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Next Steps in Updating the Regulation of Program-Related Investments: Open Questions, Large and Small

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Introduction

Over the academic year of 2013 to 2014, a group of Stanford Law School students, advised by Professor Joseph Bankman, conducted more than 30 interviews of stakeholders in the PRI community – foundation program officers, family foundation founders, generals counsel, attorneys outside of foundations, and academics. After analyzing these interviews, and the existing and proposed Treasury Regulations concerning Program-Related Investments, the group identified several areas of regulatory uncertainty that may be preventing the broader use of PRIs. This white paper presents these issues for discussion and highlights the questions that remain in promoting the optimal use of this philanthropic vehicle.

The common theme of our interviewees' perceptions of the proposed PRI regulations was that while the proposed regulations are a big step in the right direction, uncertainty remains about how to apply them. Additionally, we received many questions about tax provisions that are not addressed directly by the proposed regulations, but are closely connected to PRIs, such as self-dealing and expenditure responsibility regulations. This paper begins by providing context for the discussion of PRIs, and proceeds to analyze and exemplify the issues that we encountered in our interviews. The examples we include and issues that are raised represent our interpretation of comments made by our interviewees, as well as the legal and regulatory text.

Legal and policy background

"Program Related Investment" (PRI) is a term created by the Tax Code under Section 4944 that applies to Private Foundations. PRIs are exempted from excise taxes that might otherwise apply to financially jeopardizing investments made from the foundation's endowment.[1] Importantly, PRIs are also included as "qualifying distributions" under Section 4942 of the Code, which requires foundations to distribute five percent of their

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[1] Jeopardizing investments are those that jeopardize the long-term and short-term financial needs of the foundation, and if the managers failed to exercise ordinary business care and prudence. *See* 26 C.F.R. 53.4944-1(a)(2)(i). The IRS has identified categories of investments that trigger scrutiny or have been deemed jeopardizing, including unsecured loans and asset collateralizations.

assets annually.[2] The upshot of these exemptions is that they allow investments that provide social returns and limited financial returns to be treated similarly to a grant by the Tax Code.

Under guidance published in 1972, the IRS outlined a three-pronged test that qualifies an investment as a PRI: 1) The primary purpose of the investment must one of the exempt (charitable) purposes of the foundation; 2) no significant purpose of the investment may be the production of income or the appreciation of property; and 3), no purpose of the investment may be supporting lobbying or electioneering.[3]

In May 2012, Treasury and the IRS released a "Notice of Proposed Rulemaking Examples of Program-Related Investments," which was the first update to PRI regulations since they were written.[4] The proposed examples responded to ten years of requests from lawyers and practitioners in philanthropy for guidance on PRI regulations. Previously, the only guidance on interpreting Section 4944 was in Treasury Regulations Section 53.4944-3, and a small body of private letter rulings, which cannot be relied on for precedent. Further, the form and complexity of PRI deals changed significantly over time from the low-interest loans for urban development and revitalization that were common in the 1960's and `70's, to more complicated deals, particularly investments made overseas for international development.[5]

The American Bar Association Taxation Section submitted updated PRI examples to Treasury in 2002 and 2010 that reflected current practices. The proposed examples published by Treasury in 2012 include many of the fact patterns submitted by the ABA. The ABA and others have applauded the proposed examples as a welcome update, while acknowledging that "certain questions remain."[6]

From a policy perspective, PRIs act as a tax subsidy for qualifying charitable investments made by foundations, because they are treated like grants for the purposes of a foundation's distribution requirement. Thus, PRIs are one of the policy tools that encourage social impact investing. Some commentators see PRIs as an opportunity to increase the size of the philanthropic pie by catalyzing private investment in socially beneficial projects.

Nonetheless, total PRIs today remain relatively small: in 2010, foundations made roughly $46 billion in aggregate grants, had endowments totaling more than $600 billion, and made

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[2] *See* 26 C.F.R. 53.4942(a)-3.
[3] *See* 26 C.F.R. 53.4944-3(a).
[4] The proposed examples can be found at http://www.irs.gov/irb/2012-21_IRB/ar11.html.
[5] For a fuller discussion of the history of PRI regulation, see David A. Levitt and Robert A. Wexler, "Proposed Regulations Would Bring Program-Related Investments into the 21st Century," *Journal of Taxation*, August 2012 (100-114).
[6] *Id.*

PRIs of just over $615 million.[7] In order to determine the potential supply of, demand for, and social and financial returns of PRIs, more research is needed. Among other topics, it is important to understand how foundations might leverage other investments, made either for impact or for profit. However, this letter focuses on updating the legal and tax framework around PRIs, which has lagged behind its practice for the past four decades.

