Proposed Regulations Would Bring Program-Related Investments Into the 21st Century

By David A. Levitt and Robert A. Wexler

After decades in which the existing Regulations remained unchanged, Treasury and the IRS have responded to suggestions by the tax and private foundation communities and have issued updated guidance for special types of investments that are related to a foundation's purpose. While not every suggestion was adopted and while some questions remain unanswered, the overall impact of the new Proposed Regulations should be favorable.

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"The Treasury Department and the IRS are aware that the private foundation community would find it helpful if the regulations could include additional PRI examples that reflect current investment practices and illustrate certain principles...."[1] After prompting from the private foundation community and the ABA Tax Section, among others, Treasury and the IRS published a very thoughtful and well-crafted set of nine new modern-day examples of program-related investments (PRIs) that satisfy the tests of Section 4944. These new examples, in the form of Proposed Regulations (REG-144267-11, 4/19/12) as well as the statements of principle articulated in the Preamble, are welcome as much for their specific findings as for the signal that they send to private foundations that IRS does indeed consider PRIs to be a valid tool for private foundation charitable activity.

Currently there are probably less than 100 attorneys in the U.S. who are truly comfortable advising private foundation clients on complex PRIs, and there are probably even a fewer number of private foundations that are comfortable in making complex PRIs. We write this article, in part, to encourage private foundations and their attorneys to consider PRIs as an excellent alternative to grant-making where the circumstances warrant. PRIs provide a great way to expand a foundation's work while potentially recycling dollars and increasing the pool of funds available for future grants or investments. It is our hope that these new Proposed Regulations will encourage more PRI activity.

BACKGROUND

The PRI rules are applicable technically only to Section 501(c)(3) organizations that are characterized as private foundations under Section 509 and therefore are potentially subject to the excise taxes set forth in Sections 4940 through 4946. PRIs are an exception to the Section 4944 excise tax on jeopardizing investments. Section 4944(c), which defines PRIs, has not changed since it was first enacted as part of TRA '69. The PRI Regulations, which were promulgated in 1972,[2] have not been amended or supplemented until now. Virtually all of the guidance since the 1972 Regulations has been in the form of nonprecedential private letter rulings.

Prior to 1969, Congress had made only limited distinctions between private foundations and public charities under Section 501(c)(3) and its predecessors.[3] Indeed, all charitable organizations generally were treated the same until the Revenue Act of 1943, when Congress provided for the first time that certain exempt organizations were re-

quired to file annual information returns.[4] Private foundations were not defined, per se, in 1943, but because they are not religious organizations, schools, fraternal organizations, government entities, or publicly supported charitable organizations, they were required, after 1943, to file annual information returns.

The Revenue Act of 1950 extended the preference for publicly supported charities over organizations that generally were referred to as private foundations.[5] At this point there was still no definition of private foundation, but the 1950 legislation added loss of exemption as a possible penalty for, among other actions, investment of income in a manner that jeopardizes the achievement of exempt purposes.[6]

The 1954 Code first articulated a distinction, for purposes of the charitable contribution deduction, between public charities and private foundations. Before 1954, the percentage-of-AGI ceiling on total contributions to Section 501(c)(3) entities that was deductible was 20%. In 1954, Congress increased the percentage limitation to 30%, but the increase was available only for contributions to religious, educational, or certain hospital organizations.

Congress again expanded the preference in the Revenue Act of 1964, by extending the 30%-of-AGI limitation to organizations that were publicly or governmentally supported. The legislative history of the 1964 Act suggests that Congress viewed privately funded charities as being less worthy of tax benefits.[7]

During the 1950s and 1960s, Congress also commissioned several reports on the conduct and behavior of private foundations.[8] Ultimately, the private foundation provisions of TRA '69 were enacted in light of the findings of all of these reports, particularly the various reports from the 1960s. Most of the key changes focused on anti-self-dealing provisions, mandatory payouts, and prohibitions on excess business holdings.

For some private foundations, PRIs can be an excellent alternative to grant-making where the circumstances warrant.

Prior to 1969, a private foundation could potentially lose its tax-exempt status if its accumulated income was invested in a manner that jeopardized the carrying out of its charitable purposes. Nevertheless, there was no rule limiting or restricting the investment of principal. Based largely on a few perceived problem foundations, Congress determined that investments of principal that jeopardize exempt purposes may reduce benefits to charity just as much as jeopardizing investments of accumulated income. There is virtually no discussion in the legislative history, however, on the PRI exception.

Where did the PRI exception come from? During the 1960s, and perhaps earlier, large private foundations, particularly the Ford Foundation, were already making PRIs in the form of below-market loans to businesses in deteriorating urban communities. It is generally accepted by seasoned tax practitioners that the Ford Foundation's activities in this area became the basis for the PRI exception in Section 4944 and indeed for the specific examples set forth in the 1972 Regulations.

Between 1972 and 2002, what worked and did not work as a PRI was largely determined by a couple of dozen private letter rulings and by the willingness of private foundations to make below-market loans and less-than-attractive equity investments, based largely on the advice or legal opinions of counsel. In 2002, sensing the frustration of the private foundation community in not having updated formal guidance, David Chernoff of the John D. and Catherine T. MacArthur Foundation led the efforts of the ABA Tax Section to ask Treasury to update the Regulations to contain more modern examples of PRIs.[9]

In 2009-2010, Treasury and the IRS included on their combined work plan a project to update the PRI Regulations.[10] In response, in 2010 the ABA Tax Section decided to re-work its 2002 submission and

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1 Preamble to REG-144267-11, 4/19/12.

2 Reg. 53.4944-3; TD 7240, 12/28/72.

3 For an excellent summary of the history of private foundation legislation, see Staff of the Joint Committee on Taxation, *Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations* (JCX-29-05, 4/19/05), page 85 *et seq.* ("2005 JCT Report").

4 *Id.*, page 85, citing P.L. 78-235 (2/25/44), section 117(a).

5 *Id.*, citing P.L. 81-814 (9/23/50), section 331.

6 *Id.*, page 86.

7 *Id.*, citing H. Rep't No. 749, 88th Cong. 1st Sess. 53 (1964).

