conduct* of these businesses and the purpose of ghetto rehabilitation through business building.[81] The regulations contemplate that

> An organization may meet the requirements of section 501 (c) 3 although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business as defined in section 513.[82]

And although the regulations practically leave it to the case law to decide the meaning of "unrelated" they do provide that where an organization is engaged in a program of rehabilitation of handicapped persons, income from sale of articles made by such persons as part of their rehabilitation training and sold in the state of manufacture will not be gross income from the conduct of unrelated trade or business.[83] By analogy, the argument would run, a Type II CDC is conducting businesses for the purpose of training the hard core unemployed, and the consequent opportunities for dramatic upward mobility, creation of success models for youth and stimulation of com-

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81 Treas. Reg. Sec. 1.513-1 (d) (2) (1967).
82 Treas. Reg. Sec. 1.501 (c) (3) -1 (e) (1959).
83 Treas. Reg. Sec. 1.513-1 (d) (4) -Example (3) (ii) (1967).

munity morale all further the exempt purpose; indeed one of the CDC's exempt purposes is getting businesses started.

The legislative history of the unrelated business income provisions does not foreclose this line of argument;[84] and the IRS has been consistently beaten when it has attempted to argue that a business operated like a commercial enterprise is *ipso facto* "unrelated."[85] For a type II CDC with access to legal help this argument is one worth making.

Nevertheless, cases and rulings to date are not particularly helpful to a Type II CDC which would argue that its business income is not unrelated. An organization which sponsored sports events was held to be exempt under both (c)3 and (c)4 and not to have any unrelated business income where it was chartered as a non-profit, where children

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84 According to Sen. Rept. No. 2375:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of section 101 organizations enables them to use their profits tax free to expand operations, while their competitors can expand only with profits remaining after taxes. Also, a number of examples have arisen where these organizations have in effect used their tax exemptions to buy an ordinary business. That is, they have acquired the business with little or no investment on their own part and paid for it out of installments — a procedure which usually could not have been followed if the business were taxable. SEN. REPT. No. 2375, 81st Cong., 2nd Sess. 28 (1950).

But some income for tax exempt entities and therefore some competition was obviously contemplated where income was generated by a business related to the exempt purpose. For example, as Sen. George of Georgia, Chairman of the Committee on Finance was explaining the 1950 amendments proposed by the House, he engaged in the following dialogue:

> Mr. Butler: . . . Sec. 422 levies regular corporation taxes on unrelated activities of Section 101 exempt institutions. In that regard, would the distinguished chairman say that a tax-exempt organization which has built a new building that cost $100,000 and is advertising daily inviting the general public to patronize its dining rooms, bars, and overnight room accommodations, is subject to the tax?
>
> Mr. George: Whether or not it is a related activity is the question on which its taxability would turn. If it is a related activity — but I am not certain in the case stated by the distinguished Senator from Nebraska that it is related — that after all is the determining question. If it is an unrelated activity of course it does fall within the taxable class. 96 CONG. REC. 13273-75, 81st Cong., 2nd Sess. (1950).

85 Note: *The Macaroni Monopoly: The Developing Concept of Unrelated Business Involvement of Exempt Organizations*, 81 HARV. L. REV. 1280 (1968).

got into events at reduced rates, and where there had been operating losses for several years.[86] And similar good luck smiled on a business league's income from trade shows.[87] A charitable organization fared worse where income from the operation of orchards and farms by its employees was held to be from an enterprise not related to the charitable purpose.[88]

As the above small sample of cases indicates, whether income is taxable as "unrelated" has been decided on an *ad hoc* basis. While the area is thus ripe for a test case, it would be difficult to limit the issue to taxation of a CDC's unrelated business income. Rather the IRS would be likely to attack head-on by arguing that the CDC itself is not tax exempt because it is not operated "exclusively for" exempt purposes. The practice has been for the IRS to take a wholistic approach, interpreting the "exclusively for" language in sections 501(c)3 and 501(c)4 as limiting the *amount* of business activity as opposed to the purposes for which income may be used.[89] This IRS practice is reflected in the fact that during the first year the sections operated, only $37 of unrelated business income was collected, and through 1965, the annual amount never exceeded $2000.[90] Even if the benefit of tax free income from its economic activity were not available to a Type II CDC exempt under section 501(c)3, the (c)3 exemption would still be valuable since the CDC would continue to qualify for tax deductible contributions under section 170 and tax free sales of its capital assets.[91] But if there is a substantial danger of losing exempt status altogether, a given CDC might be well advised to limit profit generating activities to wholly separate entities — that is to fall back to the simpler Type I CDC.

c.) *Creation of "for-profit" subsidiaries*

It might be thought that a CDC could limit the danger of a head-on attack by spinning off for-profit activities to subsidiaries, since then

86 Mobile Arts and Sports Assn. v. U.S. 148 F.Supp. 311 (D.C. Ala. 1957).

87 *Orange County Builders Assn.* v. *U.S.* F.Supp. (D.C. Cal. 1965), held that the trade shows operated by a professional producer of trade shows who turned over a percentage of the profit to the organization were directly and substantially related to the organization's exempt purpose.