In the interviews conducted by the Tax Regulatory Project, we found that there are both legal and non-legal challenges to foundations making PRIs. This paper comments on the legal challenges. The non-legal challenges range from high transaction costs associated with sourcing and completing PRI deals, to cultural aversion to impact investing within some foundations. Foundations have traditionally maximized return on investment with one hand, and made grants with the other; combining those two functions presents cultural and human capital challenges to many foundations.

In the remainder of this letter, mentions of Tax Code Sections reference legal overviews of those Sections in the Appendix.

Uncertainty in applying proposed examples

Many people we interviewed expressed uncertainty about how to apply the PRI regulations, because the principles behind them remain unclear. The proposed examples are helpful in allowing practitioners to make analogies to their prospective PRIs. However, the lack of clear principles creates line-drawing problems with respect to the first two prongs of the PRI test (that the primary purpose of the investment is an exempt purpose, and that no significant purpose of the investment is the production of income). Further, the proposed examples each include many elements, leaving impact investors uncertain as to which are necessary.

Below are hypothetical examples motivated either in part or wholly from conversations that we had with practitioners, and are intended to exemplify several line-drawing problems.

The following hypothetical exemplifies difficulty in line drawing with respect to the first prong of the PRI test: That the primary purpose of the investment is an exempt purpose. Consider a foundation, P, whose grantee delivers vaccines and medical supplies to health providers serving poor individuals in sub-Saharan Africa. Based on research, P determines that the cost-effectiveness of providing medical supplies would be improved significantly if there were a useable port in an area where none existed. P makes a low interest loan to a

[7] Sources: Foundation Center; National Center for Charitable Statistics, Urban Institute. Also note that foundations may make other impact investments, called mission related investments (MRIs) in addition to PRIs, which are not tax advantaged.

developer of the port, and stipulates that the port service their grantee at a reduced rate. P might reason by analogy from Example 14 of the proposed examples to determine if their investment qualifies as a PRI. In so doing, they might conclude that the investment qualifies if the port is located in a high-poverty area and employs local residents. But what if the port does not end up servicing the poor, by and large? Aside from private benefit questions, which we address below, is this investment sufficiently closely tied to the foundation's mission to qualify as a PRI?

Generally speaking, how many steps removed from the target charitable activity can an investment be and still "significantly further the accomplishment of the private foundation's exempt activities?" Treasury Regulation 53.4944-3(a)(2)(i) requires that the investment "would not have been made but for the relationship between the investment and the accomplishment of the foundation's exempt activities." However, this requirement is difficult to translate into a practical test. Further, it blends into the line of questioning prompted by the second prong of the PRI test, that "no significant purpose of the investment is the production of income."

Similar line-drawing problems arise in the context of the second prong. Specifically, in trying to determine whether a significant purpose of the investment could be considered the production of income, foundations look to Treasury Regulation 53.4944-3(a)(2)(iii), stating that "it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation." However, questions remain about what constitutes below-market rates of return. Complicated deal structures and thin markets mean that it may be difficult to determine whether a for-profit investor would make the same deal at the same time as a foundation.

For example, consider a slight tweak of Example 12 of the proposed examples. In Example 12, private foundation Y entered into an agreement with business X on terms that had been accepted by initial investors but not by subsequent investors, because the expected rate of return was "significantly less than the acceptable rate of return on an investment of [that] type." What if X raised all of the capital it needed in its first round of fundraising from for-profit investors, and then in a later round, the foundation agreed to purchase common stock on terms less favorable than those given to the first round investors? Does X need to attempt and fail *again* to raise capital from for-profit investors at the same rates as those actually given to the foundation? Assuming that the investment risk is lower in the second round of funding than in the first – perhaps X had some proof of concept – how can X and Y prove that for-profit investors would not have wanted the deal that Y made?

Alternatively, consider a scenario in which a foundation would like to make a certain investment as a PRI, and there is a clear connection between the investment and the foundation's mission. Initially, it appears that the investment is risky, and that the rate of return is below-market. During the process of due diligence, however, the foundation and the investee are able to substantially mitigate some of the risks involved in the investment. What level of risk is required for the investment to qualify as a PRI under the second prong of the test? If the foundation were willing to invest in the deal out of its own endowment, would the investment be disqualified as a PRI at that point?

