

MEMORANDUM

February 10, 1999

TO: Nonprofit Forum Colleagues
FROM: Rochelle Korman
RE: Our Meeting on Thursday evening, February 18

Enclosed for your reading pleasure is a draft of an article on PRIs that my partner Robin Krause and I are writing. At this point, the article is descriptive; attempting not only to make the PRI regs accessible but to demonstrate the flexibility and breadth of their application. In that regard, I would also be grateful for some thinking and feedback on the following hypothetical which Robin and I are considering weaving into the piece:

"FOUNDATION X has a PRI program directed towards community economic development in demonstrably low-income communities of a foreign country. Part of the program is to encourage businesses (typically closely-held) to construct and operate factories, plants, hotels, restaurants, etc. in these areas. X thinks that it will be very beneficial if Company Y builds a factory in township Q. To induce Y to do so, Y would need financing as well as equity investors. Because of the weak economy in the community, conventional financing is not available and venture capital is too expensive. X does not want to "simply" provide below-market financing, but also wants to have an equity position.

a) Is it permissible for X to actively locate other investors and induce them to invest by stating that X is willing to take an equity position where the risk/reward ratio is unsatisfactory from a typical investor standpoint, but X will help negotiate/arrange an investment that will appeal to them. Have we crossed some line vis-a-vis private benefit?

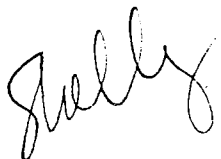
b) What if there are already several possible conventional investors, but X thinks this is a terrific PRI from the community development standpoint. Should X offer to invest at an economically disadvantageous position in order to treat the investment as a PRI, recognizing that by doing so, X can be viewed as acting to shift some possible profits to the other investors.

c) What if Y really needs only one investor, and X is willing to be that investor. How does X demonstrate that its investment is driven by charitable motives rather than appreciation? Does Y need to first actively try to secure venture capital? Can X or Y find another investor who will be offered a sweeter deal in order to demonstrate that Y's deal is a "charitable" one and a qualifying PRI?

PRI? d) Does an equity kicker affect the characterization of an investment as a

I look forward to seeing all of you next Thursday.

Regards.

 R.K.

DEMYSTIFYING PROGRAM-RELATED INVESTMENTS

Rochelle Korman, Esq.
Robin Krause, Esq.

INTRODUCTION¹

Section 4944(c) of the Internal Revenue Code² authorizes private foundations to make program-related investments³ -- a hybrid between investment and traditional grantmaking program activities. PRIs can take many forms and provide private foundations with a means of developing innovative approaches to financing charitable projects. In many circumstances, PRIs enable private foundations to make more efficient use of their assets to accomplish their charitable goals.

CONTEXT AND HISTORICAL DEVELOPMENT
OF PROGRAM-RELATED INVESTMENTS

The Internal Revenue Service ("IRS") long has accepted investment activities of exempt organizations related to their exempt programs as charitable activities. During the 1960s, the IRS issued several rulings in which it held that certain investment-type activities conducted by exempt organizations constituted "charitable" activities. For example, in one ruling, the IRS

¹ The authors wish to acknowledge the indispensable assistance of Jacqueline Sherman, an associate at Patterson, Belknap, Webb & Tyler LLP, in the preparation of this article.

² Throughout this article, all references to "Section" or "Code" are to the Internal Revenue Code of 1986, as amended. This article refers to numerous private letter rulings issued by the IRS. Although private letter rulings and similar determination letters apply only to the organizations that requested them and may not be cited as precedent, they provide useful insight into the IRS's approach to issues. See I.R.C. § 6110(j).

³ Throughout this article, program-related investments are referred to as "PRI" or "PRIs."

granted tax-exempt status under Section 501(c)(3) of the Code to an organization that was formed to promote racial integration in housing and planned to make loans at the prevailing rate of interest and to lease or resell other residential real estate in furtherance of its purposes.⁴

Section 504(a)(3) of the Internal Revenue Code of 1954 limited the investment activities of foundations by prohibiting them from investing their accumulated income in a manner that would jeopardize the carrying out of their exempt purposes. The penalty for violation of former Code Section 504(a)(3) was loss of tax exemption. Neither the Internal Revenue Code of 1954, nor preceding versions of the Internal Revenue Code contained comparable limitations on the investment of other foundation assets. In the Tax Reform Act of 1969, Congress replaced the then-existing Code Section 504(a)(3) with Section 4944, which prohibits investment of any assets of a private foundation -- income or principal -- in a manner that would jeopardize the carrying out of the exempt activities of the organization. Section 4944 imposes excise taxes on the private foundation and any foundation managers responsible for undertaking a specific jeopardizing investment.

Section 4944 itself does not define "jeopardizing investment." However, under the Treasury Regulations, an investment constitutes a jeopardizing investment when, based on the facts and circumstances prevailing at the time the investment is made, it is determined that the foundation manager(s) responsible for the decision with respect to the investment failed to "exercise ordinary business care and prudence . . . in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes."⁵ Factors to be considered

⁴ See Rev. Rul. 68-655, 1968-2 C.B. 213.