88 Rev. Rul. 58-482, 1958-2 CUM. BULL. 273.

89 Note: *Preventing the Operation of Un-taxed Business by Tax Exempt Organizations,* 32 U. CHI. L. R. 581 (1965).

90 G. D. Welsten, *Effect of Business Activities on Exempt Organizations,* 43 TAXES 77 (1965).

91 INT. REV. CODE of 1954, § 512(b) (5).

each sub would be attacked separately as a feeder organization having a "primary purpose of carrying on a trade or business." Because the test of "primary purpose" turns on whether the sub's activity is one which would be "unrelated" if carried on by the parent,[92] a Type I CDC could convert to Type II and raise the narrow issue of relation without risking its exemption. But the IRS has insisted that the extent of unrelated activity is some evidence of exempt purpose whether carried on by the parent or a subsidiary, and the legislative history indicates an intention that tax results should be the same whether activity is conducted by a parent or a sub.

What those results should be is a matter of some discussion. A senate report on the 1950 amendments stated that the tax imposed on unrelated income was not intended to have any effect on the tax exempt status of the organizations. Present exemptions were to be preserved, and any reasons for denying exemption prior to enactment of the amendments would continue to justify denial after passage.[93] While Congress did not consider the unrelated income provisions the exclusive weapons for attacking an exempt organization engaging in business, it eschewed the intention of adding new weapons to the IRS arsenal. Nevertheless, since 1950 the courts have frequently revoked an organization's exempt status where there was substantial unrelated income.[94]

In *Scripture Press Foundation v. U.S.*,[95] the court denied exemption to a printing foundation originally established by two persons interested in religious education in order to improve the quality of religious teaching materials. Although the foundation engaged in door to door evangelism, as well as free instructional work, without promoting sales, the court was unimpressed:

> We think that plaintiff's assertion that its instructional activities are more important to plaintiff than its selling activities is entirely sincere. . . . However, the intensity of religious convictions of the plaintiff's members and officers can not operate to exempt them from the tax law if the activities of the plaintiff can not in themselves justify such an exemption. Piety is no defense of the assessments of the tax collector.[96]

92 Treas. Reg. Sec. 1.502-1 (b) (1958).
93 SEN. REPT. No. 2375, 81st Cong. 2nd Sess., 29 (1950).
94 *See, supra* note 89.
95 285 F.2d 800 (1961).
96 *Id.* at 804.

That said, the court then compared how much plaintiff accumulated with how much it expended for instructional activities and, finding the latter amount "unaccountably small", asked:

> Can it be said of the plaintiff's competitively priced lesson material that financial gain was not the end to which its sale was directed? Can the impressive earnings which the sale of the lesson materials has brought the plaintiff be said to be incidental to the plaintiff's primary work?[97]

The court reasoned that competitive pricing leading to profits is some evidence of "commercial character". It then inferred that if profits from commercial activity become large enough, exempt activity is no longer the organization's primary purpose so that exempt status must be denied. While the court explicitly rejected a suggestion that large profits dictate the conclusion that an organization is *ipso facto* noncharitable, it did seem to maintain that profits mean *some part* of an organization's activities are noncharitable and that the only remaining problem is to weigh the profit-generating activity against the exempt activity to determine which is the primary purpose. With due respect, the code, regulations, and legislative history suggest that profit-making activity may indeed be related to an exempt purpose, and it is difficult to see how the amount of profit can bear on the issue of exempt purpose if that profit is generated by a "related" business.

In *Peoples Educational Camp Society Inc. v. CIR*,[98] exemption was likewise denied on the grounds that excessive profit-making negated exempt purpose. But the court gave more attention to the question of whether the income-generating activity was related to the exempt purpose. The main activity of the plaintiff socialist organization was running a resort camp. It also ran a library, published the *New Leader*, and sponsored lectures. The only issue was whether petitioner's operations were exclusively of a social welfare nature. While the court conceded that the non-camp activities served to promote the exempt purposes, lectures, plays, and art exhibits at the camp were said not to involve social welfare at all:

> They were simply part and parcel of (the camp's) operation as a commercial resort and were necessary features of a luxury vacation spot catering to a young adult intellectual clientele.[99]

97 *Id.*
98 331 F.2d 923 (1964), *affirming* 39 T.C. 756, *cert. den.* 379 U.S. 839.
99 *Id.* at 931.

The camp's "cultural activities" were not sufficient to justify the conclusion that the camp was operated for exempt purposes given the court's finding that they were no more beneficial to the community as a whole than the golfing, swimming, and dancing activities. It appears that the Society was in no position to press the argument that the camp was a business related to its exempt purpose. Neither this case nor *Scripture Press*, however, forecloses the possibility that a Type I CDC could undertake Type II activities and still win on the issue of relation of business income to exempt purpose. In *Scripture Press* the issue of relation was not reached, and a CDC would have a much stronger case for the relationship of its Type II activities than had the socialist camp. The New York "CDC" discussed above would have to show, for example, that its businesses were substantially related to an exempt purpose "of promoting social welfare by combatting community deterioration and lessoning neighborhood tensions in impoverished communities of metropolitan New York."[100]

Both cases threaten improperly that a Type II CDC, even if it is contemporaneously involved in Type I and traditional social welfare activities, will lose its tax exempt status if it does fail to win the relational issue. In *Peoples Educational Camp*, for example, after admitting that the word "exclusively" in the statute has been interpreted to mean "primarily", the court cited a case from the period before the 1950 amendments for the proposition that a single non-exempt purpose, if substantial, will destroy the exemption, regardless of the number or importance of truly exempt purposes.[101] Not only is the proposition irreconcilable with any accepted meaning of the word "primarily", but the case cited for the proposition was dealing with exemption from tax under the Social Security Act. The source of the organization's income was there not in question, but only its destination. Prior to 1950, however, the *source* of income was not considered to bear on the issue of purpose. And since the Congressional intent was to create no changes in pre-1950 criteria for exemption, there can be no foundation for assuming that if an exempt organization runs an "unrelated" business, its purpose is *pro tanto* non-exempt. The existence of "unrelated business income" however large is no evidence on the issue of exempt purpose.