8 The reports from these various committees are fascinating, but beyond the scope of this Article. See the discussion in the 2005 JCT Report, *supra* note 3, pages 87-89, describing the following hearings. The Cox Committee held hearings in November and December of 1952 and reported on January 1, 1953. See *Tax-Exempt Foundations: Hearings before the House Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations,* 82d Cong., 2d Sess. (1952); H. Rep't No. 2514, 82d Cong., 2d Sess. (1953). The Reece Committee conducted hearings in 1954 and issued a report on 12/16/54. See *Tax Exempt Foundations: Hearings before the House Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations,* 83d Cong., 2d Sess., on H. Res. 217 (1954); H. Rep't No. 2681, 83d Cong., 2d Sess. (1954). Various reports were issued beginning in the 1960s by Congressman Wright Patman: *Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy,* Report to the House Select Committee on Small Business, First Installment, 87th Cong. 2d Sess. (1962); Second Installment, 88th Cong. 1st Sess. (1963); Third Installment, 88th Cong. 2d Sess. (1964); Fourth Installment, 89th Cong., 2d Sess. (1966); Fifth Installment, 90th Cong., 1st Sess., (1967); Sixth Installment, 90th Cong., 2d Sess. (1968); Seventh Installment, 91st Cong., 1st Sess. (1969); Eighth Installment, 92d Cong., 2d Sess. (1972). Finally, see the *Treasury Department Report on Private Foundations,* Senate Finance Committee, 89th Cong., 1st Sess. (2/2/65), pages 2, 5, and 13-14.

9 See ABA Section of Taxation Comments, "Draft Examples of Program-Related Investments (For Addition to Treasury Reg. Sec. 53.4944-3(b)) and Analysis of Each," available at www.abanet.org/tax/pubpolicy/2002/020515pri.pdf.

10 See Treasury Office of Tax Policy and Internal Revenue Service 2009-2010 Priority Guidance Plan (11/24/09) (for "Exempt Organizations," item 6, "Guidance under Section 4944 on program-related investments").

proposed an even more updated set of examples.[11] The authors, who were part of the ABA Task Force that drafted the comments, believe that the ABA comments were a catalyst for the Proposed Regulations and have compared in great detail the Proposed Regulations to the ABA request. Nevertheless, what matters most, and what we have focused on here, is what the Proposed Regulations actually offer.

THE LAW

A private foundation is subject to an excise tax under Section 4944(a) if it makes an investment that jeopardizes the carrying out of any of the private foundation's exempt purposes. Section 4944(a) also imposes an excise tax on foundation managers who knowingly participate in the making of a jeopardizing investment. Section 4944(b) imposes additional excise taxes on private foundations and foundation managers when investments are not timely removed from jeopardy.

Generally, under Reg. 53.4944-1(a)(2), a jeopardizing investment occurs when, based on the facts and circumstances at the time the investment is made, foundation managers fail to exercise ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation. The determination of whether an investment is a jeopardizing investment is made on an investment-by-investment basis, taking into account the private foundation's entire portfolio. In exercising the requisite standard of care and prudence, foundation managers may take into account the expected investment return, price volatility, and the need for portfolio diversification.

Section 4944(c) excepts PRIs from the definition of a jeopardizing investment, and therefore, from the excise tax. Simply put, a PRI, by statute, is not a jeopardizing investment. 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 purposes 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 cannot be used to fund electioneering or lobbying activity.

Primary Exempt Purpose Test

There are two parts to the primary exempt purpose test:

1. The investment must *significantly further* the accomplishment of the foundation's exempt activities.
2. The investment must be such that it would not have been made *but for* its relationship to the foundation's exempt activities.[12]

Significantly further sub-test. To meet this test, the foundation must determine that the PRI is consistent with one or more purposes described in 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 also must 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.

But for sub-test. Satisfaction of this 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.

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. Nevertheless, 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,[13] 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 that, by definition, are 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.

It is generally accepted that the Ford Foundation's activities became the basis for the PRI exception and the specific examples set forth in the 1972 Regulations.

Among the Service's many private rulings addressing this issue, acceptable annual interest rates for PRI loans have varied from zero to 15%, usually below market but occasionally at market rates. Similarly, investment features designed to protect

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11 See meetings.abanet.org/webupload/commupload/TX319000/relatedresources/Comments_Concerning_Proposed_Additional_Examples_on_Program_Related_Investments.pdf.

12 Reg. 53.4944-3(a)(2)(i).

13 Reg. 53.4944-3(a)(2)(iii).

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.[14]

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 Ltr. Rul. 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 letter rulings have approved PRIs where noncharitable organizations also were investing on the same terms. In Ltr. Rul. 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 was a viable concept. A private foundation's $600,000 investment in the partnership was approved by the IRS as a PRI.[15] 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.[16]

No Political Purpose Test

Reg. 53.4944-3(a)(1)(iii) sets 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. 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 Section 162.[17] The foundation, however, 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 Rules

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

Under 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.[18]

A PRI is normally a qualifying distribution for purposes of the Section 4942 requirement that private foundations make certain mandatory annual distributions. 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.[19]

A PRI is not included in the calculation of excess business holdings for purposes of Section 4943.[20]

Under 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 under Section 4945. Expenditure responsibility is a due-diligence and reporting requirement that has the following components, normally applicable to grants, but also applicable to PRIs:

1. *Pre-grant or pre-PRI inquiry* (Reg. 53.4945-5(b)(2)). The legal standard is "a limited inquiry concerning the potential grantee ... complete enough to give a reasonable man [sic] assurance that the grantee will use the grant [or PRI] for the proper purposes." It should cover the "identity, prior history and experi-

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

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

16 See, e.g., Ltr. Ruls. 9112013, 8923070, and 8923071.

17 Regs. 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.

18 Section 4940(c).

19 Charles Stewart Mott Foundation, 938 F.2d 58, 68 AFTR2d 91-5131 (CA-6, 1991) (upholding the IRS requirement for complete reporting of PRIs on Form 990-PF).

20 Reg. 53.4943-10(b).

ence (if any)" of the grantee or investee and its managers, and "knowledge which the private foundation has," or information that is "readily available" about the "management, activities, and practices" of the potential grantee/investee. The scope of the inquiry will vary with the size and purpose of the grant or investment, the payment period, and prior experience with the grantee/investee.

2. *Written grant agreement* (Reg. 53.4945-5(b)(3)). For grants, expenditure responsibility requires that a grant to an organization that has noncharitable activities be limited to use for charitable purposes only. The written grant agreement must require the grantee (a) to use the grant only for the purposes specified in the agreement, (b) to repay to the grantor any funds not so used, (c) to refrain from a list of prohibited activities, (d) to make reports on the use of grant funds to the grantor, and (e) to maintain appropriate documentation of expenditures and make books and records available to the grantor's inspection. Normally, these same elements would be included in a PRI loan agreement, equity agreement, or other agreement.

3. *Grantee reporting* (Reg. 53.4945-5(c)). In general, the reports required of an expenditure responsibility grantee must cover how grant funds were used (including salaries, travel, and supplies), compliance with the grant agreement, and the grantee's progress towards grant purposes. The first report is due within a reasonable period after the close of the grantee's fiscal year in which grant funds were first received, then reports are required annually until the grant is spent in full or terminated. The final report must cover expenditures over the life of the grant. PRIs also require reporting, although the parameters may be different depending on whether the PRI is in the form of a loan, equity investment, or otherwise.