⁵ Treas. Reg. § 53.4944-1(a)(2)(i).

include the need for diversification, the expected return, and the risk of rising and falling price levels. Thus, in a private letter ruling issued in 1993, the IRS held that 100% ownership by a foundation of the stock of an inn located in a historic community constituted a jeopardy investment.⁶ In contrast, in a ruling issued in 1997, the IRS approved the proposed investment of a portion of the assets of a foundation in several alternative investment vehicles, including funds that were investing in high-technology partnerships and leveraged acquisitions. The IRS noted that the amount of foundation assets invested in each of the proposed investments was modest and that the foundation would not invest more than 30% of its total assets in the investments.⁷

Section 4944(c) expressly excludes PRIs from the category of jeopardizing investments. The Code defines a PRI as an investment "the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property."⁸

There is relatively little legislative history regarding Section 4944(c). The Senate Report on the provision contained the following example of forms PRIs might take: "low-interest or interest-free loans to needy students, high-risk investments in low-income housing, and loans to small businesses where commercial sources of funds are unavailable."⁹ The Senate Report also appeared to acknowledge that Congress was not creating a new class of charitable activities, but simply was making it clear that charitable activities involving investments or investment-like

⁶ See PLR 9340002 (June 16, 1993).

⁷ See PLR 9723045 (March 12, 1997).

⁸ I.R.C. § 4944(c).

⁹ Sen. Rpt. No. 91-552, 91st Cong. 1st Sess. 45-46 (1969), 1969-3 C.B. 453, 454.

activities would not be considered jeopardizing investments.¹⁰

THE STATUTORY AND REGULATORY CRITERIA FOR PROGRAM-RELATED INVESTMENTS

An investment must satisfy three criteria set forth in the Treasury Regulations under Section 4944 in order to qualify as a PRI. First, the primary purpose of the investment must be to accomplish one or more purposes described in Section 170(c)(2)(B) (i.e., religious, charitable, scientific, literary or educational purposes or the prevention of cruelty to children or animals.)¹¹ Second, no significant purpose of the investment may be the production of income or the appreciation of property.¹² Finally, a private foundation may not make a PRI where any purpose of the investment is to accomplish one or more of the purposes described in Section 170(c)(2)(D): carrying on propaganda or otherwise attempting to influence legislation or participating in or intervening in any political campaign.¹³ Each criterion is described in greater detail below.

Criterion 1: The Primary Purpose of the Investment is Charitable

The Regulations set forth the general rule as follows: "[a]n investment shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation's exempt

¹⁰ Id.

¹¹ Treas. Reg. § 53.4944-3(a)(1)(i).

¹² Treas. Reg. § 53.4944-3(a)(1)(ii).

¹³ Treas Reg. § 53.4944-3(a)(1)(iii).

activities and if the investment would not have been made *but for* such relationship between the investment and the accomplishment of the foundation's exempt activities."¹⁴ [emphasis supplied]

An investment made "primarily to accomplish one or more of the purposes described in section 170(c)(2)(B)" includes investments for charitable purposes carried out by *any* organization; accordingly, a private foundation may make a PRI to a charitable or non-charitable entity, domestic or foreign.¹⁵

PRIs may be used to support a wide range of activities that further charitable purposes. Section 501(c)(3) and the accompanying Treasury Regulations describe "charitable purposes" in some detail, including "relief of the poor and distressed or of the underprivileged; . . . advancement of education or science; . . . lessening of burdens of government; and promotion of social welfare designed to accomplish any of the above purposes," or lessening neighborhood tensions, eliminating prejudice and discrimination, defending human and civil rights secured by law, or combating community deterioration and juvenile delinquency.¹⁶

It is worth noting that "economic development," a common goal of PRIs, is not

¹⁴ Treas. Reg. § 53.4944-3(a)(2)(i).

¹⁵ Numerous examples of the variety of recipient entities are found in private letter rulings issued by the IRS. For instance, in PLR 9834033 (May 27, 1998), the IRS approved as a PRI disbursements by a foundation to capitalize a limited liability company ("LLC") formed to operate a family service support center. In PLR 9608039 (November 30, 1995), a foundation made a loan to a public charity, which planned to use the proceeds to invest in a commercial limited partnership vehicle whose purpose was to accelerate the public availability of a cure for a disease. In PLR 8445096 (August 13, 1984), a foundation made below-market loans to a commercial, non-exempt telecommunications network company that provided services and established a network for member Section 501(c)(3) entities.

¹⁶ Treas. Reg. § 1.501(c)(3) - 1(d)(2).

included in the statutory or regulatory definition of charitable. The IRS has explained that "encourag[ing] business development as an end in itself" is not a charitable activity.¹⁷ But economic development activity that is likely to confer significant benefits on impoverished or unemployed individuals or to improve or prevent further blight in geographic regions that are demonstrably poor, deteriorating, or decayed is "charitable."¹⁸

The IRS frequently has ruled on the charitability of PRI projects. For instance, the IRS recently approved a PRI program through which a foundation intended to provide financial and technical support (through a variety of means, including loans, loan guarantees equity investments, and providing deposit insurance for financial institutions) to businesses and financial institutions in economically depressed areas throughout the world.¹⁹ In another ruling, the IRS approved a PRI investment to support a venture capital fund and an affiliated non-profit business development services company formed to encourage economic development in an economically depressed area. The IRS found that the PRI significantly furthered charitable purposes, notwithstanding the fact that the venture capital fund would be able to use up to 15% of its assets

¹⁷ See GCM 38826 (March 10, 1981).