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100 Coalition Venture Corp., exemption letter, *supra* note 70.
101 Better Business Bureau v. U.S., 326 U.S. 279 (1945).

Even if a "source" test is imposed on a Type II CDC, and even if it is found that all the CDC's businesses are "unrelated", the CDC might still argue that its primary purpose continues to be the exempt one of ghetto economic rehabilitation. It is conceivable that a business may not be able to meet the statutory test on relation and yet be complementary to an exempt purpose — as where a religious educational organization runs a printing company (but not a shoe factory). Conversely, a "related" business may be such that it is some evidence of a non-exempt purpose — as where a group is organized to promote love of sports and engages in the business of sponsoring sports events so that a founder may have an expanded market for his popcorn company.

d.) *Sale and leaseback*

Because the two cases criticized above substitute a "source test" for the traditional "destination test" of exemption, they could cause a Type II CDC to lose its tax exempt status. But there is a way of reducing the risk substantially if a CDC is willing to make certain minor adjustments to organizational form. The key to success lies in the fact that section 512 excepts from the definition of "unrelated business taxable income" all interest, and all "rents from real property (including personal property leased with the real property)."

A CDC wishing to take advantage of these exceptions could buy a business and then lease its tangible assets for five years to a new corporation formed by community people or by the present operators. The new corporation would pay eighty to ninety percent of its net profits to the CDC as tax deductible rent and the CDC would pay the sellers eighty to ninety percent of amounts received from the new corporation. Sellers could elect the installment method and pay capital gains tax on the portion of each payment representing profit.[102] At the end of the period, the new corporation might exercise an option to purchase. At all phases, the original owner could take back the business on default. There would be no risk to the CDC, and the sellers would be able to get a higher price than the normal fair market value since the CDC's exemption would allow it to project a tax free income stream.

If the CDC wished to retain ownership after five years, it could

102 W. G. O'Neil, *Sales of businesses to charities—The Brown case and its aftermath*, 43 TAXES 508 (1960).

avoid granting a purchase option and instead grant a new lease. Obviously, control would be much less certain than if the CDC owned all the lessee business's stock — a luxury it could not afford if it wanted to avoid the "source test" problem. A shorter than five year lease might make it difficult to find a seller and, if tantamount to "control", might be sufficient to revive the "source" test of exemption. A longer than five year lease would subject the CDC to the business lease tax of section 514. In most instances, however, it would seem possible to build in all the *de facto* control desired through pre-selection of directors, private assurances, and the like.

As might be imagined, the IRS looks askance on this type of "trading on the charitable exemption".[103] Presumably the practice will come under review during the present discussion of tax exempt foundations. In the meantime, the IRS has essayed various attacks on the matter and has been defeated on all fronts. The commissioner's argument that capital gains treatment for the seller should be disallowed was defeated in the leading case of *Clay Brown*.[104] In *Emmanuel N. (Manny) Kolkey*,[105] where the commissioner did succeed in denying the capital gains treatment, the sales price was almost four times the fair market value; the transaction was collapsed; and the business was retrieved by the former owner within one year after the purported sale.

When the commissioner attempted to contend that rental payments should not be deductible by the new operating company he was uniformly defeated.[106] In one rare IRS vitcory, *Royal Farms Dairy Co.*,[107] the court held that to the extent amounts denominated "rents" exceeded a fair rate of rental, such amounts were not required to be paid as a condition to continued occupancy and hence were not deductible. Normally the reasonableness of the rents would not be an issue, but because of a specific finding of fact that there was no negotiation — arms length or otherwise — on the lease, the court reached the

103 Rev. Rul. 54-420, 1954-2 CUM. BULL. 128.

104 37 T.C. 461 (1961), *aff'd.* 380 U.S. 563 (1965).

105 27 T.C. 37 (1956), *aff'd.* 254 F.2d 51 (1958).

106 *See* Union Bank v. U.S., 285 F.2d 126 (Ct. Cl. 1961); Estate of Hawley, 20 T.C.M. 210 (1961); Isis Windows, 22 T.C.M. 837 [government's appeal dismissed pursuant to stipulation (9th Circ. 1965)] (1963); Oscar C. Stahl, 22 T.C.M. 966 (1963), *cert. den.*, 379 U.S. 836; and discussion in K. C. Eliasberg, *What is behind the current IRS attacks on subsidiaries of exempt organizations?*, 26 J. TAX. 236 (1967).

107 40 T.C. 172 (1963).

question of reasonableness. A CDC could avoid the *Royal Farms* result by bargaining on lease terms with the new company. In any event it would be difficult for a court to find a percentage rent unreasonably high where a history of fluctuating earnings introduced a risk element.