4. *Reporting to the IRS* (Reg. 53.4945-5(d)). Each expenditure responsibility grant or PRI must be reported on the grantor's Form 990-PF annual tax return as long as grant or investment remains outstanding.[21]

5. *Strict compliance and documentation.* Exercising expenditure responsibility is not particularly difficult. Many foundations comply in substance with most of the expenditure responsibility rules as standard operating procedure even in their grantmaking to public charities. Where expenditure responsibility is obligatory, however, it must be followed strictly. For example, in *Hans S. Mannheimer Charitable Trust*, 93 TC 35 (1989), the Tax Court held that the trust had made a taxable expenditure even though the required level of grantee oversight had occurred, because it had not been properly documented. Similarly, improper reporting to the IRS could cause an otherwise proper expenditure responsibility grant to be treated as a taxable expenditure.

6. *Diversions by the grantee/investee* (Reg. 53.4945-5(e)(1)). If a private foundation discovers that a PRI is not being used properly, the foundation must take all reasonable and appropriate steps (including legal action in some circumstances) to recover the diverted funds or ensure their restoration.

Failing to conduct a proper pre-grant or PRI inquiry, failing to use a proper written agreement, or failing to report properly to the IRS, in connection with a grant or PRI for which the law requires expenditure responsibility, will cause the grant to be a taxable expenditure, subjecting the foundation to penalties under Section 4945, regardless of whether the PRI is otherwise proper.

THE 1972 REGULATIONS

The PRI Regulations adopted in 1972 were designed to provide some real-life examples of what large private foundations were doing at the time. For the most part, foundations were making loans rather than equity investments, they were making these loans domestically, and the loans were made in deteriorating urban communities. Consider some of the favorable fact patterns from the examples in Reg. 53.4944-3(b) (also see the table in Exhibit 1).

Examples 1 and 2. X is a small business enterprise located in a deteriorated urban area, and which is owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose for making the loan is to encourage the economic development of such minority groups.

Example 3. X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling to provide funds to X at reasonable interest rates unless it increases the amount of its equity capital. Consequently, Y, a private foundation, purchases shares of X's common stock. Y's primary purpose in purchasing the stock is to encourage the economic development of such minority group, and no significant purpose involves the production of income or the appreciation of property.

Example 4. X is a business enterprise that is not owned by low-income persons or minority group members, but the continued operation of X is important to the economic well-being of a deteriorated urban area because X employs a substantial number of low-income persons from such area. Conventional sources of funds are unwilling or unable to provide funds to X at reasonable interest rates. Y, a private foundation, makes a loan to X at an interest rate below the market rate for commercial loans of comparable risk. The loan is made pursuant to a program run by Y to assist low-income persons by providing increased economic opportunities and to prevent community deterioration.

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21 See note 19, *supra*.

EXHIBIT 1
Reg. 53.4944-3(b)

PRI Example	Type of Investment	Recipient	Charitable Purpose	Other Funds Available?	Other
1	Loan (below market rate)	Small business enterprise • In deteriorated urban area • Owned by underserved minority group	Economic development of minority group	No	May earn income equal or higher than earnings from conventional investment
2	Extension of due date of loan in Example 1	Same as Example 1	Same as Example 1	No	Extension permits enterprise to achieve greater financial stability
3	Purchase of common stock	Same as Example 1	Same as Example 1	No	PF may realize a profit if company is successful and stock appreciates
4	Loan (below market rate)	Business enterprise important to deteriorated urban area because it employs low-income residents	Assist low-income persons by providing increased economic opportunities and prevent community deterioration	No	—
5	Loan (below market rate)	Business enterprise • Financially secure • Stock listed on national exchange	Induce recipient to establish a new plant in deteriorated urban area: enhance economic development, provide employment for low-income persons	Does not say	Qualifies as PRI even though recipient is large and established
6	Loan (below market rate)	Business enterprise owned by nonprofit community develop ment corporation	Encourage economic redevelopment of depressed areas	Financial institutions will lend if PF makes the loan (PF to lend at a lower rate)	Provide marketing outlet for low-income farmers in depressed rural area.
7	Purchase of common stock	Corporation	Dividends from investment are later applied in furtherance of PF's exempt purpose	Does not say	Not a PRI—no relationship between investment per se and charitable purpose
8	PF owns all voting stock	Business corporation	Does not say	Does not say	Various changes in stock form or terms of existing PRI for the prudent protection of the investment; PRI status retained in each case
9	Interest-free loan	Socially and economically disadvantaged individual	Enable recipient to attend college	Does not say	—
10	Loan insured by FHA	Does not say	Low-income housing	Does not say	High risk investment in low income housing

Example 5. X is a business enterprise that is financially secure, the stock of which is listed and traded on a national exchange. Y, a private foundation, makes a loan to X at an interest rate below the market rate in order to induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. The loan is made pursuant to a program run by Y to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant, and no significant purpose involves the production of income or the appreciation of property.

Simply put, a PRI, by statute, is not a jeopardizing investment. An investment must meet three requirements to qualify.

Example 6. X is a business enterprise owned by a nonprofit community development corporation. When fully operational, X will market agricultural products, thereby providing a marketing outlet for low-income farmers in a depressed rural area. Y, a private foundation, makes a loan to X bearing interest at a rate less than the rate charged by financial institutions that have agreed to lend funds to X if Y makes the loan. The loan is made pursuant to a program run by Y to encourage economic redevelopment of depressed areas, and no significant purpose involves the production of income or the appreciation of property.

Example 9. X is a socially and economically disadvantaged individual. Y, a private foundation, makes an interest-free loan to X for the primary purpose of enabling X to attend college.

Example 10. Y, a private foundation, makes a high-risk investment in low-income housing, the indebtedness with respect to which is insured by the Federal Housing Administration. Y's primary purpose in making the investment is to finance the purchase, rehabilitation, and construction of housing for low-income persons.