¹⁸ See, e.g., Rev. Rul. 74-587, 1974-2 C.B. 162, amplified by Rev. Rul. 81-284, 1981-C.B. 130; Rev. Rul. 76-419, 1976-2 C.B. 146; and Rev. Rul. 77-111, 1977-1 C.B. 144. For a recent discussion of PRI-supported economic development activity that qualifies as charitable, see PLR 9826048 (March 31, 1998). In general, the IRS has treated the issue of the charitability of economic development activities in greater detail in rulings regarding the characteristics an organization must possess to qualify for exemption under Section 501(c)(3) of the Code than it has when it has considered PRIs the purpose of which is to promote economic development and related activities. The standards employed by the IRS in connection with determinations regarding tax exemption appear to be more rigorous than the standards it applies to determine whether an investment that promotes economic development furthers the charitable purposes of an organization.

¹⁹ See PLR 9826048 (March 31, 1998).

for investments and activities outside of the depressed "target" region.²⁰ In another ruling, the IRS approved a PRI loan -- which was part of a complex financing structure involving numerous investors -- to a bank holding company to support a failing minority-owned bank.²¹

IRS guidance reveals several factors that help to demonstrate that an investment furthers charitable purposes. Imposition of limits on the activities of a PRI recipient is one factor. For instance, in one private letter ruling, the IRS approved a PRI in a commercial telecommunications company where participation in the communications network to be established by the commercial investee was limited to exempt organizations, the majority of which were required to be described in Section 501(c)(3).²² In another private letter ruling, the IRS approved a private foundation's loan to a public charity to purchase an interest in a limited partnership engaged in disease research, where the partnership agreement limited the purposes of the partnership to research, development and education for the discovery of a cure, care for

²⁰ See PLR 8807048 (November 23, 1987).

²¹ See PLR 9134030 (May 31, 1991). For other examples of PRIs approved by the IRS, see, e.g., TAM 9240001 (May 1, 1992) (grant to college earmarked for general support of a non-profit business incubator affiliate was not a taxable expenditure, because the grantee qualified as a tax-exempt community development organization); PLR 8710076 (December 10, 1986) (loan to public charity to capitalize taxable subsidiary, which was to be general partner and manager of a limited partnership to provide early stage financing to companies organized to provide quality human services at reasonable costs that were unable to meet financing needs through conventional sources); PLR 8004102 (October 31, 1979) (investment by private foundation organized to preserve theaters and perpetuate the performing arts through its wholly-owned subsidiary, a theater operator, was made solely to carry out the educational purposes of the foundation and to help continue the operation of theaters).

²² See PLR 8445096 (August 13, 1984).

persons with the disease, and distribution and marketing of the cure and treatment.²³ Further, the IRS approved a PRI in an entity that was to finance social and human service organizations, where the funds could not be used to finance entities -- such as proprietary hospitals -- where the practicality of for-profit social services already had been established.²⁴

The presence of limitations on subsequent investment activities of PRI recipients is another factor that suggests that a proposed PRI furthers charitable purposes. For example, the IRS approved the use of PRI funds to purchase a limited partnership interest, where the purchaser retained the right to transfer its interest if the partnership deviated from its specifically enumerated charitable purposes and the right to veto any transfer of substantially all of the assets of the partnership.²⁵ In a similar vein, the IRS approved a PRI that supported a partnership formed to invest in for-profit social service organizations, where the partnership's investment in a particular organization would terminate when the organization became self-sufficient.²⁶

Criterion 2: No Significant Purpose of the Investment is the Production of Income or the Appreciation of Property

The Treasury Regulations under Section 4944 set forth the general rule that: "[i]n determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment

²³ See PLR 9608039 (November 30, 1995).

²⁴ See PLR 8710076 (December 10, 1986).

²⁵ See PLR 9608039 (November 30, 1995).

²⁶ See PLR 8710076 (December 10, 1986).

for profit would be likely to make the investment on the same terms as the private foundation."²⁷

The Treasury Regulations further provide that "the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property."²⁸ The IRS applies a facts and circumstances test to determine whether this criterion is satisfied.

In rulings considering whether a significant purpose of an investment is production of income or the appreciation of property, the IRS has examined the following factors: interest rates; availability of conventional financing, and rate of return. With respect to PRI loans, interest rates below the prevailing market rate for investments of comparable risk are a typical and significant indicator of the required absence of production of income as a motive. For instance, one example in the Regulations describes a loan made to a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group at a rate below the commercial rate for loans of comparable risk.²⁹ Another indication that no significant purpose of an investment is the production of income or the appreciation of property is that financing is unavailable from conventional sources on terms that are feasible for the recipient.

²⁷ Treas. Reg. § 53.4944-3(a)(2)(iii).

²⁸ Treas. Reg. § 53.4944-3(a)(2)(iii).

²⁹ Treas. Reg. § 53.4944-3(b); see also PLR 9826048 (March 31, 1998)(low interest rate loans to start up businesses and small businesses in need of working capital to stimulate business in economically depressed areas throughout the world); PLR 9551005 (September 15, 1995) (low interest rate loans to media organizations in former communist countries were PRIs); PLR 9148052 (September 6, 1991) (below market-rate loans to a partnership to develop housing for low-income elderly persons were PRIs).