The commissioner has been handed his most recent defeat in *University Hill Foundation v. Commr.*,[108] where he attacked the status of a 501(c)3 organization which had engaged in numerous purchase and lease-back transactions as part of its efforts to raise funds for Loyola University of Los Angeles. Reviewing the legislative history, the court emphasized the twin Congressional objectives of avoiding unfair competition and undue impairment of fund raising. It noted that Congress had been concerned with purchase lease-back operations by charities at least as early as 1950; that attempts to deal legislatively with the problem in ways other than withdrawing exempt status had been proposed but had never reached fruition. Additionally the court noted that prior to the 1950 amendments petitioner would have been exempt under the destination of income rule. The court then found section 502 tax of "feeder" organizations inapplicable since the foundation was not carrying on a trade or business, rental of real property including personal property leased with real property being excluded from the section 502 definition of trade or business. The foundation had no control abnormal to the status of lessor. A similar analysis was applied to the exception of rents from the unrelated business income provisions. Five judges filed strong dissents in which they argued that the continued activity of acquiring and leasing so many businesses was itself "carrying on a trade or business" within the meaning of sec. 502, despite the specific exception for rent therein. They would have limited the exception to a more normal renting of real property with incidental personal property.

### 3. Type III CDC

While it is possible that legislative reform may eliminate the opportunity for purchase and lease-back transactions, this should not obscure the fact that what present tax law permits is in reality a third type of exempt CDC.

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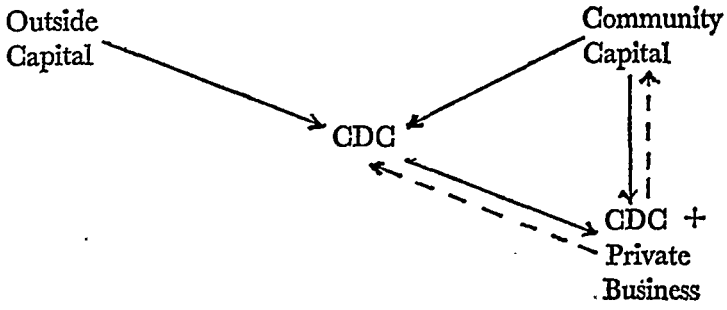
108 51 T.C. No. 54 Ch. Tax. Ct. Dec. 29, 407 (1969).

FIGURE 3: *Type III CDC*




The Type III CDC not only makes it possible to plough back funds for reinvestment but also permits the use of financial return as an incentive to community investment. Substantially the same result which the purchase lease-back transaction makes possible might be obtained, with less *de jure* CDC control, through reliance on the exception of "interest" from the sec. 512 definition of "unrelated business taxable income". A business which borrowed from a Type III CDC could deduct interest costs under I.R.C. sec. 163; and it is likely that a high ratio of debt to equity could be sustained against a "thin incorporation" attack by the commissioner.

Since *Gooding Amusement*,[109] courts determining the availability of the interest deduction to a corporate taxpayer have considered controlling the intention of the parties creating the obligation as evidenced by surrounding circumstances. Valid business reasons and the absence of pro rata holding of debt and equity have been taken to justify a ratio of approximately seven hundred to one.[110] In the case of ghetto businesses, with equity money particularly difficult to obtain, there is a strong argument that valid business reasons exist for a "high" debt-equity ratio. The Small Business Administration itself recognizes this reality, to an extent, when it provides debt of seven times equity for minority businesses. The gravamen of equity is participation in the growth of a business; an attack by the commissioner would thus be particularly weak where the CDC held no common stock and received a fixed return on debt.

109 236 F.2d 159 (6th Cir. 1956), *cert. den.* 352 U.S. 1031.

110 Baker Commodities, 48 T.C. 374 (1967). See also Rowan v. U.S., 219 F.2d 51 (1955), Leach Corp. v. Commr., 30 T.C. 563 (1958).

### B. *Other Aspects of Non-profit CDC's: Corporate and Securities Problems*

Whatever path is followed by a CDC interested in business development, the provisions of state corporation statutes dealing with non-profit corporations will not generally be constraining. For corporate purposes, "non-profit corporations" traditionally means a corporation no part of the income or profit of which is distributable to its members, directors or officers.[111] Profit is contemplated for corporate purposes; only its use is restricted. The Model Non-Profit Corporation Act provides that corporations may be organized for any lawful purposes including *inter alia* educational, civic and charitable.[112] Stock may not be issued, nor any dividends paid,[113] but in none of the CDC types herein discussed would it be necessary for the CDC to pay dividends. If a CDC desired to rely on financial return as incentive to participation, the Model Act would seem to leave open the payment of dividends by a CDC affiliate to the affiliate's shareholders, as long as the CDC itself offered no return for contributions.[114] Within the general powers of a non-profit under the Model Act are the powers

> to lend money for its corporate purposes, invest and reinvest its funds, and take and hold real and personal property as security for the payment of funds so loaned or invested.[115]

Constraints may vary from state to state, but the flexibility provided by the Model Act is not unusual.[116]

Neither the 1933 Securities Act nor the Uniform Securities Act would regulate the "sale" of a right to vote in the parent CDC in return for contributions made.[117] A mere right to vote, without participation in profits or right to distribution upon liquidation would

111 Model Non-Profit Corporation Act, ALI-ABA Sec. 2(c). Since a fifty state analysis is beyond the scope of this paper, the Model Act will be used as a basis for discussing state law. The laws of Wisconsin, Ohio, Ala., N. Carolina, Virginia, Illinois, Minn., and Mo., approximate the Model Act. In California, Delaware, Georgia, Kentucky, Mich., Miss., Okla., Vermont, and W. Virginia there is one statute for profit and non-profit corporations. New York and Pennsylvania require court approval of a non-profit charter. L. Haller, *The Model Non-Profit Corporation Act*, 9 BAY. L. R. 319 (1957).