These examples highlight the need for additional conceptual clarity in defining the boundaries of a PRI. The problem is that charitability is a difficult concept to operationalize in a discrete rule. The PRI test in Section 4944 employs two kinds of tests in its two prongs: A substantive test (the charitability prong), and a benchmark (the below-market prong). However, the content of each prong makes them difficult to translate for everyday use. Here are other options for different rules that might, in combination, govern what qualifies as a PRI from the standpoint of a policymaker or practitioner:

- Substantive rules: The stated end goal of the foundation making the investment must be fewer than three steps removed from the direct effect of the investment itself. Therefore, if a foundation aims to distribute a vaccine in a developing country, but the infrastructure needs prevent them from doing efficient distribution, then investing in roads would be only one step removed from the end goal, and would qualify under this substantive rule. A second step removed might be an investment in a data analytics company that provides transparent reports on the use of tax revenues to prevent corruption. A third step might be an investment in a private radio broadcasting company. A substantive rule for the second prong of the current test could be that the charitability of the endeavor is not compromised by an effort to earn a financial return.

- Procedural rule: An investment might be said to satisfy the second prong of the PRI test if the recipient organization tries and fails to secure a loan or investors under terms that the foundation later accepts. Another procedural requirement might be that the foundation's own investment team would not make the investment in question with the foundation's endowment.

To be clear, we have not recommended that Treasury in fact adopt these rules. We include them here to demonstrate how PRIs might be regulated, to broaden the conversation among community members, as well as to provide possible internal policies that foundations may want to adopt in their own selection procedures.

Uncertainty around ancillary provisions

Aside from line-drawing questions related to the PRI regulations themselves, there are questions about tax regulations and principles that affect PRIs, but are unaddressed by the proposed examples. These ancillary provisions include private benefit and self-dealing rules, as well as expenditure responsibility rules.[8]

a) Self-dealing

One of the most common questions that we heard from practitioners was how self-dealing rules apply to their PRIs. Self-dealing regulations under Section 4941 pose potential challenges, for example, for high-net worth families who start foundations and have family investment offices that also aim to make socially driven investments. In cases where the family office and the foundation manage their money in a fund with the same money manager, the IRS has issued several private letter rulings (PLRs) suggesting that such co-investing does not run afoul of self-dealing regulations.[9] These PLRs rest on the idea that any disqualified persons vis-à-vis the foundation do not receive any substantial economic benefit as a result of the foundation's participation in the investment fund.

With PRIs, however, a problem might arise related to self-dealing if the co-investment strategy does in some way benefit the disqualified person. For example, if a foundation makes a below-market rate investment as a PRI, and market-rate co-investors earn a higher risk-adjusted return, what happens if a disqualified person is among the co-investors? How does the co-investing structure need to be set up in order to avoid self-dealing?

As far as we know, there is no guidance on how Section 4941 applies in the case of a PRI transaction. Because the practice of mission investing by foundations has increased in the past decade, and the mixture of investing for profit with pursuing a social mission presents novel circumstances, we argue that it is important to clarify the application of these rules.

In the case of a family foundation investing alongside a family office through a genuine PRI, the main concern from a policy standpoint is that the family office would earn outsize returns simply because the foundation made a subsidized investment as a PRI. One way to prevent such deals or prove charitable intention would be to require that other market-rate co-investors in a deal receive terms at least as good as those given to the family office. See, however, the policy concern related to private benefit, below.

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[8] *See* Appendix for legal overview of Section 4941; *see also* Notice of Proposed Rulemaking Examples of Program-Related Investments Preamble, referring to a list of Code Sections that "accord special tax treatment to PRIs."
[9] *See*, *e.g.* PLR 200420029 (Feb. 19, 2004)

b) Private benefit

The concept of private benefit is another source of trouble for foundations making PRIs. Indeed, PRIs very often generate some private benefit to third parties. For example, refer back to the hypothetical posed above about a foundation investing in a port. However, it is unclear what counts as non-incidental private benefit when a foundation invests in a for-profit company alongside investors for whom profit is their primary motive. Is the profit that accrues to the investee private benefit? What about the profits of a foundation's for-profit co-investors? What is the appropriate test for determining private benefit in this context? We are aware of at least one Private Letter Ruling (PLR) that addresses the issue of private benefit in the context of PRIs, but Treasury has not issued any precedential guidance in this area.

The question of whether private benefit is truly incidental – the foundation could not have achieved its exempt purpose without generating it – could be seen as a stronger version of the first prong of the PRI test, that the investment be related to the foundation's exempt purpose. That interpretation leaves open the possibility that certain PRIs could pass the tests in Section 4944 but still generate non-incidental private benefit.

