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Legal Explanation of Program Related Investments ("PRI Primer")

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This document describes the legal framework and requirements for program-related investments ("PRIs"). This document is intended as a general discussion to help educate advisors of small to mid-sized private foundations, including family and company foundations. It is not a legal opinion. It is not an endorsement of any particular program-related investment or investments.

PRIs in Context

Classically, a private foundation makes investments to increase or maintain the size of its corpus and to generate income so that it may make grants and otherwise engage in charitable programs and activities. Section 4944 of the Internal Revenue Code ("IRC") imposes an excise tax on private foundation investments that are deemed to "to jeopardize the carrying out of any of its exempt purposes." Both a private foundation and its directors and officers can potentially be subject to excise taxes for making imprudent investments.

PRIs are mission-driven investments that are not subject to the normal prudent investment standards for foundations and foundation boards of directors. For legal purposes, PRIs are considered to be more akin to grants, which can be made purely to further a charitable purpose, without regard to any return on investment. PRIs are not subject to the Section 4944 excise tax.

What is a PRI?

An investment must meet three requirements (each discussed in more detail below) to qualify as a PRI:

- The primary purpose of the investment must be to further one or more exempt purpose of the foundation. In large measure, this is a determination specific to each foundation, its mission and the proposed PRI.
- The production of income or the appreciation of property may not be a significant purpose of the investment.
- The PRI can not be used to fund electioneering or lobbying activity.

***1. Primary Exempt Purpose* Test.**

There are two parts to the primary exempt purpose test. First, the investment must *significantly further* the accomplishment of the foundation's exempt activities. Second, the investment must be such that it would not have been made *but for* its relationship to the foundation's exempt activities.[1]

a. Significantly further sub-test. To meet this test, the foundation must determine that the PRI is consistent with one or more purposes described in IRC Section 501(c)(3). In addition, if that foundation has purposes that are more limited than those described in Section 501(c)(3), then the foundation must also determine that the particular PRI is consistent with the specific purposes of the foundation. For example, if a foundation's stated purpose is to promote the arts, then, a PRI to

promote economic development in Africa might not be consistent with that foundation's exempt purposes, even though the PRI might be consistent under Section 501(c)(3) and might be permitted for another private foundation.A foundation will need to review its own Articles of Incorporation or Certificate of Incorporation, along with any other restrictions that may have been placed on its assets to determine whether a PRI is consistent with that foundation's mission.Foundations and their advisors are generally more comfortable making a PRI if there is some authority, either in the outdated PRI regulations or in a subsequent letter ruling or revenue ruling to support the type of PRI being made.

b. "But for" sub-test. Satisfaction of this sub-test requires that analysis of the purpose of the investment permits the conclusion that it would not have been made but for its contribution to the accomplishment of the exempt purposes of the foundation.

***2. No Significant Investment Purpose* Test.**

The single test here is whether *no significant purpose* of the investment is the production of income or the appreciation of property. The Regulations point out that the IRS will consider whether investors solely concerned with profit would be likely to make the investment on the same terms. However, the fact that an investment produces significant income or capital appreciation is not, in the absence of other factors, conclusive evidence that income or appreciation was a significant purpose of the investment,[2] and therefore does not preclude the investment from being a valid PRI.

The *no significant investment purpose* test is typically satisfied if a PRI is made in the form of a loan at below-market interest rates which are, by definition, unattractive to commercial lenders. Even a loan at market rates can pass muster if, for some other reason (such as high risk or inadequate security), the loan would not be made conventionally. Among the many private rulings issued by the IRS addressing this issue, acceptable annual interest rates for PRI loans have varied from 0 to 15%, usually below market but occasionally at market rates. Similarly, investment features designed to protect the investor's interest or secure repayment have ranged from none at all (a willingness to convert loans into grants) to a full set of conventional mortgages and guarantees.[3]

An investment in an entity having the dual purpose of both producing a return on investment and achieving a charitable purpose also may qualify as a PRI. In Private Letter Ruling 200136026, a private foundation proposed to invest in a for-profit corporation formed for the purpose of financing and promoting the expansion of environmentally-oriented businesses that would contribute to conservation and economic development in economically and/or environmentally sensitive areas. The corporation had dual goals of providing a rate of return for investors and demonstrating a clear environmental benefit through each investment. Only companies that met certain environmental guidelines were eligible for investment. The corporation also created an advisory committee, which included representatives of exempt public charities interested in preserving the environment, to scrutinize each investment. The foundation represented that the rate of return, taken by itself, would not compensate for the speculative nature of the investment and overall risk associated with the corporation's unique investment characteristics. The IRS determined that although the foundation expected a financial return, the investment was made directly to accomplish the foundation's charitable goals and thus qualified as a PRI.