112 MNPCA Sec. 4.

113 MNPCA Sec. 26.

114 R. S. Lesher, *Non-Profit Corporation: Neglected Stepchild Comes of Age*, 22 BUS. LAW. 951 (1967).

115 MNPCA Sec. 5(i).

116 Some state non-profit corporation statutes do not deal with the power to engage in income-generating activity, but define "purpose" quite broadly. *See, e.g.* MASS. GEN. LAWS, ch. 180, § 2 (1955).

117 Although state blue sky laws vary greatly, the Uniform Securities Act will be used to focus discussion.

probably not fall within either act's broad definition of "security".[118] But in any case, both acts exempt securities "issued by a person organized and operated not for private profit but exclusively for religious, educational, benevolent, charitable" or other named purposes of similar nature.[119] The exemption would be broad enough to cover securities issued by a CDC in a related business affiliate if the word "exclusively" were seen as meaning "primarily" as it does for tax purposes. But a major purpose of securities regulation is to protect the unsophisticated investor, and there is every reason to assume that federal and state agencies would interpret "exclusively" to mean "solely".[120]

Potentially the most serious legal constraint both for the related business affiliate of an exempt CDC and for a for-profit corporation interested in community development are the federal and state securities regulation laws.

Unless a corporation were prepared to rely on the capital of a few sophisticated investors, the substantial costs of SEC registration could become the price of broadly based community ownership. The SEC has the power to exempt an issue offered to the public at $300,000 or less,[121] but even the Regulation A offering authorized under this power involves a rather complicated filing and may entail expenses of $5,000 or more. For a new ghetto business, the prospect of Federal regulation and the difficulty of providing the information required may prove a serious impediment to beginning operations.[122]

118 *See,* Uniform Securities Act, Sec. 401 (1); Securities Act of 1933 Sec. 2 (1), 15 U.S.C. § 77b (1) (1964).

119 Uniform Securities Act, Sec. 402 (a) 9; *see also,* Securities Act of 1933, Sec. 3 (a) (4), 15 U.S.C. § 77c (a) (4) (1964).

120 Interview with Prof. Louis Loss, Harvard Law School, Mar. 18, 1969.

121 Securities Act of 1933, Sec. 3 (b), 15 U.S.C. § 77c (b) (1964).

122 According to William Jackson, general counsel to Fairchild Hiller Corporation which was starting a manufacturing operation in cooperation with "Fairmicco" a ghetto organization: "Securities laws will hit anyone getting involved in this kind of thing. We initially went to the SEC on behalf of Fairmicco asking for exemption from the 1933 Securities Act to market shares to the public. It is possible to get such an exemption but not probable. They said they would take this and all other similar requests and formulate a general rule—a rule which would cover exemptions in situations similar to Fairmicco's. They did not get to that but did come out with a proposed rule under the Small Business Act for local development corporations. Informally they told us that the best thing to do was to file under Regulation A. They would not cut corners but would bear in mind the unusual purpose of the business. The SEC has been excellent to deal with. They have gone out of their way to be helpful." Telephone interview with Mr. Jackson, April 14, 1969.

If a corporation did not wish to meet the Regulation A filing requirements, it might choose to rely on the exemption in section 3(a)11 of the Act for

> any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such a State or Territory.[123]

The intrastate exemption, however, is a shaky one on which to rely. A single offer to a non-resident destroys the exemption for the entire issue, as does a secondary sale by an investor before completion of the ultimate distribution.[124] Particularly troublesome in cities bordering on other states[125] would be the requirement that a purchaser be a resident. Although criminal suit by the Commission is not a serious danger here,[126] a class action for recission and damages under section 12(1) of the Act poses a substantial risk.[127]

A final possibility for a community business seeking to avoid federal securities problems is to eschew the use of jurisdictional means — that is to avoid using either the mails or any instrument of interstate commerce in making the distribution. This method of avoiding federal securities regulation is impractical for normal business operations since both direct and indirect use of the jurisditional means brings a corporation within the Act. When shareholders pay by mail or by check for example the Act would apply.[128] A community organization, however, might drum up interest door to door or at public meetings and only make sales in person for cash at its community office. Subsequent use of the mails or telephone for corporation business should not subject the issue to the Act.[129] In any event, only a person who purchases a security sold by the jurisdictional means can recover under section 12 of the Act. And as a practical matter it would be difficult for the SEC to make a case under Section 17 which provides for criminal sanctions.

