

**Patterson Belknap Webb & Tyler <sup>LLP</sup>**

**THE UNIVERSITY OF TEXAS SCHOOL OF LAW  
Nonprofits Organizations Institute**

**Program Related Investments**

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# Introduction: Why Are We Here?

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- Shrinking boundaries between sectors
  - Rise of mission/impact as a force in the commercial sector
    - Increased awareness and notion of corporate responsibility
    - New corporate forms
- Heightened interest in mission/impact investing generally
- Leads to Increased (and better) charitable investment opportunities
- And more foundations willing/eager to jump in

# What is a Program Related Investment (PRI)

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- A PRI is an investment made (by a private foundation) to accomplish one or more charitable purposes
  - A grant in investment clothing
  - Technically unique to private foundations
  - A distinct subset of larger universe of mission related investments (MRI)
  - Not considered a “jeopardizing investment”, though other private foundation rules apply
  - Although public charities are not subject to the PRI rules, many now seek to make investments that are PRI-like
- A PRI can be made in/to a for-profit or non-profit entity

# The Social Context: MRIs and PRIs

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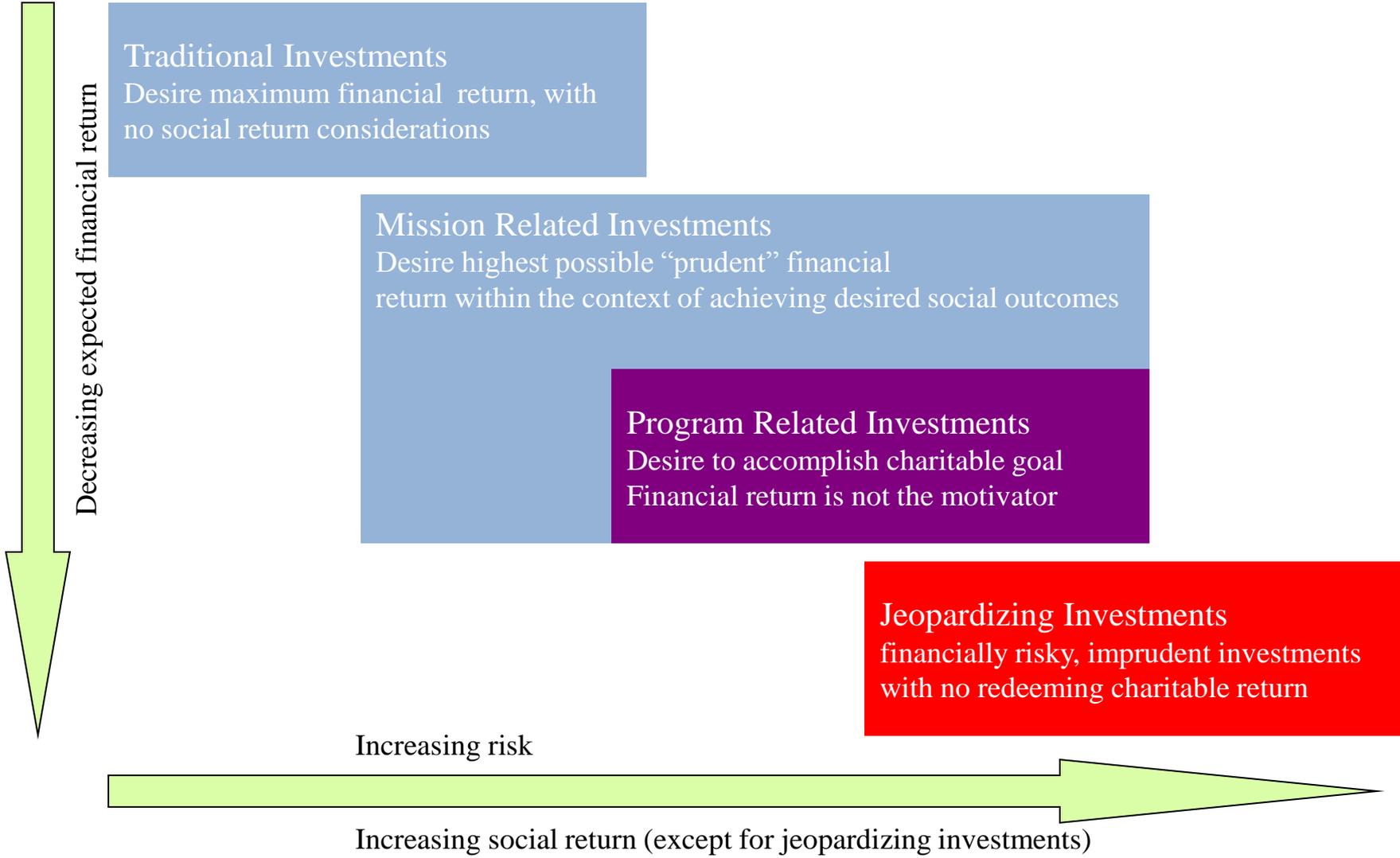
- MRIs are characterized by attention both to profit and social impact
  - Distinguished from investments motivated solely by profit that may compromise social values or ignore externalities (e.g., environmental impact, fair labor standards) to maximize profit.
  - MRIs may or may not advance charitable purposes
    - Charitable is usually a higher threshold than “mission-related”
    - MRIs may or may not offer a market-rate expected return
    - MRIs whose expected return and risk/return ratio are consistent with foundation’s overall investment strategy and policy may be considered “prudent” investments
    - MRIs (that do not qualify as PRIs) generally do not count towards pay-out requirements