Feasibility is determined from the perspective of the proposed recipient of PRI funds.³⁰

Furthermore, when commercial investors also are involved in a proposed transaction, returns to the private foundation that are less favorable than those of other investors and do not yield impermissible private benefit to other investors help to demonstrate the lack of income production or property appreciation as a significant purpose of the investment.³¹

Criterion 3: No Purpose of the Investment is to Accomplish Political Purposes or to Support Lobbying Activities Described in Section 170(c)(2)(D)

The Treasury Regulations prohibit the use of PRI funds to accomplish political purposes or to support lobbying activities described in Section 170(c)(2)(D). The Regulations state the general rule that: "[n]o purpose of the investment [may be] to accomplish one or more of the purposes described in section 170(c)(2)(D)."³² The Regulations further explain that "[a]n investment shall not be considered as made to accomplish one or more of the purposes described in section 170(c)(2)(D) if the recipient of the investment appears before, or communicates to, any legislative body with respect to legislation or proposed legislation of direct interest to such recipient, provided that the expense of engaging in such activities would qualify as a deduction under Section 162."³³

³⁰ See Treas. Reg. § 53.4944-3(b) (Example 1)

³¹ See Treas. Reg. § 53.4944-3(b) (Example 6).

³² Treas. Reg. § 53.4944-3(a)(1)(iii).

³³ Treas. Reg. § 53.4944-(a)(2)(iv).

FORMS OF PROGRAM-RELATED INVESTMENTS

Any form of investment activity that meets the criteria described above ought to be able to qualify as a PRI, and the IRS has ruled on various forms of PRIs.

Loans

PRIs most commonly take the form of loans, which may be made directly to organizations to carry out specific projects, to intermediary organizations, or to individuals. Characteristically, PRI loans are interest-free or made at lower rates than conventional financial institutions would be willing to accept from the borrower. Some PRI loans include provisions for loan forgiveness at the discretion of the lender or upon the occurrence of other events, such as the borrower's success in raising matching funds.³⁴

PRI loans may be made to support any type of charitable program. They are most often made, however, to assist organizations and business ventures engaged in community economic development and housing.³⁵ PRI loans may be structured to meet diverse goals and may support a wide range of organizations. For instance, a foundation may use PRI loans to provide direct support to nonprofit community development corporations or to business enterprises established by or on behalf of economically disadvantaged persons. Loans also may be made to support established, for-profit businesses that employ persons in economically depressed areas; to induce established companies to invest resources in economically depressed communities as a means of creating jobs, or to leverage financing from conventional sources by making loans at

³⁴ See PLR 8708067 (December 1, 1986).

³⁵ As noted above, "economic development" *per se* does not qualify as an exempt purpose. See Section 1.03[1][a][ii], *supra*.

preferential interest rates.³⁶ Another common use of PRI loans is to support development of housing for low and moderate income persons. In one private letter ruling, the IRS approved a loan to a limited partnership to develop city property into housing for elderly, low income persons.³⁷ Another similar project approved by the IRS involved a foundation's participation in a state-sponsored joint loan program to provide financing to investors who were seeking to rehabilitate housing for low income persons and had been unable to obtain financing from conventional sources.³⁸ The foregoing examples are not intended to suggest limitations on the types of projects to which PRI loans may be made. PRI loans may be made to support any project that furthers the charitable, exempt purposes of a private foundation.³⁹

Private foundations also may make PRI loans to individuals. The Treasury Regulations provide the example of loans to enable economically disadvantaged persons to attend college.⁴⁰ Similarly, the IRS has ruled that low-interest loans to help blind persons establish business ventures were PRIs, where the loan recipients otherwise would have been unable to obtain affordable financing.⁴¹

³⁶ See Treas. Reg. § 53.4944-3(b), Examples (4), (5), (6).

³⁷ See PLR 9148052 (September 6, 1991).

³⁸ See PLR 8141025 (July 20, 1981)

³⁹ For additional examples of the breadth of charitable purposes for which PRI loans may be made, see, e.g., PLR 9826048 (March 31, 1998) (small businesses in developing countries) PLR 9608039 (November 30, 1995) (medical research); PLR 9551005 (September 15, 1995)(media organizations); PLR 9014063 (January 10, 1990)(media organization).

⁴⁰ See Treas. Reg. § 53.4944-3(b) (Example 9).

⁴¹ See Rev. Rul. 78-90, 1978-1 C.B. 380.

Equity-Type Investments

Equity investments to help finance new business ventures and to enhance their ability to access additional sources of financing may qualify as PRIs. A PRI equity investment may take the form of a stock purchase to assist a new or financially troubled business venture in obtaining required financing.⁴² An example in the Regulations describes an investment by a private foundation in the common stock of a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. The purpose of the stock purchase is to encourage the economic development of the group.⁴³ Private foundations also may invest in limited partnerships organized to serve charitable and other exempt purposes.⁴⁴

⁴² Treas. Reg. § 53.4944-3(b) (Example 3); see also, PLR 9826048 (March 31, 1998) (proposed acquisition of equity interests in small businesses in economically depressed areas throughout the world to assist in economic development and development of jobs); PLR 8807048 (November 23, 1987) (investment in holding company to be invested in community development projects); PLR 8549039 (September 10, 1985) (investment in stock of for-profit developer incorporated by non-profit community development groups to undertake project to revitalize an economically depressed neighborhood); PLR 8526084 (April 5, 1985) (purchase of shares in small business investment company to establish pool of investment funds to assist small businesses in economically depressed area.)

⁴³ See Treas. Reg. § 53.4944-3(b) (Example 3).