All of the possibilities for avoiding regulation present difficulties; and one might have suspected that the SEC would be drafting more

123 15 U.S.C. § 77c(a) (11) (1964).
124 L. Loss, SECURITIES REGULATION 592 (1961).
125 *Id.*
126 *Id.* at 603.
127 *Id.* at 605.
128 *Id.* at 1524-1528.
129 *Id.* at 1525.

simplified procedures to deal with ghetto based businesses. Indeed a proposed Rule 237 which has not been promulgated would have waived the full requirements of Regulation A for companies qualified as Local Development Corporations under section 502 of the Small Business Act if certain conditions were met. The problems of qualifying under section 502 are beyond the scope of this paper. Indications are that the commission is not contemplating any specially flexible regulation for ghetto based business and that the main route for them is seen as Regulation A, discussed above.[130]

Even if a business resolves its federal securities difficulties, it will have to deal with state blue sky law administrators. On the state level, however, there are "all kind of conditions you can impose that will provide some kind of public protection without preventing an enterprise from going forward."[131] A fidelity bond could be required, a limit of no more than $20 worth of shares per person might be imposed if that were consistent with a group's planned financing, and initial amounts received might be placed in escrow until a certain

130 Telephone interview with Courtney Whitney, Jr., Chief Counsel, Corporation Finance Division, SEC (Apr. 10, 1069).

While no moves have yet been made to resolve the tension between the disclosure requirements of the 1933 Act and the need to facilitate ghetto economic development, a recent release under the 1935 Public Utility Holding Company Act reveals that pressure to make concessions to urban realities is being felt. In the Matter of Michigan Consolidated Gas Company, Michigan Consolidated Homes Corporation (Holding Company Act Release No. 16331) a public utility subsidiary of a registered holding company sought SEC permission to provide financing for a moderate and low income housing project in the Detroit inner city. Despite the act's purpose of creating single integrated utilities systems and despite cases and rulings requiring an extremely close functional relation between the utility system and non-utility business, two commission members found sufficient relation to grant the application:

> "There is no need to give this 1935 statute an inflexible, static historical reading. Companies subject to it are now presented with the Congressionally recognized urban problems of the 1960's 1970's that could not have been contemplated by the original enacters. The desireability of private capital becoming involved in the rebuilding of our cities is widely recognized and urged, and the posture today of the utility industry is substantially changed . . . Equally relevant, there has been evolving since the 1930's a broader notion of corporate responsibility to the community." (Footnotes by the commission omitted.)

One commissioner concurred on grounds of finding an exemption from the relationship requirements for home construction companies. The fourth commissioner dissented. (There is presently one vacant seat.)

131 Telephone interview with Stanley Ragle, Securities Administration, Public Service Commission, Washington, D.C., Apr. 9, 1969.

minimum amount was obtained.[132] Not all states will be flexible in their approach to community businesses however, and since the SEC has done little to ease the problem, the question of how government can allow a business to go to its community for capital without depriving investors of protection should be a major target for legislative reform.

### *C. For-profit "Community Benefit Corporations*

In the discussion of exempt organizations it was assumed that if a CDC's business income were tax exempt, community development would be greatly speeded. The assumption is correct if the net profits of a corporation over time and its accumulated surplus are viewed as rough measurements of the entity's power to generate additional job-creating structures, management opportunities, and welfare services for residents. Of course it may be true that ability to undertake community devolopment projects will depend on factors unrelated to after-tax profits. Thus a for-profit corporation which owns a supermarket with $2 million of annual sales may be in a better position to establish a community shopping center than an exempt CDC — even though the latter entity has a positive annual cash flow from several purchase and lease-back arrangements, while the for-profit corporation's sales money goes to debt service, upkeep, and wages. Where, as in the example, the key to success would be obtaining commitments to lease, the for-profit corporation's proven administrative ability would be a more relevant consideration than the CDC's accumulated surplus.

Even if both entities were equally capable of undertaking the shopping center, and if after-tax profits were considered a major measure of success, the examples illustrate that ownership of a given project by the non-profit entity is not always the best path. Due to depreciation of plant, the for-profit corporation might realize as great a cash flow from the shopping center as the CDC could by "selling" the tax losses. In many normal business situations requiring investment in depreciable assets, the for-profit corporation can thus approximate, if only for a while, the results of a tax exempt CDC.

The ability to approximate exempt status through the use of deductions is more questionable, however, when it comes to social welfare

132 *Id.*

expenditures. The section 170 charitable deduction would be of little help to the for-profit enterprise with significant taxable income because it is limited to five percent of adjusted gross income.[133] A more hopeful possibility is the section 162 deduction for ordinary and necessary business expenses.[134] Here corporate law becomes the first relevant consideration; before a corporation can argue that its social welfare expenditures are ordinary and necessary business expenses, it must have the power to make the expenditures. Corporation statutes will not generally bar such expenditures. For example, the Model Business Corporation Act (MBCA) defines "corporation" as "a corporation for profit subject to the provisions of this act . . ."[135] Since corporations may be organized under the Act "for any lawful purpose",[136] a corporation may be organized for profit and yet have other lawful purposes such as improving community environment. One is entitled to assume, in other words, that a corporation may be "for-profit" and have some purposes other than short-run profit maximization. The assumption is strengthened by section 4 of the Act which gives a corporation the power to make donations for the public welfare or for charitable, scientific, or educational purposes.[137] *A fortiori*, a business-motivated social welfare expenditure which will arguably be of financial benefit to the corporation — one which would raise the educational standard of the labor pool, generate community good will, or improve the workers' morale — is not *ultra vires* the corporation.