We argue that Treasury should clarify the application of the incidental private benefit concept to PRIs, specifically, whether they will layer a private benefit test over the PRI test. There is a genuine policy concern with respect to private benefit that might accrue to co-investors with foundations that make PRIs. Specifically, the concern is that potential investees or market-rate co-investors seek out foundations to invest in or with them simply because the foundation subsidizes the investment. Treasury and foundations should take this concern seriously, and screen for investors who attempt to take advantage of the tax advantage given to PRIs.

c) Expenditure Responsibility

The application of expenditure responsibility rules to PRIs is also unclear, particularly with respect to equity investments. Treasury Regulations 53.4945-5(b)(4) require the repayment of any portion of a PRI that is used by the recipient organization for a purpose other than the one for which it was intended. Tracking and returning PRI funds is difficult in the context of a direct equity investment in a company, challenging the substantive interpretation of this rule. How should the foundation get repaid if the investee uses the funds in a way that violates the agreement?

One option that Treasury could consider is a requirement that a foundation and the investee agree ahead of time that the parties can use business judgment to specify a repayment plan if a PRI recipient acts in a way that violates a PRI agreement. That is, if a recipient organization moves in a direction that is not consistent with the social goals of the foundation, then the foundation would have an agreement to formulate some plan under which they would be repaid. This is less burdensome than a requirement to pre-specify an exit strategy, allowing for flexibility to accommodate the different and uncertain circumstances around a future exit.

d) Five percent distribution requirement

One of the concerns about PRIs among members of the academic and policy community is that foundations might be able to make their required distributions in the form of high-return PRIs in perpetuity. That is, there is a concern that the five percent distribution requirement could be eroded by PRIs. Based on current information, it is difficult to discern whether such a situation happens or might happen in practice. However, the principle behind this concern is valid: per the second prong of the PRI test, foundations should be making investments that traditional investors are unwilling to make; consistently high returns on PRIs might suggest otherwise. Thus, addressing concerns about distribution rules might serve as a backstop to the second prong of the test in Section 4944.

One way of addressing this concern might be to require that if a PRI portfolio generates returns that are a certain amount above a floating average market rate of return, those excess returns must be distributed as grants within a given number of years. It is unclear whether the administrative complexity and risk of undue burden on social investors inherent in such a rule would be warranted. Further research is needed to determine whether the current PRI regulations in fact allow for consistently above-market returns on PRI portfolios, and if so, whether and how the PRI test should address them.

Conclusion

This white paper highlights the uncertainty that remains among the impact investing community around how to apply the PRI regulations, even after the IRS proposed the recent updated examples. In order to understand how the IRS and Treasury should address some of this uncertainty, more research needs to be done. However, the IRS should clarify which elements of the proposed examples are necessary for an investment to qualify as a PRI. Further, the IRS could state certain procedures that foundations could undertake to ensure that their investments will qualify as PRIs. We also hope that this sparks future conversation within the impact investing community around foundations' understanding and internal processes for deciding whether investments can be made as PRIs. Uncertainty surrounding the PRI regulations alone should not stand as a barrier to foundations wishing to do impact investing. Further communication within the impact investing community and between the community and the IRS and Treasury will help to reduce that uncertainty.

Appendix: Explanation of Relevant Tax Code Sections

a) Program Related Investments

"Program Related Investment" (PRI) is a term created by the Tax Code under Section 4944 part (c) that applies to 501(c)(3) organizations classified as private foundations under Section 509. PRIs are excepted from excise taxes that apply to jeopardizing investments under part (a) of the same Section.[10] Additionally, PRIs are significant because they are included as a "qualifying distribution" under Section 4942 of the Code, which requires foundations to distribute five percent of their assets annually.[11] Under guidance published in 1972, the IRS outlined a three-pronged test that qualifies an investment as a PRI: The primary purpose of the investment is one of the exempt purposes of the foundation under Section 170(c)(2)(b); no significant purpose of the investment is the production of income or the appreciation of property; and, no purpose of the investment is supporting lobbying or electioneering.[12]

The regulations elaborated on this test by detailing certain criteria that would tend to indicate the fulfillment of each prong. The first prong is fulfilled "if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities."[13] For the second prong, "it is relevant whether investors who are engaged in the investment solely for the production of income would be likely to make the investment on the same terms as the private foundation."[14] Further, the 1972 regulations included nine examples of investments that qualified as PRIs, along with one example that did not. The investments in these examples could be characterized entirely as domestic urban development investments.