Several other IRS private letter rulings have approved PRIs where non-charitable organizations were also investing on the same terms. In Private Letter Ruling 8710076, a $10 million limited partnership was established with a taxable general partner, and limited partnership interests were offered to a small group of private foundations and private individuals. The purpose of creating the limited partnership was to go beyond informational services, to provide financial support to actual enterprises seeking to demonstrate that privatization of human services is a viable concept. A private foundation's $600,000 investment in the partnership was approved by the IRS as a PRI.[4] PRI loans to for-profit limited partnerships are also a common mechanism for private foundations to support low-income housing and economic development in blighted areas.[5]

***3. No Political Purpose* Test.**

The Regulations set forth a requirement that *no purpose* of the PRI may be to attempt to influence legislation, or to participate or intervene in campaigns of candidates for public office.[6] There is an exception: the PRI recipient may appear before or communicate with a legislative body on a legislative matter of direct interest to the recipient, if the expense of doing so is deductible by the recipient under IRC Section 162.[7] However, the foundation must not earmark any PRI funds for use in such communications or appearances. The most common method of assuring compliance with this requirement is to obtain a statement from the recipient of the PRI funds pledging compliance with the IRS restriction on use of PRI funds for political purposes. Typically, one would find this statement in the PRI loan agreement, in the case of a loan or in the guarantee agreement, in the case of a guarantee. It can be more difficult to find this type of statement in an equity investment.

Other Considerations and Obligations

In fulfilling its responsibilities and obligations under the law, a foundation making a PRI must address the following:

1. Changes in PRIs.

The Regulations, at Section 53.4944□3(a)(3)(i), address the possibility that after a PRI has been made, the foundation and the recipient may find that changes in the terms of the investment are needed. If the changes, like the original investment, are made primarily to further the investment's exempt purposes and not significantly to improve the prospects for income or capital appreciation from the PRI, the IRS sees no problem. Otherwise, changes may affect the loan's qualification as a PRI. In that case, reliance on a legal opinion based on circumstances before the change would no longer protect the foundation or its directors.

If a change is made *for the prudent protection of the foundation's investment*, then it will not *ordinarily* cause the investment to lose PRI status. This brings the *prudent person* standard back into the picture, but from a different direction. Under IRC Section 4944, a foundation is penalized if the management falls below this standard in its conventional investing. For PRIs, however, the foundation is permitted to rise to the level of the *prudent person* standard to protect its investment.

A *critical change in circumstances*, such as where the PRI turns out to be serving illegal purposes or private purposes of the foundation or its managers, will cause the investment to cease to be program□related. A foundation will not be penalized, however, if it terminates the PRI within thirty days after it or its managers have actual knowledge of the critical change in circumstances.

2. Private Foundation Restrictions.

PRIs are affected by several other provisions of the IRC that govern private foundations generally.

Under IRC Section 4940, there is an annual 2% tax on a private foundation's net investment income. Where the terms of the loan provide for the payment of interest, the 2% tax will apply to PRI interest income just as it does to a foundation's other investment income. The tax also applies to capital gains.

A PRI is a *qualifying distribution* for purposes of the requirement that private foundations make certain mandatory annual distributions, found in IRC Section 4942. The foundation will need to plan for appropriate accounting of PRIs under this Section, both when investments are made and also when they are repaid.[8]

A PRI is not included in the calculation of excess business holdings for purposes of IRC Section 4943.[9]

Under IRC Sections 4942 and 4945, a foundation's administrative expenses incurred in connection with its PRIs receive favorable treatment. These expenditures are considered direct charitable expenditures not subject to penalty taxes.

If a private foundation makes a PRI to an organization that is not an exempt public charity, the foundation must exercise expenditure responsibility.[10]

[1] Treas. Regs. Section 53.4944-3(a)(2)(i).

[2] Treas. Regs. Section 53.4944-3(a)(2)(iii).

[3] *See, e.g.*, PLR 8141025 (approval of secured low-income housing loans at 3% interest, with 20-year terms); PLR 8030079 (approval of urban renewal loan at 7% interest, with a 10-year term); PLR 8301110 (approval of secured loan for hotel construction in blighted area, charging 15% annual interest over 25 years).

[4] *See also*, PLR 9016078 (purchase of a large equity interest in a holding company affiliated with a for-profit enterprise, to develop business in a depressed area) and PLR 8807048 (investment in construction of low-income housing, accomplished through limited partnerships with for-profit corporations).

[5] *See, e.g.*, PLRs 9112013, 8923070, 8923071 and 8637120.

[6] Treas. Regs. Section 53.4944-3(a)(1)(iii).

[7] Treas. Regs. Sections 53.4944-3(a)(2)(iv) and 53.4945-2(a)(4) thus allow a business organization to use PRI funds for direct lobbying in certain circumstances.

[8] A court decision involving a PRI made by the Charles Stewart Mott Foundation upheld strictly the IRS requirement for complete reporting of PRIs on Form 990-PF. *Charles Stewart Mott Foundation v. United States*, 938 F.2d 58 (6th Cir. 1991).

[9] Treas. Regs. Section 53.4943-10(b).

[10] That term refers to procedures that must be followed by the foundation before, at the time of, and after the making of the PRI, as follows: 1. Pre-grant Inquiry. The Regulations require private foundations to conduct the same kind of pre-grant inquiry for a PRI as for a grant to a non-charitable recipient. This is a limited inquiry, which must be complete enough to give a reasonable person assurance that the PRI will be used for the proper purposes. The inquiry should address the identity, prior history, and experience of the organization's managers, and consider any information the foundation has, or can readily obtain, concerning the management, activities, and practices of the recipient. 2. Written Contract. A foundation must enter into a written contract with the recipient of funds containing provisions specified in the Regulations. Therefore, every PRI made to a non-charity will require a separate agreement that meets this requirement. 3. IRS Reporting. The foundation must report each expenditure responsibility PRI to the IRS on Form 990-PF, in each year that it is outstanding, in a manner that satisfies the Regulations.