133 There is some doubt, in any case, about the freedom of a corporation to make a charitable contribution. In some states, a ceiling is placed on corporation contributions to charity without legislative approval. (Mass. Ann. Laws U. 155, Sec. 122, N.J. Rev. Stat. Sec. 14:3-13). ICBIF, the black community development entity noted at footnote 13 supra requires many of the businesses it funds to contribute to a separate fund for community development. Presumably the percentage limitation on charitable contributions apply but below that ceiling ICBIF can approximate the *tax* advantages of a Type III CDC.

134 According to Regs. § 1.162-15, no deduction is allowed to a corporation under section 162 for a gift or contribution if any part of it is deductible under sec. 170. But the limitation may not apply where the business receives some consideration from the sec. 170 organization — or where it contributes money to an organization not described in sec. 170 with a reasonable expectation of financial return. In the following discussion it will be assumed that all expenditures for social welfare are made by the for-profit corporation itself.

135 MBCA Sec. 2 (a).

136 MBCA Sec. 3.

137 Many state corporation statutes like that of Delaware lend themselves to similar anlysis. All but a few states have statutory provisions authorizing donations. Ruder, *Public Obligations of Private Corporation*, 114 U. PA. L. REV. 209 (1965).

And if the relevant state corporation law makes business-motivated social welfare expenditures a legitimate corporate activity, the danger of losing a shareholder's derivative action because of such outlays could be diminished by indications in the articles of incorporation that such expenditures are contemplated. Such a provision would reduce the conflict between corporate (profit maximizing) and non-corporate (public welfare) goals which might otherwise form the basis for a shareholder attack on a director's loyalty. Even absent such a charter provision, it is likely that welfare expenditures reasonably related to long-term corporate benefits could be defended against an attack by shareholders charging waste of corporate assets.[138] Such expenditures, if related to a corporation's general size, its net annual earnings, its capital, and its place in the community, should be within the "business judgment rule" which has insulated directors in past shareholder derivitive actions.[139]

Whether a given expenditure would be of sufficient benefit to the corporation to qualify for deduction under section 162 is a more difficult question. The strongest case for deductibility is where expenditures are solely for the benefit of a corporation's employees. Amounts paid by a taxpayer as compensation for injuries of employees are deductible as ordinary and necessary business expenses.[140] And amounts for

> dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expenses, recreation, welfare, or similar benefit plans, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business.[141]

Ordinarily such expenses are deductible if the business of the tax payer is thereby benefited by reduced labor turnover or increased efficiency of personnel, but there must be a causal connection between the payments, the effect on the employees, and the benefits to be derived therefrom in connection with the business.[142]

The courts have been lenient in deferring to employer estimates of

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138 *Id.* at 218-219, 221-224.
139 *Id.* at 219.
140 Treas. Reg. Sec. 1.162-10 (1958).
141 *Id.*
142 J. MERTONS, JR., 4A LAW OF FEDERAL INCOME TAXATION, § 25.119 (rev. 1966).

benefit to the business,[143] but each case will be decided on its facts. Some "welfare" activities such as job training would always be of obvious benefit to the business and should be recognized as ordinary and necessary for a business in slum communities; for other activities the question may turn on the relationship of the employees who benefit to the particular business. To take one example, a corporate day-care center would have the strongest claim to be considered an ordinary and necessary business expense where the corporation employed mainly women in low-income brackets. Where the employees were primarily male, the expenditure would have to be justified on grounds of the more remote benefit of morale or less employee turnover. But the tax court has been willing to see expenditures calculated to improve employee morale as ordinary and necessary business expenditures where the IRS challenged an employer's attempted deductions for employee dances, picnics, and in one case an employee recreation lodge.[144] The latter case is most apposite here since it involved a continuing benefit to employees.[145] And the service itself has determined that an amount contributed by an employer to an exempt association of its employees for the construction of a new hospital building title which was to be in the association was deductible as an ordinary and necessary business expense.[146]

If a given expenditure is deductible to the corporation it may nevertheless be includible as income to the employee. The code explicitly excludes from gross income certain expenditures for employee health[147]

143 *See, e.g.*, W. M. Ritter Lumber Co. 30 B.T.A. 231, Supp. opinion 33 B.T.A. 117, holding deductible expenditures for the purpose of welfare work and employees at mill and camp sites. Money was turned over to employee committees for needy employees. *Also* Champion Spark Plug Co. 30 T.C. 298 (1958) *aff'd.* 266 F.2d 347 (6th Cir. 1959), holding deductible payment to employee to alleviate financial suffering resulting from fatal illness.

144 Employee dances: Popular Dry Goods Co. 6 B.T.A. 78 (1927).
Employee picnic: H. H. Bowman, 16 B.T.A. 1157 (1929).
Employee recreation lodge: Slaymaker Lock Co., 18 T.C. 1001 (1952) *rev'd. on other grounds sub nom.* Sachs v. Comm. 208 F.2d 313 (3rd Cir. 1953).

145 Whether an expenditure is an ordinary and necessary expense deductible under Section 162 or a capital expenditure which must be depreciated or amortized turns on traditional distinctions which will not be discussed here. But it seems likely that the depreciation or amortization deduction would have to meet the same standard of relation to financial return as would the section 162 deduction. Of course, it may be more "ordinary" in a given case for a corporation to rent a facility than to construct the facility itself.