⁴⁴ In PLR 9834033 (May 27, 1998), the IRS approved a foundation's plan to become a 50% owner in an LLC being established to operate a family service support center. Many other rulings regarding partnerships involve either lending to a partnership or a two-step process of loans to charities that then invest in limited partnerships, rather than direct investment by the private foundation. See, e.g., PLR 9608039 (November 30, 1995), the IRS approved a loan to a public charity for investment in a limited partnership where there was a possibility that the private foundation would become the holder of the limited partnership interest; PLR 9148052 (September 6, 1991)(loan to partnership); PLR 8710076 (December 10, 1986).

On the other hand, the IRS has issued several private letter rulings holding that specific equity investments do not qualify as PRIs. In one such ruling, a private foundation sought to invest in a hotel in order to stimulate tourism and economic development in a historic community.⁴⁵ Similarly, the IRS issued an adverse ruling to a foundation that sought to qualify its ownership of nearly all of the voting stock of a corporation that owned a racetrack as a PRI.⁴⁶

Guarantees and Letters of Credit

Private foundations often act as guarantors of loans to finance charitable projects. As guarantees and investments in letters of credit often do not require immediate expenditure of foundation resources, they can be a particularly effective use of foundation resources to leverage financing from other sources.⁴⁷

Real Property

The IRS has ruled favorably on the acquisition of real property as a PRI. For example, in one ruling, the purchase of real property, which was leased, at a nominal rate, to an unrelated charitable organization, was held to be a PRI.⁴⁸

CONSEQUENCES OF PROGRAM-RELATED INVESTMENTS --

⁴⁵ See PLR 9340002 (June 16, 1993).

⁴⁶ See PLR 8201050 (October 7, 1981).

⁴⁷ See, e.g., PLR 9033063 (May 24, 1990) (private foundation investment in letter of credit was a PRI). Cf. PLR 9148049 (September 5, 1991) (foundation obtained ruling enabling set aside of funds to exercise purchase option on bonds under a guaranty it had executed, where it would be called upon to make payments as guarantor.)

⁴⁸ See PLR 9117044 (January 29, 1991). See also, PLR 8803060 (October 27, 1987) (purchase of building to be used by private foundation as its headquarters and leased to other charitable organizations was a PRI).

INTERPLAY WITH OTHER CODE SECTIONS

Code Section 4944 interacts with many other sections of the Internal Revenue Code of concern to private foundations that make PRIs and public charities and other entities that receive them.

Section 4940: Excise Tax on Net Investment Income

Section 4940 of the Code imposes an excise tax, in the amount of 2%, on the net investment income of a private foundation.⁴⁹ Income that a private foundation receives from PRIs is included in the net investment income of the organization for Section 4940 purposes; but capital gains and losses on PRIs are not included in the net investment income of a private foundation.⁵⁰

Section 4942: Minimum payout requirement -- Tax on Failure to Distribute Income

Section 4942 of the Code requires a private foundation to make annual distributions in an amount equal to 5% of the value of its assets not used directly in carrying out its exempt purpose, less the amount paid for the Section 4940 excise tax and unrelated business income tax, plus certain amounts received by the foundation during the year, including: repayments of amounts previously treated as qualifying distributions, amounts received on the disposition of assets previously treated as qualifying distributions, and amounts previously set aside, but not used, for charitable projects.⁵¹

⁴⁹ The tax may be reduced to 1% if the foundation's qualifying distributions for the year exceed its average "distribution ratio" over the past five years by an amount equal to at least 1% of the foundation's net investment income for the year. The term "distribution ratio" refers to the ratio of qualifying distributions to not non-charitable use assets of a private foundation.

⁵⁰ See Treas. Reg. §§ 53.4940-1(d)(1), 53.4940-1(f)(1).

⁵¹ See I.R.C. § 4942(d); Treas. Reg. § 53.4942(a)-2(d)(2)(iii)(c).

Disbursements for PRIs count as qualifying distributions towards satisfying a private foundation's minimum payout requirement for the year in which they are made.⁵² A PRI to another private foundation or to an organization controlled by the investing foundation (or one or more of its disqualified persons) may not be a qualifying distribution for the investing foundation, unless the recipient distributes an amount equal to the amount of the PRI by the end of its tax year following the tax year in which funds from the PRI were received and the recipient's distribution is treated as a qualifying distribution made out of corpus.⁵³

Normally, when a foundation recovers all or a portion of the principal amount of a PRI it must increase its distributable amount (in an amount equal to the amount recovered) in the year of recovery.⁵⁴ But a foundation can avoid the redistribution requirement if it elects not to treat a PRI as a qualifying distribution that counts towards its minimum payout. This may be a viable option if, for instance, it already has made adequate qualifying distributions or it has excess distribution carry-forwards. Amounts recovered in respect of PRIs that have not been counted as qualifying distributions for purposes of the payout requirement do not increase the foundation's distributable amount in the year of recovery.⁵⁵

PRIs are considered assets used (or held for use) directly in carrying out the exempt purposes of the foundation and are not taken into account for purposes of calculating

⁵² See Treas. Reg. § 53.4942(a)-3(a)(2).

⁵³ See Treas. Reg. §§ 53.4942(a)-3(a)(2)-(3); 53.4942(a)-3(c).

⁵⁴ See I.R.C. § 4942(f)(2)(C).