Request for expansion. The ABA request for guidance sought to retain the existing examples and add 17 others. The significant principles addressed by the ABA examples were:

1. If an activity is charitable when conducted in the U.S., it is likewise charitable if conducted in a foreign country.
2. Efforts to preserve and protect the natural environment and endangered species serve a charitable purpose.
3. Raising the living standards of needy families in underdeveloped or developing countries serves a charitable purpose.
4. The recipients of loans and working capital need not themselves qualify for charitable assistance because they are "merely the instruments" by which the charitable purposes are served.
5. The presence of a seemingly high projected rate of return should not, alone, prevent an investment from qualifying as a PRI because determination of the significant purposes for an investment requires an analysis that takes into account all of the objective facts and circumstances of an investment, including evidence of the motive behind the investment, and the potential production of income or property appreciation is merely a factor in the analysis.
6. PRIs may be properly accomplished by or through loans to individuals, tax-exempt organizations, or for-profit domestic or foreign organizations, as well as by or through equity investments in for-profit domestic or foreign organizations, including LLCs.
7. Providing credit enhancement, whether in the form of a guarantee, letter of credit, or otherwise, for a borrowing by a third party that accomplishes a charitable purpose may qualify as a PRI.
8. The existence of an "equity kicker" as part of the overall return does not prevent an investment from qualifying as a PRI.

THE PROPOSED REGULATIONS

The Preamble to REG-144267-11 is a significant statement of the Treasury's and Service's interest in making private foundations feel more comfortable engaging in PRIs. Consider the partial quote at the beginning of this article, which is directly from the Preamble.

After summarizing the PRI rules, the Preamble notes that the Proposed Regulations are being issued because "[t]he existing examples focus on domestic situations principally involving economically disadvantaged individuals and deteriorated urban areas.

"The Treasury Department and the IRS are aware that the private foundation community would find it helpful if the regulations could include additional PRI examples that reflect current investment practices and illustrate certain principles, including that: (1) an activity conducted in a foreign country furthers a charitable purpose if the same activity would further a charitable purpose if conducted in the United States; (2) the charitable purposes served by a PRI are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas; (3) the recipients of PRIs need not be within a charitable class if they are the instruments for furthering a charitable purpose; (4) a potentially high rate of return does not automatically prevent an investment from qualifying as program-related; (5) PRIs can be achieved through a variety of investments, including loans to individuals, tax-exempt organizations and for-profit organizations, and equity investments in for-profit organizations; (6) a credit enhancement arrangement may qualify as a PRI; and (7) a private foundation's acceptance of an equity position in conjunction with making a loan does

not necessarily prevent the investment from qualifying as a PRI."

All nine new examples in Prop. Reg. 53.4944-3(b), numbered 11 through 19, demonstrate favorable fact patterns. The conclusion, in each example, is that the investment qualifies as a PRI (also see the table in Exhibit 2).

Example 11. X is a business enterprise that researches and develops new drugs. X's research demonstrates that a vaccine can be developed within ten years to prevent a disease that predominantly affects poor individuals in developing countries. Nevertheless, neither X nor other commercial enterprises like X will devote their resources to develop the vaccine because the potential return on investment is significantly less than required by X or other commercial enterprises to undertake a project to develop new drugs.

Y, a private foundation, enters into an investment agreement with X in order to induce X to develop the vaccine. Pursuant to the investment agreement, Y purchases shares of the common stock of S, a subsidiary corporation that X establishes to research and develop the vaccine. The agreement requires S to distribute the vaccine to poor individuals in developing countries at a price that is affordable for the affected population.

The agreement also requires S to publish the research results, disclosing substantially all information about the results that would be useful to the interested public. S agrees that the publication of its research results will be made as promptly after the completion of the research as is reasonably possible without jeopardizing S's right to secure patents necessary to protect its ownership or control of the results of the research. The expected rate of return on Y's investment in S is less than the expected market rate of return for an investment of similar risk.

Example 12. Q, a developing country, produces a substantial amount of recyclable solid waste materials that are currently disposed of in landfills and by incineration, contributing significantly to environmental deterioration in Q. X is a new business enterprise located in Q. X's only activity will be collecting recyclable solid waste materials in Q and delivering those materials to recycling centers that are inaccessible to a majority of the population. If successful, the recycling collection business would prevent pollution in Q caused by the usual disposition of solid waste materials.

X has obtained funding from only a few commercial investors who are concerned about the environmental impact of solid waste disposal. Although X made substantial efforts to procure additional funding, X has not been able to obtain sufficient funding because the expected rate of return is significantly less than the acceptable rate of return on an investment of this type. Because X has been unable to attract additional investors on the same terms as the initial investors, Y, a private foundation, enters into an investment agreement with X to purchase shares of X's common stock on the same terms as X's initial investors. Although there is a high risk associated with the investment in X, there is also the potential for a high rate of return if X is successful in the recycling business in Q.

Example 13. The facts are the same as in Example 12, except that X offers Y shares of X's common stock in order to induce Y to make a below-market rate loan to X. X previously made the same offer to a number of commercial investors. These investors were unwilling to provide loans to X on such terms because the expected return on the combined package of stock and debt was below the expected market return for such an investment based on the level of risk involved, and they were also unwilling to provide loans on other terms X considers economically feasible.

Y accepts the stock and makes the loan on the same terms that X offered to the commercial investors. Y plans to liquidate its stock in X as soon as the recycling collection business in Q is profitable or it is established that the business will never become profitable.

Example 14. X is a business enterprise located in V, a rural area in state Z. X employs a large number of poor individuals in V. A natural disaster occurs in V, causing significant damage to the area. The business operations of X are harmed because of damage to X's equipment and buildings. X has insufficient funds to continue its business operations and conventional sources of funds are unwilling or unable to provide loans to X on terms it considers economically feasible. In order to enable X to continue its business operations, Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose in making the loan is to provide relief to the poor and distressed.

Example 15. A natural disaster occurs in W, a developing country, causing significant damage to W's infrastructure. Y, a private foundation, makes loans bearing interest below the market rate for commercial loans of comparable risk to H and K, poor individuals who live in W, to enable each of them to start a small business. H will open a roadside fruit stand. K will start a weaving business. Conventional sources of funds were unwilling or unable to provide loans to H or K on terms they consider economically feasible.

Example 16. X is an LLC treated as a partnership for federal income tax purposes. X purchases coffee from poor farmers residing in a developing country, either directly or through farmer-owned cooperatives. To fund the provision of efficient water management, crop cultivation, pest management, and farm management training to the poor farmers by X, Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. The loan agreement requires X to use the proceeds from the loan to provide the training to the poor

EXHIBIT 2
Prop. Reg. 53.4944-3(b)

