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Recent IRS Ruling Raises Questions Among Impact Investors: What It Really Means

If, like us, you spend significant time thinking about impact investing by 501(c)(3) organizations and parsing through non-binding IRS guidance trying to ascertain what works, you may have run into **Private Letter Ruling 202041009**. To fully understand the facts, it is worth a read.

This PLR has caused some concern in the impact investment community because, in it, the IRS denies the 501(c)(3) exemption application of an organization that proposed to operate an investment fund for various purposes that often qualify as charitable (e.g., economic development in low-income communities, activities combatting climate change). The applicant clearly thought these investments were sufficiently charitable such that operating an investment fund to attract private capital to support them should qualify as a charitable activity. After all, many charities engage in impact investing as a significant portion of their charitable activities.

Does this denial mean that the IRS is making it harder for impact investment to qualify as a charitable activity? Do charities need to start re-evaluating their structure and putting their investment fund activities in taxable subsidiaries? Is it the start of a larger initiative against impact investing? Is the sky falling?

Anything is possible, but, in my view, this PLR is less a call for pessimism, and more a reminder of two recurring themes when it comes to impact investing and exempt organizations:

1. From a tax law perspective: making program-related investments ("PRIs," defined below) is a charitable activity; but making mission-related investments ("MRIs," defined below) is not.
2. In the real world: impact investment firms and advisors sometimes resist this binary PRI/MRI classification, and instead prefer to emphasize BOTH the charitable impact AND the return. While that is good for attracting more impact investors to support good work, it can muddy the important distinction between a charitable activity (PRIs) and investment activity that is socially beneficial, but not charitable (MRIs). (Admittedly, there is no formal legal definition of an MRI — the best working definition may be "an investment that does not meet the definition of a PRI, but where impact on the investor's charitable mission is counted as a positive factor in evaluating whether the investment is prudent.")

To explain what I mean, remember that the requirements of a PRI (at least for a private

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foundation) include that the investment (a) significantly furthers a charitable purpose and (b) has *no significant* investment purpose. (The public charity definition for Form 990 reporting purposes is more flexible, but still effectively requires that the investment purposes be at most secondary.) In other words, a PRI needs to be more than just charitable; it also needs to be “imprudent” (or at least “not good enough”) from an investment perspective. It is okay if individual PRIs, in fact, result in significant return (e.g., a high-risk bet on a new technology with the potential for great charitable impact that the market would not support actually works out and pays off). However, the expected value of a PRI (i.e., the risk-adjusted return) generally needs to be clearly distinguishable from that of a return-seeking investment. In contrast, an MRI must always constitute a *prudent* investment under applicable law — while that law permits taking mission into account (and perhaps that means it is not the *most* profitable investment available), MRIs still generally need to be “good” investments.

In contrast, impact investment funds very often describe opportunities as being BOTH good investments and having a sufficiently charitable impact. Even if that is true in a (perhaps small) number of instances, the tax law forces us to choose: is it impact-first or return-first? Under the above definitions, once an investment fund is marketed as providing market returns to investors, it has effectively conceded that it is not making PRIs, and so not conducting a charitable activity. While that can be okay if it has other charitable activity and the investments fund that activity, MRIs do not work as a charity’s sole activity.

If you read the PLR keeping that in mind, it makes sense that the IRS denial focuses significantly on the facts that (a) as a registered investment advisor, the fund was set up to pursue market returns for investors, and (b) risk/return analysis was the first screen any investment must pass, suggesting a requirement for, and priority on, market-rate returns.

Using the above framework (though not the IRS’s own words, unfortunately), you can make sense of this PLR by reading it as the IRS interpreting these facts about market returns to mean that these were really “MRI Funds,” not “PRI Funds.” While you could argue about whether the IRS had sufficient facts to conclude that these were market-rate investments (I’m sure the applicant disagrees and the facts publicly available in the PLR are too limited to tell for sure), the logical conclusion following from that premise is at least sound: managing MRI Funds for the private sector is not a charitable activity and never has been.

If there is a lesson to take away from this PLR, it may be that charities, in thinking about their impact investment activity, must continue to be mindful of the PRI/MRI distinction, even if they prefer other terms. Both private foundations and public charities end up needing to classify PRIs on their tax return (and there are additional important consequences for private foundations). And if impact investment is the primary activity of an organization, then, as this PLR illustrates, that organization’s exempt-status rests on knowing the difference between charitable and non-charitable investment activity.

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