146 Rev. Rul. 160, 1953-2 CUM. BULL. 114.

147 INT. REV. CODE of 1954, §§ 104-106.

and meals or lodging furnished for the employer's convenience.[148] But includibility of the value of services such as job training, education, day-care and recreation programs presumably presents traditional (IRC section 61) "gross income" considerations. In theory, compensation paid other than in cash is includible in gross income,[149] but the threshold question is: what services are to be considered "compensation". And the line between non-taxable conditions of employment designed primarily to benefit the employer and taxable compensation primarily benefitting the employee is a hazy one.[150] As a practical matter, the administrative problems of taxing individual employees on welfare benefits received have proven a barrier to taxation in the past.[151] But as corporations begin to spend large proportions of income on deductible welfare type services, the IRS can be expected to feel pressure to seek includability.

Any argument by the Service that certain welfare expenditures are income to employees could be greatly weakened if the benefits were made available to the entire community. It would then be evident that they were being offered not as compensation but to promote the long-range interests of the corporation in the community, and an attempt to enforce includibility as to employees would surely stumble on administrative difficulties. (Where a large proportion of the community consisted of a corporation's shareholders, the Service could theoretically argue that a proportionate amount of the expenditure was a corporate dividend.) To be sure, the commissioner might argue that the benefits were too remote, but depending on the nature of the expenditure, the taxpayer may have a good case for deductibility.[152] Entertainment or recreation expenditures are closest to the types of expenses for advertising traditionally deductible. In fact, "expenses for goods, services, and facilities made available to the general public" are excepted from the special showing of relation to trade or business

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148 *Id.* § 119.

149 Treas. Reg. Sec. 1.61-2(d) (1957), T.D. 6416, 1959-2 CUM. BULL. 131 (1959), T.D. 68881966-2 CUM. BULL. 23.

150 H. MACAULEY, FRINGE BENEFITS AND THEIR FEDERAL TAX TREATMENT 29 (1959).

151 J. H. Guttentag *et. al., Federal Income Taxation of Fringe Benefits: A Specific Proposal,* 6 NAT. TAX J. 251 (1953).

152 It would not always be necessary to capitalize such expenditures—*e.g.*, where the corporation was engaged in continuous annual outlays for social services. *See,* Godfray v. C.I.R. 335 F.2d 82 (6th Cir. 1964).

imposed by the code on deductions for a recreation facility or activity.[153] And the regulations approve of advertising to promote civic causes.[154]

Whether an expenditure can be considered a business expense will turn on whether it was made primarily for business or social purposes, and it will be "ordinary and necessary" if a hard-headed businessman would have incurred the expense under like circumstances.[155] Obviously the two considerations are not unrelated, and the dichotomy between business and social purposes begins to break down for businesses in a ghetto community. The implicit threat of violence hanging over even a community organization which gains a reputation for exploitation might be urged as justification for a number of community welfare and recreation programs. Deductibility of community job training and education expenditures is especially easy to justify if the Service agrees that the decision to hire local labor is within the purview of the corporation's business judgement.

## III. Conclusion

Whether an organization goes the profit or non-profit route, both tax and corporate law afford significant opportunity for adaptation to ghetto business needs. The main bottleneck is securities regulation, state and national, which makes mobilization of community capital for a common venture a problem of expensive and time-consuming negotiation. It may be that poor people, as well as rich need the protection of securities laws; a series of well-publicized failures might spell the end of community capitalism. On the other hand, securities regulation cannot guarantee business success, and the effect of private

153 Int. Rev. Code of 1954, § 274.

154 Treas. Reg. § 1.162-15 (c) (i) (1958), T.D. 6435, 1960-1 Cum. Bull. 79 (1960).

155 First National Bank of Omaha v. U.S., 276 F.Supp. 905 (D.C. Neb. 1967), holding that a bank had met the burden of proof in showing that parties and dinners for customers were ordinary and necessary business expenses. The 1930 case, *American Rolling Mill Co.* v. *Commr.*, 41 F.2d 314 (6th Cir. 1930), held deductible as an ordinary and necessary business expense $360,000 contributed by a corporation to various civic groups. The case is weakened as precedent here by the fact that under the 1918 Revenue Act corporations were not entitled to deduct contributions to charity. The court's language nevertheless does support deductions for community corporations under certain circumstances: "The question always is whether balancing the outlay against the benefits reasonably expected, the business interest of the taxpayer will be advanced. The answer must depend among other things upon the nature and size of the industry, its location, the number of its employees and what other employers similarly situated are doing." *Id.* at 315.

offering exemptions in existing statutes is to make access to capital more difficult for one who does not have a few wealthy acquaintances. Certainly special streamlined procedures could achieve a balance between conflicting objectives more responsive to the exigencies of contemporary urban problems.

This article's discussion of flexibilities under existing business law and its criticism of the community Self-Determination Act should not be taken as rejection of that Act's basically progressive approach. On the contrary, as the Act recognizes, many problems can be alleviated by government financial aids to ghetto economic development organizations. There is progress in recognition of the fact that organizations which are ghetto based and controlled offer greater hope for social change than past efforts to aid or rehabilitate individuals. There does, however, exist a wide variety of ghetto development organizations and a potentially flexible body of law. The abandonment of organizational variation should not be made the cost of government assistance.