PRI Example	Type of Investment	Recipient	Charitable Purpose	Other Funds Available?	Other
11	Purchase of common stock	Subsidiary of business enterprise that researches and develops new drugs	Advance science; recipient must (1) distribute vaccine to poor in developing countries at affordable price and (2) publish research results	No (businesses will not dedicate resources to develop drug because return is too low)	Below market rate of return for an investment of similar risk
12	Purchase of common stock	New business enterprise in developing country that collects recyclable solid waste materials in that country and delivers it to generally inaccessible recycling centers	Combat environmental deterioration by preventing pollution caused by waste materials	No (a few initial commercial investors but no additional funding on same terms)	PF invests on same terms as initial investors; high risk but potential for high rate of return
13	Loan in return for stock	Same as Example 12	Same as Example 12	No (same terms declined by "a number of" commercial investors)	PF to liquidate stock when recycling business is profitable or establishes that business will never be profitable
14	Loan (below market rate)	Business enterprise in a rural state where natural disaster occurs	Relief of poor and distressed; business employs many poor people and was damaged in natural disaster	No	—
15	Loan (below market rate)	Poor individuals in a developing country where natural disaster occurs, to enable them to open small businesses	Relief of poor and distressed	No	—
16	Loan (below market rate)	LLC that purchases coffee from poor farmers in developing country	Fund the provision of efficient water and farm management; training to poor farmers	Does not say	Recipient must use loan proceeds to provide training
17	Loan (below market rate)	501(c)(4) nonprofit organization	Encourage interest in the arts; conduct weekly community art exhibits	No	Loan to fund the purchase of large exhibition space
18	Bank deposit; bank lends same amount to recipient (interest earned on bank deposit below market)	501(c)(3) organization; child care services under 501(k)	Child care services in low-income neighborhood	No (because lacks sufficient credit)	Must use loan proceeds to construct new child care facility
19	Guarantee	Same as Example 18	Same as Example 18	Bank unwilling to make loan without guarantee	Same as Example 18

farmers. X would not provide such training to the poor farmers absent the loan.

Example 17. X is a social welfare organization that is recognized as an organization described in Section 501(c)(4). X was formed to develop and encourage interest in painting, sculpture, and other art forms by, among other things, conducting weekly community art exhibits. X needs to purchase a large exhibition space to accommodate the demand for exhibition space within the community. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X at an interest rate below the market rate for commercial loans of comparable risk to fund the purchase of the new space.

Example 18. X is a nonprofit corporation that provides child-care services in a low-income neighborhood, enabling many residents of the neighborhood to be gainfully employed. X meets the requirements of Section 501(k) and is recognized as an organization described in Section 501(c)(3). X's current child-care facility has reached capacity and has a long waiting list. X has determined that the demand for its services warrants the construction of a new child-care facility in the same neighborhood. X is unable to obtain a loan from conventional sources of funds (including B, a commercial bank), because X lacks sufficient credit to support the financing of a new facility.

Pursuant to a deposit agreement, Y, a private foundation, deposits $h in B, and B lends an identical amount to X to construct the new child-care facility. The deposit agreement requires Y to keep $h on deposit with B during the term of X's loan and provides that if X defaults on the loan, B may deduct the amount of the default from the deposit. To facilitate B's access to the funds in the event of default, the agreement requires that the funds be invested in instruments that allow B to access them readily. The deposit agreement also provides that Y will earn interest at a rate of t% on the deposit. The t% rate is substantially less than Y could otherwise earn on this sum of money, if Y invested it elsewhere. The loan agreement between B and X requires X to use the proceeds from the loan to construct the new child-care facility.

Example 19. The facts are the same as in Example 18, except that instead of making a deposit of $h into B, Y enters into a guarantee agreement with B. The guarantee agreement provides that if X defaults on the loan, Y will repay the balance due on the loan to B. B was unwilling to make the loan to X in the absence of Y's guarantee. X must use the proceeds from the loan to construct the new child-care facility. At the same time, X and Y enter into a reimbursement agreement whereby X agrees to reimburse Y for any and all amounts paid to B under the guarantee agreement. The signed guarantee and reimbursement agreements together constitute a "guarantee and reimbursement arrangement."

ANALYSIS

The nine examples in the Proposed Regulations reflect not only a more contemporary view of PRIs but also a much wider variety. The examples in the current Regulations are limited largely to aiding minorities in deteriorated urban areas, and seven of the ten examples involve below-market loans. As summarized in the principles set forth in the Preamble, the Proposed Regulations are not limited to this purpose. In addition, the types of investments are more varied, including loans, acquisitions of stock, a combination of the two, linked deposits, and a guarantee. The investment recipients are similarly varied, including both domestic and foreign organizations as well as individuals.

Many exempt organization topics require further guidance from the Service, and draft Regulations must go through a long process before being proposed. That PRIs were enough of a priority to reach this stage suggests that Treasury and the IRS not only condone PRIs but wish to encourage their use. Also noteworthy is that each new example supports an expansive view of permissible PRIs, while no example identifies a possible abuse of or failure to qualify as a PRI. At this point, the news about PRIs is very positive.

The proposed examples reflect investments that the Service already has recognized qualify as PRIs in private letter rulings issued to specific foundations, and so in one sense do not break new ground. Letter rulings are not binding on other foundations, however, and also are not easily retrieved without research. Consolidating these examples in the Regulations, as opposed to scattered, nonprecedential private rulings, should help facilitate PRIs by reducing uncertainty in the field and providing a greater number of foundations and their advisors with information regarding the different investment possibilities. The Proposed Regulations should provide comfort that many types of investments are viewed by the Service as legitimate PRIs.

Certain general misconceptions regarding PRIs tend to persist—that a PRI means a below-market loan or that an investment will not qualify if it produces a high rate of return. If the proposed examples catch the attention of enough foundations and their advisors, they should help dispel these myths.

As to what can (and cannot) be found in the Proposed Regulations, let us revisit each prong of the PRI test described above and consider what the new examples contribute.

Primary Charitable Purpose

The first prong, or primary purpose test, is met if (in the words of Reg. 53.4944-3(a)(2)(i)) an investment "significantly furthers the accomplishment of the private foundation's exempt activities" and "the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities."

Each example states affirmatively that these two sub-tests demonstrating primary purpose have been met.

What qualifies as a charitable purpose? While "[t]he new examples demonstrate that a PRI may accomplish a variety of charitable purposes, such as advancing science, combating environmental deterioration, and promoting the arts,"[22] the examples do stay within carefully drawn lines of clearly charitable activity.

This may explain why certain examples include facts intended to establish the charitable nature of the funded activity beyond any doubt. For instance, Example 11 states that the pharmaceutical company receiving the investment must not only develop the vaccine but also must distribute it to poor individuals in developing countries at an affordable price *and* furthermore requires publication of the scientific research conducted.

The drafters also declined to include examples where the charitable purpose could be debated. For instance, the following specific examples requested by the ABA Task Force are not included in the Proposed Regulations:

- Investments in newspapers (the possibilities for nonprofit journalism is a current topic among practitioners).
- Mortgage assistance to avoid foreclosure (for the relief of the distressed, but not necessarily limited to the poor).
- Loans to purchase health insurance (also not limited to the poor).
- Mixed-income, as opposed to purely low-income, housing.