In April 2012, the Treasury Department released proposed additional examples of program-related investments to supplement and update the current regulations under Section 4944(c).[15] These examples responded to suggestions from practitioners, including 2010 comments from the ABA Section on Taxation. The ABA comments argue that the field of PRI-makers has grown and changed significantly since the initial PRI regulations were

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[10] Jeopardizing investments are those that jeopardize the long-term and short-term financial needs of the foundation, and if the managers failed to exercise ordinary business care and prudence. *See* 26 C.F.R. 53.4944-1(a)(2)(i). The IRS has identified categories of investments that trigger scrutiny or have been deemed jeopardizing, including unsecured loans and asset collateralizations.

[11] *See* 26 C.F.R. 53.4942(a)-3.

[12] *See* 26 C.F.R. 53.4944-3(a).

[13] *Id.*

[14] *Id.*

[15] Prop. Treas. Reg. 144267-11, 77 Fed. Reg. 23429 (April 19, 2012).

written.[16] Specifically, while the initial regulations dealt almost exclusively with low-interest loans by foundations to urban development and revitalization, the field has been making loans and equity investments in much more various organizations and charitable causes. The proposed updated examples focus on investments in activities conducted in a foreign country, investments in for-profit entities, and investments that potentially provide a high rate of return.[17] The nine proposed updated examples include details of both debt and equity investments that qualify as PRIs.

b) Self-Dealing and Private Benefit

Several other Sections of the tax code are implicated by PRIs. Internal Revenue Code Section 4941 imposes additional taxes on individuals who engage in self-dealing transactions, which are made between a private foundation and a disqualified person (one defined in Section 4946). Self-dealing transactions include:

A. Sale, exchange, or leasing of property,

B. Lending money or other extension of credit,

C. Furnishing of goods, services, or facilities,

D. Paying compensation or paying or reimbursing expenses to a disqualified person,

E. Transferring foundation income or assets to, or for the use by or benefit of, a disqualified person,

F. Certain agreements to make payments of money or property to government officials.[18]

The concept of private benefit is also a possible concern for PRI-makers. The prohibition on private benefit in tax-exempt organizations comes from Section 501(c)(3)(d)(1)(ii) of the tax code, which requires that a qualifying organization "establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests."

Additionally, the Tax Court defined the concept of incidental private benefit in American Campaign Academy v. Commissioner, as "non-incidental benefits conferred on

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[16] ABA Section of Taxation Comments, "Draft Examples of Program-Related Investments (For Addition to Treasury Regulations Section 53.4944-3(b)) and Analysis of Each," available at www.abanet.org/tax/pubpolicy/2002/020515pri.pdf.
[17] Prop. Treas. Reg. 144267-11, 77 Fed. Reg. 23429 (April 19, 2012), preamble.
[18] *See* IRS, "IRC 4941 – The Nature of Self-Dealing," EO CPE Text 1985. Available at: http://www.irs.gov/pub/irs-tege/eotopicq85.pdf.

disinterested persons that serve private interests."[19] The IRS Exempt Organizations group explains this definition, elaborating on each term. Incidental means "a mere byproduct of the public benefit" […] "it would be impossible for the [tax exempt] organization to accomplish its purposes without providing [private] benefits."[20] "Benefits" are not limited to a flow of funds; and "disinterested" means that the benefits can accrue to a private party who is not affiliated with the tax-exempt organization in any way.[21]

c) Expenditure Responsibility

IRC Section 4945 establishes accountability and reporting requirements on foundations making grants and PRIs through expenditure responsibility rules. Expenditure responsibility "means that the private foundation is responsible to exert all reasonable efforts and to establish adequate procedures—

(1) to see that the grant is spent solely for the purpose for which made,

(2) to obtain full and complete reports from the grantee on how the funds are spent, and

(3) to make full and detailed reports with respect to such expenditures to the [IRS] Secretary."[22]

Section 53.4945-5(b)(4) details the expenditure responsibility requirements specific to a foundation making a PRI. These include the repayment of any portion of the investment that is not used for the stated purpose; yearly financial reports from investees; maintenance of records by investees as is usually required by commercial investors; and prohibition of the use of PRI funds for political activity.[23]

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[19] *Am. Campaign Acad. v. Comm'r*, 92 T.C. 1053, 1066 (1989); *see also* Bruce R. Hopkins, "The Law of Tax-Exempt Organizations, 8th Ed." 2003, page 523; Andrew Megosh et al., "Private Benefit under IRC 501(c)(3)," 2001, IRS TEGE EO Topic H.
[20] Andrew Megosh et al., "Private Benefit under IRC 501(c)(3)," 2001, IRS TEGE EO Topic H. 137.
[21] *Id*.
[22] *See* 26 C.F.R. 4945(h)
[23] *See* Wexler, Robert A., "Expenditure Responsibility – A Primer and Ten Puzzling Problems," Adler & Colvin, September, 2010.