⁵⁵ See PLR 9620039 (February 22, 1996).

minimum investment return.⁵⁶ Certain set-asides by private foundations to meet obligations incurred in connection with PRIs may count as qualifying distributions in the year in which the set-aside is made, notwithstanding the fact that payments are not to be made until future years.⁵⁷

Section 4943: Excise Tax on Excess Business Holdings

Code Section 4943 generally limits the combined holdings of a private foundation and all of its disqualified persons to 20% of the voting stock in any corporation (or comparable interest in other types of business enterprise) conducting a business that is not substantially related (aside from the foundation's need to generate revenues for its exempt purposes).⁵⁸ The excess business holdings rules and regulations are extremely complex and contain numerous exceptions and special provisions. Thus, for example, PRIs (and functionally related businesses) are excluded from the definition of "business enterprise" for purposes of the excess business holdings rules.⁵⁹

An interesting illustration of the interaction between the rules regarding excess business holdings and PRIs is found in a private letter ruling which describes a private foundation's conversion of an excess business holding -- ownership of a large plot of land which included a cattle ranch and a citrus grove -- into a PRI, and therefore, not subject to the prohibition on excess business holdings. The foundation accomplished this by leasing the property -- for a nominal amount -- to a public charity for research purposes.⁶⁰ Under the ruling,

⁵⁶ Treas. Reg. § 53.4942(a)-2(c); see PLR 8803060 (October 27, 1987).

⁵⁷ See, e.g., PLR 9148049 (September 5, 1991).

⁵⁸ I.R.C. § 4943(c).

⁵⁹ See Treas. Reg. § 53.4943-10(b).

⁶⁰ See PLR 9426044 (April 6, 1994).

if the circumstances of the PRI changed so that it ceased to qualify as program-related and became an excess business holding, the private foundation would be required to dispose of the investment within five years of the change.⁶¹

Section 4945: Expenditure Responsibility

A private foundation must exercise expenditure responsibility over PRIs to private foundations or charitable projects conducted by non-charitable or non-exempt organizations. The applicability of the expenditure responsibility provisions of the Code and regulations is discussed in detail below.⁶²

Section 509: Public Support for Public Charities

In general, PRIs do not count as support of the recipient organization for purposes of calculating public support received by public charities. The definition of "public support" in Section 509(d) of the Code, includes gifts, grants, contributions and membership fees. Funding received by a charitable organization in the form of a PRI loan may, however, constitute support under Section 509(d)(1), if the loan is forgiven.⁶³

Section 511: Taxation of Unrelated Business Taxable Income

Section 511 of the Code imposes a tax on the unrelated business taxable income of tax exempt organizations, including private foundations. The Code defines "unrelated business taxable income" as the "gross income derived by any organization from any unrelated trade or

⁶¹ See Treas. Reg. § 53.4943-10(d).

⁶² See Section §1.05[1], *infra*.

⁶³ See PLR 9608039 (November 30, 1995).

business (as defined in section 513) regularly carried on by it."⁶⁴ An "unrelated trade or business" is "any trade or business the conduct of which 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 for its exemption under section 501."⁶⁵ The PRI, and income it produces generally have a "substantial causal relationship" to the achievement of the exempt purposes of the foundation and does not constitute unrelated business taxable income.⁶⁶

COMPLIANCE ISSUES, DOCUMENTATION AND REPORTING REQUIREMENTS

Application of Expenditure Responsibility Rules and Compliance Procedures

A private foundation is not required to exercise expenditure responsibility over a PRI made to a public charity,⁶⁷ unless it has earmarked the investment for a secondary recipient over which it would be required to exercise expenditure responsibility.⁶⁸ When a private foundation considers making a PRI to a foreign organization that has not obtained a ruling or

⁶⁴ I.R.C. § 512(a).

⁶⁵ I.R.C. § 513(a).

⁶⁶ See PLR 8803060 (October 27, 1987)(The fact that private foundation charged nominal rent to cover overhead costs of leasing space in its headquarters to other charitable organizations did not alter characterization of purchase as PRI. Amounts received by the foundation as rental payments would not be unrelated business taxable income because the uses of the building were substantially related to the exempt purposes of the organization and would contribute importantly to the accomplishment of the charitable and exempt purposes of the foundation)

⁶⁷ See PLR 8030079 (April 30, 1980).

⁶⁸ See PLR 9608039 (November 30, 1995).

determination letter from the IRS as to its public charity status it may determine whether the proposed recipient is a public charity equivalent.⁶⁹ If the foundation concludes that the foreign organization is a public charity equivalent, it need not exercise expenditure responsibility over the PRI.

In order to avoid the tax on taxable expenditures imposed by Section 4945 of the Code, a private foundation must exercise expenditure responsibility over PRIs to organizations other than Section 501(c)(3) public charities (and their equivalents, and Section 4940(d)(2) exempt operating foundations). A foundation also must exercise expenditure responsibility over a PRI made to a foreign organization that is not a public charity or public charity equivalent. If a PRI is earmarked for payment to a secondary recipient that is a private foundation or is not a charitable entity, the investing private foundation must exercise expenditure responsibility with respect to the secondary recipient.⁷⁰

In order to exercise expenditure responsibility over a PRI, a private foundation must: exert all reasonable efforts and establish adequate procedures to see that PRI funds are expended solely for the purpose for which the PRI has been made; obtain full and complete reports from the PRI recipient with respect to how the fund were spent; and make full and detailed reports to the IRS with respect to PRI expenditures.⁷¹

⁶⁹ See Rev. Proc. 92-94, 1992-2 C.B. 507; Treas. Reg. § 53.4945-5(a)(5).