In each of these instances, the charitable purpose is less well-established than the examples provided in the Proposed Regulations. Therefore, no one should look to the proposed examples for an opportunity to expand what qualifies as a legitimate charitable purpose under Section 170(c)(2)(B).

Although specifically requested by the ABA Task Force, the Proposed Regulations also omit one clearly charitable purpose: lessening the burdens of government. The ABA Task Force submitted an example involving the provision of additional parking in a downtown area to serve businesses and create jobs, a role that the city acknowledged was a government responsibility. The authors understand that the Service did not include lessening the burdens of government as a charitable purpose because it is too complicated an area of the tax law to address in examples intended to provide guidance on PRIs.

What must be required in order to accomplish the charitable purpose? Given a legitimate charitable purpose, the PRI test requires that an investment *accomplish* this purpose. In a loan context, it is straightforward to require a specific use of loan proceeds. In an equity investment, what conditions should be imposed? Must a foundation require that a recipient accomplish certain objectives to demonstrate the investment is furthering a charitable purpose? Or is simply investing in an appropriate recipient sufficient, with the expectation that the investment reasonably will lead to the charitable result desired? How does the foundation know, for instance, whether its investment actually results in low-income hires, or a measurable reduction in pollution that was the justification for the investment?

In some of the examples in the Proposed Regulations, the investments require that PRI funds be used for a specific purpose (e.g., producing a vaccine in Example 11), while others assume that the charitable purpose will be accomplished without any further requirement (e.g., the investment in a recycling company in Example 12; the loan to a business in a rural state following a natural disaster in Example 14). None of the examples explicitly mentions the use of charitable benchmarks, such as target numbers for low-income people to be hired, or trash to be recycled, to demonstrate that the investment actually accomplishes the charitable purpose described. An example in which the foundation explicitly required the investment recipient to meet certain charitable targets would illustrate how investments typically attempt to meet the first prong of the PRI test and encourage foundations to include these types of provisions.

No Significant Investment Purpose

The second prong of the PRI test requires that the production of income or the appreciation of property not be a significant purpose of the investment. Reg. 53.4944-3(a)(2)(iii) states that in making this determination, it is 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. The Regulations also tell us that the presence of significant income or appreciation alone is not conclusive evidence of a significant investment purpose.

No example where foundation is the lead investor rather than an alternative source of funding. Almost all of the examples describe situations where the recipient already has searched for other sources of funding for the project, and funding was not available because alternative sources declined.[23] The foundation therefore is filling a gap that others have not been willing to fill, at least not on the same terms as the foundation.

It also is possible that the foundation may look to be the *first* investor, not the investor of last resort, and play a role in molding the way a certain business will develop. Private foundations can add value as lead investors by providing credibility and expertise in an impact area that other investors may not have. The proposed examples do not address a scenario where other investors *might* be willing to invest, and the founda-

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22 See the Preamble, *supra* note 1.

23 All of the examples, other than Example 11, provide that investees turn to foundations only *after* the investees were unable to secure sufficient financing from conventional sources. Example 11 provides that the recipient company and other commercial enterprises would not dedicate their resources to conduct the research without foundation funding, which is a similar point.

tion differentiates its investment by investing on less-favorable financial terms or by including charitability requirements that purely commercial investors would not require.

For example, the ABA Task Force requested an example where the investee turns to the foundation as the lead investor. The investee believes that the foundation's lead investment "would help bolster the credibility of the venture," and that the foundation's investment "is necessary to enable it to attract sufficient other investors." The Proposed Regulations do not include a similar fact pattern.

The lack of alternative funding does appear to be a significant factor for Treasury and the IRS. The ABA Task Force submitted proposed examples which stated that although the borrowers had not sought funding from conventional sources, they *believed* that conventional sources of funds would be unwilling or unable to provide funds on terms that they would consider economically feasible. Examples 14 and 15 in the Proposed Regulations modify these facts to state that conventional sources of funds *are* unwilling or unable to provide loans on terms the borrower considers economically feasible. The pattern in the proposed examples suggests that demonstrating an *actual* lack of alternative funding is significant in demonstrating that other investors would not invest on the same terms as the foundation. While certainly this fact pattern is helpful in meeting the second prong of the PRI test of no significant investment purpose, it is not required in the Code or the existing Regulations.

The broader question involves a private foundation's proper role in making a PRI. Is it only proper to step in when the market will not support a business on its own, or can foundations take the lead and mold a business through their investment? One concern that has been raised by some is that private foundations, particularly very large ones, may begin to compete with entrepreneurs for investments. The authors, however, do not view competition from private foundation dollars as a problem to be avoided and would not limit a private foundation's role as a program-related investor only to investments that the market will not support.

No example of investing in an intermediary. It is common in practice for a foundation to invest in a fund, rather than directly in one specific business, that has a specific social objective and whose fund manager identifies and invests in a portfolio of companies that meet the specific fund objective.[24] No proposed example covers this intermediary investment.

Some fund issues are unique, such as considering how and by whom are portfolio companies selected and what must the fund require of its portfolio companies in order for a foundation to meet PRI requirements (as well as expenditure responsibility). In addition, funds often involve equity investments in a limited partnership or LLC, which raise different issues than a purchase of stock (see below). An example involving an intermediary fund would both reflect common practice and provide helpful guidance for foundations that increasingly will encounter such investment opportunities.

No example illustrating equity investment in a partnership or LLC. As mentioned above in the discussion of intermediary funds, these funds are typically structured as limited partnerships or LLCs. An example in the Regulations could demonstrate that an equity investment may be made in an LLC as well as a corporation.

For instance, Example 16, which already involves an LLC recipient, could be modified to describe an equity investment, rather than a low-interest loan. Alternatively, another example, such as Example 14, could be modified to reflect an equity investment in an LLC rather than in a more generic "business enterprise."

If one of the purposes of the Proposed Regulations is to reflect current investment practices, an example describing an equity investment in a flow-through vehicle such as an LLC makes sense. Our understanding is that the Service views the tax implications of equity ownership in an LLC as too complicated an area of the tax law to cover in these examples.

Does the foundation's investment policy matter? Often a relevant factor in reviewing a proposed PRI is whether the investment is of the type that would be permitted under the foundation's investment policy. This is another fact that might support qualification under the second prong of the PRI test, in that an investment that is too risky to be permitted under a foundation's existing investment policy is less likely to be pursued for purposes of generating a return.

Rather than comparing the proposed investment to that of other investors, as described in the Regulations, the foundation is comparing the investment to other investments for which the foundation itself is making decisions as a commercial investor. Failure to fit within an investment policy could be viewed as an indicator that the foundation has concluded that the risk inherent in the investment does not justify the projected return and as a commercial investor it would not invest. While a few of the ABA proposed examples mention that the investment did not fit within the foundation's investment policy, this factor is not included in any of the proposed examples.

