IRS Proposed Regulations Add New Examples for Private Foundation Program-Related Investments

The Internal Revenue Service (IRS) has recently released proposed regulations that provide guidance to private foundations engaging in program-related investments (PRIs).[1] The proposed regulations do not change the substantive rules and regulations or replace the existing examples, but add nine new examples that illustrate investments that qualify as PRIs. The new examples are based on prior guidance issued by the IRS.

This Advisory provides an overview of program-related investments and the proposed regulations. It also provides additional information about how foundations and other grantmakers may use mission related investments—including investments in social enterprises, such as L3Cs, benefit corporations, flexible purpose corporations, and B Corporations—to move beyond grantmaking.

Overview of program-related investments

Program-related investments (or PRIs), defined in Section 4944 of the Internal Revenue Code, are investments designed to further a private foundation's exempt purposes. In general, an investment qualifies as a PRI if the investment is made primarily to accomplish one or more charitable purposes and no significant purpose of the investment is the production of income or the appreciation of property.

PRIs provide foundations an opportunity to combine their skills in grantmaking and investments. Foundations have been making PRIs in some form since at least the 1960s. PRIs may be made in both for-profits (or non-501(c)(3) organizations), as well as 501(c)(3) organizations. Common examples of PRIs include below-market rate loans or loan guarantees to minority-owned small businesses in deteriorating urban areas. PRIs can also be made in the form of equity investments.

There are a number of advantages for private foundations to structuring an investment as a PRI. PRIs count toward a private foundation's minimum payout requirement, are excluded from a foundation's asset base used to calculate the minimum payout amount, and are excluded from the excess business holdings rule, which generally limits a private foundation

1 REG-144267-11 (April 19, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-04-19/pdf/2012-9468.pdf.

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from holding more than a 20 percent interest in a business enterprise. PRIs made to non-501(c)(3) organizations remain subject to the expenditure responsibility rules, requiring, in general, a written commitment from the recipient that the funds will be used only for purposes of the program-related investment.

It should be noted that PRIs are not limited to private foundations. Other tax-exempt organizations, such as public charity grantmakers, may use PRIs. In that case, public charities should be familiar with how private foundations structure PRIs and, in general, follow the published IRS guidance on PRIs, even though public charities will not be subject to the specific private foundation restrictions.

Apart from the legal considerations, PRIs also provide several programmatic advantages for foundations and other grantmakers, including allowing a foundation to recover its investment and recycle its assets for future grants, increase the pool of eligible recipients who can receive funding from a foundation, and build a grantee's credit history by structuring a grant as a PRI.[2]

The current regulations for program-related investments, including ten examples, were developed and published by the IRS in the early 1970s. Although the examples are illustrative of the types of PRIs undertaken at the time, the IRS has published numerous private letter rulings since then that describe PRIs that are not reflected in the current examples. As a result, the foundation community has been urging the IRS to update the examples to encompass current programmatic and financial practices reflected in PRIs.[3]

2 *See* also James P. Joseph, "Program-Related Investments and You – Perfect Together?", Taxation of Exempts (March/April 2011), *available at* http://www.arnoldporter.com/resources/documents/Arnold&PorterLLP_TaxationofExempts_Joseph_March-April10.pdf; James P. Joseph and Andras Kosaras, "New Strategies for Leveraging Foundation Assets", Taxation of Exempts (July/August 2008), *available at* http://www.arnoldporter.com/resources/documents/TaxationOfExempts_Article_Jul-Aug08_2.pdf.

3 *See, for example,* American Bar Association, Section on Taxation, Comments on Proposed Additional Examples on Program-Related Investments (March 3, 2010), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/Comments_Concerning_Proposed_Additional_Examples_on_Program_Related_Investments.authcheckdam.pdf.

Proposed regulations

The new examples in the proposed regulations are based on PRIs described in previously published IRS guidance and private letter rulings. None of the examples describes an investment that does not qualify as a PRI. They illustrate the following principles:

(a) The charitable purposes of PRIs are not limited to serving economically disadvantaged individuals and deteriorating urban areas, but include, among others, promoting the arts, advancing science, combating environmental deterioration, assisting in disaster recovery, and supporting other 501(c) organizations (e.g., 501(c)(4) social welfare organizations and 501(k) child care services);

(b) PRIs may be used to fund charitable activities in foreign countries;

(c) A potentially high rate of return does not, by itself, disqualify an investment from qualifying as a PRI;

(d) A loan, in conjunction with an equity position, may qualify as a PRI; and

(e) The provision of credit enhancement, through linked bank deposits or guarantees, may qualify as a PRI.