## The Social Context: MRIs and PRIs (cont'd)

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- PRIs are a subset of the larger MRI category
  - PRIs have distinct tax characteristics and a long history
  - Greater interest in PRIs as focus on mission investing generally has grown
- PRIs must advance charitable purposes & may not be profit driven
  - Excessive risk/lower financial return—which is typically prohibited for private foundation investments—is permitted if investment achieves a charitable purpose
  - PRIs rarely have market-rate expected return, since they are driven by charitable focus and have a restriction on “profit motive”

- Spectrum of Private Foundation Investing



# The Legal Context: Jeopardizing Investments

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- Section 4944 imposes a tax on the “jeopardizing investments” of private foundations
  - An investment will be considered “jeopardizing” if it was not made with ordinary business care and prudence
    - Look at risk/return ratio
  - Determined on a case-by-case basis taking into account the portfolio as a whole
  - The IRS will not employ hindsight
  - The determination is a function of the facts as they existed at the time of the investment decision

## The Legal Context: Jeopardizing Investments (cont'd)

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- Under the (antiquated) Treasury Regulations, certain investments will be more closely scrutinized
  - Margin trades, futures, short selling, puts, calls, and straddles
- PRIs are an exception to the jeopardizing investment rules
- Excise tax penalties on foundation and potentially organization managers
  - Excise tax imposed on foundation managers who knowingly make a jeopardizing investment, unless the making was not willful and was due to reasonable cause
    - Written advice from investment counsel can eliminate foundation manager's liability
    - Legal opinion that investment is not a jeopardizing investment (e.g. is a PRI) can also eliminate manager liability

# The PRI Requirements

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- Three basic PRI requirements:
  - primary purpose to accomplish one or more charitable purposes
  - not have as a significant purpose the production of income or appreciation of property
  - not have as a purpose influencing legislation or intervening in any political campaign of any candidate for public office

# The PRI Requirements: Charitable Purposes

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- An investment will be considered to be made primarily to accomplish one or more charitable purposes if...
  - it significantly furthers the foundation's exempt activities and
  - it would not have been made but for the relationship between the investment and the accomplishment of the foundation's exempt activities

## The PRI Requirements: Charitable Purposes (cont'd)

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- Typical PRI charitable purposes : include:
  - Providing relief to the poor and distressed
  - Revitalization of distressed communities (combatting community deterioration)
  - Lessening the burdens of (the U.S.) government
  - Conducting educational activities/promoting education
  - Protecting and preserving the natural environment
  - Supporting scientific research