When must a foundation liquidate the investment? An investment that qualifies as a PRI on the day that it is made does not lose this character if ultimately the investment is successful. Other than as a result of an improper use of funds, the Code and Regulations do not require that a foundation liquidate a PRI at any particular stage. Nevertheless, Example 13 of the Proposed Regula-

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24 The ABA Task Force in its comments noted that "[i]t is important in a world economy to be able to use foreign, for-profit financial intermediaries to accomplish philanthropic goals. The role of [the fund] is consistent with the use of the non-tax exempt entities described in existing guidance as 'mere instruments' by which charitable purposes are accomplished."

tions specifies that the foundation "plans to liquidate its stock in [the venture] as soon as the recycling collection business in [the affected country] is profitable or it is established that the business will never become profitable."[25]

The examples in the Proposed Regulations have more variation in both types of investments and investment recipients.

One advantage of PRIs is the ability to recycle funds for multiple charitable uses. Recycling would not occur, of course, if the foundation's investment is never liquidated (although dividends might be paid that are then used by the foundation for charitable purposes). Does this matter? A foundation may point to an established plan to liquidate its investment on reaching a certain level of return, thus effectively capping the return, to support the assertion that the foundation has no significant investment purpose in making the investment. Nevertheless, the PRI tax rules do not require divestment on an investment's being deemed either successful or unsuccessful. The significance of including in this example the foundation's plan to liquidate is not clear to the authors.

Fee for credit enhancement. The examples involving linked deposits and a guarantee (Examples 18 and 19) do not mention that a foundation might be paid for providing such credit enhancement. An example could make clear that any payment for this service should be analyzed like any other return on an investment (e.g., whether it is a below-market payment), and should not preclude qualification as a PRI.

Natural disaster example given, but terrorist attack omitted. The ABA Task Force requested an example involving a PRI in response to a terrorist attack, stating in its analysis that "[w]hile urban redevelopment is reflected in several examples in the current Regulations, a new example addressing terrorism would be helpful because [a foundation] would need to act quickly, without taking time to seek a ruling." Two examples do address PRIs in response to natural disasters (one domestically and one in a developing country), which involve similar urgent circumstances. In the interest of addressing a more varied range of circumstances, one of these examples might provide a PRI response to a terrorist attack instead.

Confirmation of no unrelated business income. We generally assume without further analysis that if an investment meets the first prong of the PRI test, the investment is also substantially related to the foundation's charitable purpose and therefore will not result in unrelated business income tax (UBIT). The UBIT question is particularly relevant to investments in flow-through intermediaries, where the intermediary's underlying investments and the use of acquisition indebtedness could have tax implications to the foundation. While the proposed new examples may not be the appropriate place to provide guidance on the relationship between UBIT and PRIs, the Service might consider confirming in other guidance that the first prong of the PRI test and the substantially related requirement to avoid UBIT are aligned.

No Political Purpose

None of the examples address this third part of the PRI test. In our experience, it does not come up very often in practice. Nevertheless, an example could illustrate, for instance, that an equity investment in a foreign organization that lobbies foreign legislatures still qualifies as a PRI, if a written agreement with the recipient prohibits any use of foundation funds for lobbying. This prohibition typically is what a foundation includes and relies on in a side letter with the investment recipient.

OTHER LEGAL AND PRACTICAL ISSUES

As explained above, qualifying an investment as a PRI has implications for the investing private foundation under different sections of the Code applicable to private foundations. Neither the existing examples nor the proposed examples address "the interplay between section 4944 and section 4941, section 4942, section 4943, or section 4945."[26] The current proposed examples fall under Section 4944, and the examples only address the requirements for qualifying as a PRI under Section 4944. In the spirit of clarifying existing law, we encourage the Service to issue further guidance describing how certain common PRI situations affect foundations under other sections of the Code not addressed in the Proposed Regulations. We have included some examples below.

Qualifying Distributions

A PRI is normally a qualifying distribution for purposes of the mandatory annual distribution requirement under Section 4942.

With respect to a guarantee (Example 19), where no money changes hands at the time of entering into the arrangement, the Preamble to the Proposed Regulations states that there is no qualifying distribution under Section 4942, but that "[u]nder certain circumstances" a foundation may treat payments made under the guarantee as qualifying distributions. We encourage Treasury and the IRS to include this statement in the final Regulations. It also would be helpful for the Service to clarify what "certain circumstances" may be required for a qualifying distribution to occur.

Below are two additional questions that arise regarding the impact

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25 The ABA Task Force suggested similar facts in its proposed example 14: "[a]fter a company has fully developed or adapted its technology, or it is established that the technology has failed to achieve its promise, [the foundation's] share in the company would be liquidated or sold to a third party within a reasonable period of time consistent with the company's overall operations and access to capital." In its analysis, the Task Force explained that this example illustrates how a foundation "*may* exit an equity PRI once the purpose of the PRI has ended" (emphasis added).

26 See ABA Task Force comments, at 7.

of PRIs on Section 4942 qualifying distributions:

1. *When a PRI is repaid, what is the actual amount that is "recaptured" and must be redistributed in a future period?* When a loan is repaid or the foundation sells an equity holding, Section 4942 provides that only the return of the loan principal or capital contribution is recaptured and must be used for a subsequent qualifying distribution in the year following the year in which the investment is concluded. Any additional interest, dividends, or capital gains that the foundation receives become part of the foundation's corpus on which the minimum investment return is calculated for the following year, but there is no immediate repayment requirement.

A close reading of Section 4942 and its accompanying Regulations is necessary to reach this conclusion, however. Section 4942(f)(2)(C) includes different modifications affecting calculation of the distributable amount for any year. In terms of what amounts are recaptured, there is a distinction between (a) an amount that is *paid to accomplish* a charitable purpose that is then repaid and (b) an amount that is *paid to acquire an asset* used (or held for use) directly in carrying out a charitable purpose that is then sold. The amount that must be recaptured differs depending on which modification applies.

Treasury and the IRS could make life easier for foundations by facilitating this determination and stating explicitly what amount is recaptured under Section 4942 when a PRI is repaid.

2. *What if the foundation did not need the PRI to satisfy its minimum distribution requirement at the time of the investment? Must it still "recapture" this amount when repaid?* A foundation must report all PRIs as qualifying distributions in the year made. There is some support, however, in certain rulings for the position that only repaid amounts which were actually "taken into account" in the year in which they were made to satisfy a foundation's qualifying distribution requirement need be recaptured and factored into the calculation of a future year distributable amount.