The examples in the proposed regulations are effective when the final regulations are published and finalized, but taxpayers may rely on the proposed regulations until they are finalized.

Submitting comments to the IRS regarding the proposed regulations

Taxpayers may submit comments to the IRS regarding the proposed regulations until July 18, 2012. Although the IRS expressly states in the proposed regulations that the examples in the proposed regulations do not modify the existing regulations, some foundations may wish to provide comments to the IRS regarding the examples.

A close reading of the examples may raise questions and concerns for foundations engaging in PRIs. Some issues are highlighted below as examples:

How to structure equity investments in a business enterprise? For example, Example 11 describes a private foundation that makes an equity investment in a drug manufacturer to induce the manufacturer to develop a low-cost vaccine for poor people in developing countries. The example indicates that the equity investment is made in a subsidiary that the manufacturer established to research and develop the vaccine. The example does not indicate whether using such a subsidiary is a key factor in holding that the investment qualifies as a PRI.

When to exit from an equity investment? In another example, Example 13, a private foundation makes a loan, in conjunction with an equity investment, in a new business enterprise in a developing country that collects recyclable solid waste materials and delivers those materials to a recycling center that is inaccessible to a majority of the country's population. The example provides that the foundation plans to liquidate its stock in the business as soon as the business is profitable or it is established that the business will never become profitable. This example highlights the need for any foundation that undertakes a PRI to plan its exit strategy before making the investment. But the example also raises questions about how the IRS will determine whether a business is "profitable" and how soon thereafter must a foundation pull out of a PRI. (Example 12 provides the same facts as Example 13, except without the additional loan.)

The other examples may also be of interest to foundations and grantmakers. As mentioned above, all of the examples describe situations in which the investment qualifies as a PRI. A brief description of each example is as follows:

- Example 14 describes a business enterprise located in a rural area of a state that employs a large number of poor individuals. A natural disaster causes damage to the equipment and buildings of the business enterprise and the business is unable to obtain commercial financing to rebuild its facilities. A private foundation steps in to provide a below-market rate loan to the business.
- In Example 15, in the wake of a natural disaster that causes significant damage to the infrastructure of a developing country, a private foundation makes a below-market rate loan to two poor individuals, who are unable to secure conventional sources of financing, to enable each of them start a small business.
- Example 16 describes a situation in which a private foundation makes a below-market rate loan in a limited liability company (LLC) (treated as a partnership for federal income tax purposes) where the LLC is required to use the proceeds from the loan to provide training to poor farmers in a developing country about advanced agricultural methods. The LLC would not provide the training absent the loan from the foundation.
- In Example 17, a private foundation provides a below-market rate loan to a section 501(c)(4) social welfare organization that promotes the arts by, among other things, conducting weekly community art exhibits, to provide financing for the purchase of an exhibition space within the community. The organization is unable to obtain conventional financing that it considers economically feasible for the purchase of the exhibition space.
- In Example 18, a section 501(k) tax-exempt child care organization providing services in a low-income neighborhood desires to build a new facility in the community to meet the demand for its services, but is unable to obtain conventional financing because it lacks sufficient credit. Pursuant to a deposit guarantee, a private foundation deposits funds in a commercial bank sufficient to build the new facility. The bank lends the identical amount to the organization to build the facility. If the organization defaults on the loan, the bank may deduct an amount equal to the amount of default from the foundation's deposit. The funds are invested in instruments that allow the bank to access them readily and the foundation earns a below-market rate of return on the deposit.

- Example 19 provides the same facts as Example 18, except that the private foundation enters into a guarantee agreement with the bank that requires the foundation to repay any amount remaining on the loan if the organization defaults. In addition, the child care organization and the foundation enter into a reimbursement agreement that requires the organization to reimburse the foundation for any amount the foundation pays to the bank under the guarantee agreement.