# The PRI Requirements: Financial Returns

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- In determining if a significant purpose is the production of income or appreciation of property, relevant factors include
  - whether investors engaged in the investment solely for profit would be likely to make the investment on the same terms as the foundation
  - Foundation's typical risk/return profile for investments of this type
  - But note how the world has changed/become more nuanced as the lines between pure for-profit investors, mission investors, charitable investors, etc. have blurred
- The fact that an investment produces significant income or appreciation is not conclusive evidence of a significant purpose involving the production of income

## Additional Considerations: For-Profit Recipients

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- A PRI recipient may be a for-profit entity
  - A non-charitable entity may serve as a vehicle to achieve a charitable objective
  - Pay attention to private benefit concerns
    - Be careful that the charitable benefits outweigh the private benefit flowing to the non-charitable recipient as a result of the investment
      - Note inherent tension of traditional private benefit concerns in the investing context
    - Calibrate deal terms in order to induce the desired result without giving rise to excessive private benefit.
    - Determination of PRI-acceptable deal terms is heavily dependent on specific facts and circumstances.

## Additional Considerations: PRI Types

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- PRIs may take any form
  - Loans (below market)
  - Equity Investments
    - 1) Direct investments
    - 2) Fund vehicles (LLCs, Limited Partnerships)
  - Guarantees/Letter of Credit
  - Linked Deposits
- New corporate structures
  - L3Cs
  - Benefit Corporations

## New PRI Examples

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- Newly issued proposed Treasury Regulations add nine new PRI examples
- Welcome guidance for PRI makers and practitioners
  - Confirmed common practice
  - No real surprises
- The new examples include
  - Equity investment in a financially secure business to induce it to develop a vaccine to prevent a disease that predominantly affects poor individuals in developing countries
  - Equity investment in a new recycling business in a developing country the activities of which will prevent pollution and combat environmental deterioration

## New PRI Examples (cont'd)

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- Loan to a business that employs a large number of poor people in a rural area that suffered significant damage in a natural disaster
- Loan to poor individuals to start businesses in a developing country that just experienced a natural disaster
- Loan to a limited liability company that purchases coffee from poor farmers residing in a developing country, to fund the provision of efficient water management, crop cultivation, pest management, and farm management training to the poor farmers

## New PRI Examples (cont'd)

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- Loan to a social welfare organization that conducts community art exhibitions to purchase a large exhibition space
  - Deposit as credit support to induce a bank to make a loan to a charitable organization to construct a new child care facility
  - Guarantee to induce a bank to make a loan to a charitable organization to construct a new child care facility
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- The text of the proposed Regulations can be found at <http://www.gpo.gov/fdsys/pkg/FR-2012-04-19/pdf/2012-9468.pdf>

# Applicability of Other Private Foundation Rules

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- “Taxable expenditure” rules apply
  - Expenditure responsibility is not required for a PRI to a U.S. public charity (or the foreign equivalent thereof)
  - Must exercise expenditure responsibility over a PRI to a non-public charity
- Income from PRIs included in gross investment income for purposes of section 4940 tax
- Self-dealing rules (section 4941)
- Amounts disbursed as PRIs are qualifying distributions for purposes of the 5% payout requirement (section 4942)
- Excess business holdings under section 4943 do not include PRIs

# Typical PRI Documentation

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- Loan
  - Due Diligence
  - Loan Agreement
  - Note
  - Opinions
- Equity
  - Due Diligence
  - Subscription documents
  - Side Letter
  - Opinions

# International PRIs

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- Determining appropriate standards
  - e.g., who is “low-income”?
- Currency exchange risk
- Compliance with local law – local counsel?
- Translations
- Legal restrictions on foreign investment
- Anti-terrorism considerations

# Public Charities as PRI Makers

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- PRI (and other private foundation) rules do not apply to public charities
- Many public charities make PRI-like investments
  - E.g., mission or impact investing
- Structural concerns
- Fiduciary concerns

# Contacts

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