It would be very helpful for Treasury and the IRS to confirm whether or not a foundation could exclude PRI repayments where the initial payments were not used to satisfy the qualifying distribution requirement for any year. This would be particularly valuable given our experience that foundation clients often are interested in PRIs for programmatic purposes even when the client has no need for additional qualifying distribution credit. A foundation might be discouraged from making an additional investment out of concern regarding future recapture, particularly if repayment occurs after the five-year carryforward period.

In the case of a guarantee or credit enhancement, simply lending the foundation's financial statement can be of tremendous value to a small enterprise with little credit history, even where no foundation money is ever needed. The Proposed Regulations include two different examples of credit enhancement (Examples 18 and 19), and this type of credit assistance should be encouraged. A foundation may be more willing to provide this credit enhancement if it has some comfort that, if a payment ultimately *is* required, and such payment was not needed at the time as a qualifying distribution, the payment will not increase the foundation's future distributable amount. This is especially true given the uncertainty regarding when, if at all, a payment on a guarantee or letter of credit would be required. A clear understanding of the Section 4942 implications for providing credit enhancement could have a significant impact on foundations' willingness to provide this benefit.

Practice Notes

The broader question involves a private foundation's proper role in making a PRI. Is it only proper to step in when the market will not support a business on its own, or can foundations take the lead and mold a business through their investment? One concern that has been raised by some is that private foundations, particularly very large ones, may begin to compete with entrepreneurs for investments. The authors, however, do not view competition from private foundation dollars as a problem to be avoided and would not limit a private foundation's role as a program-related investor only to investments that the market will not support.

Expenditure Responsibility

Expenditure responsibility requirements under the Regulations for a grant and a PRI are identical in many ways. Nevertheless, an investment is fundamentally different from a grant, and understanding how the expenditure responsibility rules apply to an investment is not always straightforward. Below are two areas relating to expenditure responsibility and PRIs that the Service could clarify.

What reporting is necessary? The Section 4945 Regulations contain a provision specific to PRIs enumerating what must be in a written agreement with the PRI recipient. The agreement must require the recipient to provide full and complete financial reports of the type ordinarily required by commercial investors under similar circumstances and a statement that it has complied with the terms of the investment.

"Grant" is defined broadly under the Regulations to include PRIs,[27] and another Regulation requires other specific reports from expenditure responsibility grantees regarding the use of funds and the progress made by the grantee toward achieving the purpose for which the "grant" was made. In addition, when the "use of the grant funds" is completed, a final report is due "with respect to all ex-

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27 Reg. 53.4945-4(a)(2).

penditures made from such funds." Although these reports are not mentioned in the earlier Regulation enumerating what a foundation must require in writing from a PRI recipient, these expenditure responsibility requirements also appear to apply to PRIs as a form of grant.

Depending on the foundation's role in the investment and its size compared to other investors, it may be difficult if not impossible to compel the target fund to agree to provide these additional reports. Could there be circumstances where it is sufficient for a foundation to obtain only the reporting that other commercial investors receive and a compliance statement without further reporting?

In addition, it is confusing that the Regulations require specific language in a written agreement for a PRI entitling the foundation to receive certain reports, without referencing at all the more general reporting requirements applicable to all expenditure responsibility grants. It also is not always clear how to apply these more general grant reporting requirements to a PRI, especially an equity PRI where foundation funds are not being precisely tracked.

Repayment of funds in an equity investment. The expenditure responsibility rules under Section 4945 require that a foundation, in order to meet the expenditure responsibility requirements with regard to a PRI, obtain a written commitment of the recipient organization that all funds received from the private foundation be used only for the purposes of the investment. In addition, the recipient must agree "to repay any portion not used for such purposes...."[28]

These last nine words might create more complication in negotiating an equity PRI than any of the PRI requirements under Section 4944. It is relatively straightforward in a loan context to require acceleration of the loan and demand for repayment under specific circumstances. Retrieving contributions paid for stock or other equity interests is not as easy to achieve. Companies and fund managers (in the case of a PRI in an investment fund) do not at all like providing investors with the ability to withdraw their investments. Investment recipients, as well as other investors, are also very resistant to granting preferential rights to foundations that other investors do not have. The foundation, on the other hand, must require a repayment mechanism in order to meet this expenditure responsibility requirement. As a result, a foundation's abilities to exit the investment and be repaid for its holdings are typically heavily negotiated terms in an equity PRI.

The Regulations do provide that "with respect to equity investments, repayment must be made only to the extent permitted by applicable law concerning distribution to holders of equity interests."[29] No more is said regarding how to meet this requirement when equity is involved. Given the resistance by investees to provide redemption or withdrawal rights at all to a private foundation, any clarification regarding what rights would meet expenditure responsibility requirements would go a long way in facilitating equity PRIs.

For instance, would it be sufficient for the foundation to redeem its shares for the value of the original contribution made by the foundation? This is problematic for the foundation where the equity interests have appreciated in value, so we prefer redemption at the greater of the foundation's initial contribution or FMV at the time of redemption. This approach often meets with much resistance, however, and investment recipients will not always accept this obligation. Is it acceptable to require redemption at FMV at the time the right is triggered, even if the value of the investment has depreciated?

Because an investee often will not be willing or able to redeem shares at FMV, another solution sometimes suggested is to allow transfer of the foundation's shares to a third-party purchaser, and for the company to have a redemption requirement only if another buyer cannot be found. Clarification would be useful that this third-party transfer mechanism satisfies the Section 4945 repayment obligation. Also, an interesting question is how long can the negotiated period be before the foundation is to get its money back, if the parties are still to be in compliance with expenditure responsibility.

Reg. 53.4945-5(c)(3) provides that a PRI recipient need not segregate PRI funds or separately account for such funds on its books. If the PRI recipient does not do so, this Regulation describes the accounting procedures for determining how an expenditure will be allocated among different grants received by the recipient in different years. For instance, grants received within an earlier tax year are deemed to be spent before grants received in a later tax year, and expenditures of grants received within a tax year will be prorated among all such grants. Guidance regarding how these rules apply to PRIs as opposed to grants, and how an amount spent by a PRI recipient will be allocated to specific equity investors, would be very useful.

Finally, full redemption or withdrawal may not be necessary. The foundation should be able to determine what portion of any amount not properly spent by the investment recipient is attributable to the foundation and then demand repayment only of that amount.

CONCLUSION

While certain questions remain, the Proposed Regulations provide very welcome guidance to private foundations interested in beginning or expanding their PRI programs. As the new examples illustrate, the types of investments that can qualify as PRIs are diverse both in purpose and in structure. We hope that this new guidance from Treasury and the IRS will encourage foundations to use PRIs as a flexible and powerful means of accomplishing their charitable goals. ■

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28 Reg. 53.4945-5(b)(4)(i).
29 *Id.*