⁷⁰ This rule does not apply if the primary PRI recipient controls the destination of the PRI funds or the selection process for the distribution of funds (in this case, the investing foundation is not deemed to have earmarked the PRI for a secondary recipient.); see, e.g., PLR 9608039 (November 30, 1995); PLR 8923071 (March 16, 1989). Cf. PLR 9717024 (January 23, 1997).

⁷¹ I.R.C. § 4945(h).

Prior to making a PRI that would require expenditure responsibility, a private foundation must conduct an inquiry sufficient to provide it with reasonable assurance that the recipient will use the PRI funds for proper purposes. The inquiry should examine the identity, prior history, activities and experience of the recipient organization and its managers. The scope of the inquiry may vary depending on the size and purpose of the PRI, the period over which it will be paid, and any prior experience the foundation has with the proposed recipient organization.⁷²

A PRI that requires expenditure responsibility must be memorialized in a written agreement, signed by an officer or director of the recipient, in which the recipient agrees to certain terms. First, the recipient must commit to use all funds received from the foundation only for the purpose of the PRI and to repay any portion of funds not used for such purposes (except that with respect to equity investments, repayment only is to be made to the extent permitted by applicable law concerning distributions to holders of equity interests.)⁷³ Second, at least annually during the duration of the PRI, the recipient must submit to the investing foundation full and complete financial reports, of the type ordinarily required by commercial investors under similar circumstances, and a statement that the PRI recipient has complied with the terms of the investment.⁷⁴ Third, the proposed recipient organization must maintain books and records of the type required by commercial investors under similar circumstances, and must make its books and

⁷² See Treas. Reg. § 53.4945-5(b)(2).

⁷³ See Treas. Reg. § 53.4945-5(b)(4)(i).

⁷⁴ See Treas. Reg. § 53.4945-5(b)(4)(ii).

records available for inspection by the investing foundation at reasonable times.⁷⁵ Finally, the proposed PRI recipient must agree not to use any PRI funds: to carry on propaganda, or otherwise attempt to influence legislation (within the meaning of Section 4945(d)(1) of the Code), influence the outcome of any specific public election; to carry on, directly or indirectly, any voter registration drive within the meaning of Section 4945(d)(2); or, if the recipient is a private foundation, to make any grant which does not comply with the individual or organizational requirements of Section 4945(d)(3) or (d)(4) of the Code.⁷⁶

The recipient of a PRI that requires expenditure responsibility must make annual reports and a final report to the investing private foundation. Annual reports, required as of the end of the recipient's annual accounting period within which any PRI funds are received and all subsequent accounting periods until the PRI funds have been expended or the PRI has been terminated, must describe the use of the PRI funds, compliance with the terms of the PRI, and progress made in achieving the purpose of the PRI. The final report, which must be made within a reasonable period of time after the end of the recipient's tax year in which PRI funds are fully expended or returned to the investing foundation, must report on all expenditures made from PRI funds and the recipient's progress in accomplishing the goals of the PRI.⁷⁷ A private foundation need not verify the accuracy of information provided in annual or final reports of a PRI recipient unless it has reason to doubt their accuracy or reliability.⁷⁸

⁷⁵ See Treas. Reg. § 53.4945-5(b)(4)(iii).

⁷⁶ See Treas. Reg. § 53.4945-5(b)(4)(iv).

⁷⁷ See Treas. Reg. § 53.4945-5(c)(1).

⁷⁸ See Treas. Reg. § 53.4945-5(c)(1).

When a PRI is made to increase the endowment of a private foundation or to provide it with funds for the purchase of capital equipment or other capital purposes, the investing foundation must require reports from the recipient concerning the use of the principal and any income derived from the PRI funds, but the recipient foundation must provide such reports annually only for the taxable year (of the recipient) in which it receives the PRI and the next two taxable years. The investing foundation then may cease to require reports if it is reasonably apparent to the investor that, before the end of the year, the PRI funds have not been used for any purpose that would result in liability for tax under Section 4945.⁷⁹

A private foundation that makes PRIs over which it is required to exercise expenditure responsibility must report to the IRS on its annual information return (Form 990-PF) with respect to every PRI made during the taxable year or as to which an amount is outstanding at any time during a taxable year. The report to the IRS must contain the following information: the name and address of the recipient of the PRI; the date and amount of the PRI; the purpose of the PRI; the amounts spent by the PRI recipient (based on the most recent report received from the recipient); whether -- to the knowledge of the investor -- the PRI recipient has diverted any portion of the fund (or income, in the case of endowment grants) from the purpose of the PRI; the dates of any reports received from the PRI recipient; and the date and results of any verification of the PRI recipient's reports undertaken by the investing foundation.

An investing foundation may rely on adequate records or other sufficient evidence

⁷⁹ See Treas. Reg. § 53.4945-5(c)(2).

supplied by the PRI recipient in reporting required information to the IRS.⁸⁰ Failure to provide reports regarding PRIs over which a foundation exercises expenditure responsibility to the IRS causes the PRI to be considered a taxable expenditure.⁸¹

In addition to the reporting requirements, a private foundation must retain certain records in respect of PRIs over which it exercises expenditure responsibility. A foundation must retain a copy of the written agreement covering each outstanding PRI over which it exercises expenditure responsibility.⁸² It also must retain a copy of each report received in respect of PRIs over which it exercises expenditure responsibility.⁸³ Finally, the foundation must retain a copy of each report made by its own personnel or by outside auditors of any audits or other investigations made during the year with respect to any PRI over which it exercises expenditure responsibility.⁸⁴

Unlike a grant to a non-charitable entity, the recipient of a PRI need not maintain the funds in a separate, segregated fund.⁸⁵

Reporting PRIs on Form 990-PF⁸⁶

A private foundation must list all PRIs made during the tax year in Part IX-B of

⁸⁰ If the required information is supplied in the annual report of the PRI recipient to the investing foundation, the investor may satisfy the reporting requirement by attaching the report to its annual information return.