Beyond PRIs: Mission related investments and social enterprise

Increasingly over the past several years, grantmakers (private foundations and other tax-exempt grantmaking organizations) have been asking how they can use more of their assets to support their charitable missions. Grantmakers are increasingly asking how they can achieve the most impact, rather than just limiting their grants to 501(c)(3) organizations. Historically, private foundations have relied on program-related investments as a way to further their charitable purposes beyond grantmaking. More recently, grantmakers are relying on the full spectrum of "mission related investments" (MRIs) (or impact investments) to advance their charitable missions. Mission related investments, unlike program-related investments, are not defined in law, but rather refer to different types of investment strategies that further a grantmaker's mission. For example, MRIs may include market-rate investments in for-profit entities that further a grantmaker's exempt purposes and are part of a grantmaker's investment portfolio, subject to prudent investment standards. Many commentators also use MRIs as an umbrella term that includes PRIs.

Recently, grantmakers have also faced more options in the types of social enterprise legal entities in which they can make PRIs and MRIs. The first type of social enterprise entity established was the low-profit limited liability company (L3C). The L3C is a corporate entity authorized under state statutes that expressly incorporates the federal tax requirements for an investment to qualify as a PRI. A number of states have legally recognized L3Cs (Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont, Wyoming, and two Indian tribal nations). The goal of an L3C is to serve as a vehicle that will make it easier (if not automatic) for a foundation's investment to qualify as a PRI. To date, however, the IRS has not provided any guidance that suggests that a private foundation's investment in an L3C would qualify automatically as a PRI.[4]

Following on the heels of L3Cs, some states have passed statutes recognizing other types of social enterprise entities, including "benefit corporations" and "flexible purpose corporations." A number of states have passed legislation authorizing benefit corporations (California, Hawaii Maryland, New Jersey, New York, Vermont, and Virginia), while only California has legally recognized flexible purpose corporations.

A key difference between a benefit corporation and a flexible purpose corporation is the ability to incorporate social and other considerations into the organization's purposes. A benefit corporation must be formed for a general public benefit, which is defined by the model benefit corporation statute as a "material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation." A flexible purpose corporation, like a benefit corporation, may also take into account considerations that are not purely profit maximizing, but flexible corporations must specifically define those alternative purposes in their organizing documents and may only consider those designated alternate purposes.[5]

The primary legal consideration for creating these new social enterprise entities arises from the concern that the fiduciary duties of care and loyalty (including the business

4 Additional information about L3Cs is available from the Americans for Community Development, *available at* http://www.americansforcommunitydevelopment.org/index.php.

5 Additional information about benefit corporations is *available at* http://benefitcorp.net/. The flexible purpose benefit legislation was enacted in California by the Corporate Flexibility Act of 2011 (Senate Bill No. 201), *available here*: http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0201-0250/sb_201_bill_20111009_chaptered.pdf.

judgment rule) do not afford sufficient legal protection to directors and officers who wish to take additional factors into consideration, other than just maximizing profits for shareholders, when making business decisions. These additional factors can include social justice, environmental, community and societal impact. The other key reason for the creation of these new entities is branding. Branding and marketing businesses as social enterprise entities may give entrepreneurs an edge in the fierce competition for investment capital and customers.[6]

The importance of branding is clear for certified B corporations (B Corps). A B Corporation may be any type of business enterprise (for-profit or tax-exempt) that has been certified by B Lab, a section 501(c)(3) organization, that it meets certain social and accountability standards that include consideration of the interests of employees, consumers, the community, and the environment. According to B Lab, there are over 500 certified B Corps across 60 different industries.[7]

Because the entities described above are relatively new, grantmakers should conduct an appropriate level of due diligence when making investments in these entities and determine whether an investment is appropriate and complies with prudent investment standards. For purposes of making PRIs to social enterprises described above, foundations must comply with the same requirements that apply when a foundation makes a PRI to any other for-profit entity. Finally, grantmakers should develop internal policies that guide them in complying with legal requirements and help them in making prudent and effective investment and program-related investment decisions.

6 Tax-exempt organizations, such as section 501(c)(3) public charities, are also considering using benefit corporations when establishing subsidiaries.

7 Additional information about B Lab is *available at* http://www.bcorporation.net/.

We hope you have found this Advisory useful. If you would like more information or assistance in addressing the issues raised in this Advisory, please feel free to contact:

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