⁸¹ See Charles Stewart Mott Foundation v. U.S., 938 F.2d 58 (6th Cir. 1991).

⁸² Treas. Reg. § 53.4945-5(d)(3)(i).

⁸³ Treas. Reg. § 53.4945-5(d)(3)(ii).

⁸⁴ Treas. Reg. § 53.4945-5(d)(3)(iii).

⁸⁵ Treas. Reg. § 53.4945-6(c)(1)(i).

⁸⁶ The references in this paper are to information required by the 1998 Form 990-PF. A copy of the 1998 990-PF follows this article (Appendix I).

Form 990-PF, and must show the total amount of funds distributed as PRIs and taken as qualifying distributions on Part XII, line 1.b. In addition, it must report any repayment of PRI principal received during the year as a recovery of a qualifying distribution on Part XI, Line 4.a ("Distributable Amount").

A private foundation must report all income it receives from PRIs on Part I, Line 11 ("Other Income") and Part XVI -A ("Analysis of Income Producing Activities") on Line 1, column e ("Program Service Revenue -- Related or Exempt Function Income"). On Part II, Line 15 ("Other Assets") of the balance sheet, a foundation must report the value of outstanding PRIs as of the last date of the reporting period. For each outstanding PRI that is subject to expenditure responsibility, the investing private foundation must attach an expenditure responsibility report in response to Part VII-B, Line 5 (c) ("Statements Regarding Activities for which Form 4720 May be Required"). Finally, the investing foundation must explain the purposes of the PRI in Part XVI-B ("Relationship of Activities to the Accomplishment of Exempt Purposes").

In addition to the reporting requirements to set forth above, if the recipient of PRI funds is a non-charitable exempt organization, the PRI must be reported on Part XVII ("Information Regarding Transfers to and Transactions and Relationships with Non-Charitable Exempt Organizations")

POLICY ISSUES RAISED BY PROGRAM-RELATED INVESTMENTS

PRIs raise numerous policy issues by virtue of their status as hybrids between investment activities and traditional grantmaking activities of private foundations.⁸⁷ Among the

⁸⁷ For an excellent, detailed exposition of key issues foundation PRI programs face, see Christie I. Baxter, Program Related Investments: A Technical Manual for Foundations

key issues for consideration is whether PRIs ought to be allocated to the grants budget or to the investment assets of a foundation. It is important to remember that decisions regarding the internal allocation for PRIs do not affect their treatment as qualifying distributions. There are three general policy alternatives for allocating PRIs: (i) from the grants budget; (ii) from the investment assets; or (iii) as a stand-alone program with a fixed budget.

Unlike traditional grants, to the extent that a foundation is repaid the principal of a PRI loan or the equity invested, PRIs can be "recycled" and re-invested or re-granted by the investing foundation. Thus, if PRIs are viewed as "recyclable, interest-bearing grants," they may constitute a more effective use of funds than grants to accomplish charitable purposes. Because disbursements made as part of PRIs constitute qualifying distributions, they help a foundation to meet its annual payout requirements. Conceptually, however, by considering PRIs as part of the grants program budget, a foundation is reducing the size of its grantmaking activity in the year that it makes PRIs. This can lead to a "rollercoaster" effect on the size of the grants program because of the unpredictability of repayment. One way to address the problem (if it is a problem) is to consider PRIs as additions to the grants budget that generate a distribution carry-forward to cushion the impact of the increased redistribution requirement that results from the repayment of a PRI.

Because a PRI constitutes a qualifying distribution and is not included in the asset base of the investing foundation for purposes of determining the minimum investment return (and the required annual distributions), it in effect has a presumptive minimum investment return of 5%. On the other hand, the "loss" a foundation suffers on the return on its PRI assets in excess of

(John Wiley and Sons, Inc., 1997).

5% by making a PRI results in less money available for grants. That may be troubling to a board that is not comfortable with expending even a small amount of capital.

Creating a Separate PRI Program

Establishing a distinct PRI program does not eliminate the effect of PRIs on assets or the grants budget, but it does provide the opportunity for the investing foundation to develop a distinct framework to plan, monitor and evaluate PRIs in a manner analogous to operating a grants program.

One way for a private foundation to operate its PRI program is to allocate a specific portion of assets for PRIs, not to be charged against the grants budget. In this scenario, the foundation meets its annual payout requirement through its regular grants program; PRIs simply create a carry-forward of excess distributions. The excess is reduced in subsequent years, when the foundation receives repayment in respect of PRIs. The effect of this method of allocation on the growth of the total assets of the foundation will depend upon the total return for the asset base for the years during which PRIs are outstanding.

During a bull market, there is little doubt that conventional (including socially responsible) investing will "outperform" PRIs. But performance is not the defining rationale for making PRIs. By thinking of PRI activities as a separate program area, a foundation will be less inclined to evaluate the program's "success" by reference to investment returns and more likely to see PRIs as what the law intends: an additional tool to further a private foundation's tax-exempt purposes.

375236.1

APPENDIX I