

**Morgan Lewis**

**ROCKY MOUNTAIN TAX SEMINAR FOR PRIVATE FOUNDATIONS**

**IMPACT INVESTING: WHAT PRIVATE FOUNDATIONS NEED TO KNOW**

**SEPTEMBER 22, 2016**

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# Impact Investing

- Impact investing allows private foundations to align their mission with their investment strategies
- Impact investing can take several forms:
  - Socially-Responsible Investments (SRIs)
  - Mission-Related Investment (MRIs)
  - Program-Related Investments (PRIs)
- SRIs involve the use of screens to exclude certain investment categories, such as fossil fuels, tobacco companies, etc.
- This outline focuses on MRIs and PRIs, including:
  - Laws and regulations, both federal and state, governing MRIs and PRIs
  - Considerations when beginning a program of impact investing

# Mission-Related Investing

- Mission-related investing is one form of impact investing. MRIs allow foundations to leverage their investment assets to further their charitable purposes
- MRIs are subject to federal and state legal requirements
  - MRIs are subject to the jeopardy investment rules under Section 4944 of the Internal Revenue Code
  - MRIs are subject to state laws governing the investment of charitable funds based on the Uniform Prudent Management of Institutional Funds Act (UPMIFA)

# Federal Tax Regulation of MRIs: Section 4944

- Section 4944
  - Imposes an excise tax on a foundation that invests “any amount in such manner as to jeopardize the carrying out of its exempt purposes”
    - First tier tax of 10% on foundation for each year investment is outstanding
    - Second tier tax of 25% on foundation if investment not removed from jeopardy after initial tax imposed
    - First tier tax of 10% on foundation manager for each year, up to a maximum of \$10,000, if foundation manager participated in the making of the investment **knowing** that it would jeopardize carrying out the foundation’s exempt purposes
    - Second tier tax of 5% on foundation manager, up to a maximum of \$20,000
  - Investment that violates Section 4944 is called “jeopardizing investment”
  - Investment is a jeopardizing investment if foundation managers fail to exercise ordinary care and prudence in providing for the financial needs of the foundation

# IRS Examples of Jeopardizing Investment

- Example 1: Investment in common stock of a corporation with a promising product and uneven earnings record that has never paid a dividend and is widely reported to be seriously undercapitalized (Treas. Reg. 53.4944-1(c) Ex. 1)
  - However, if the foundation makes the investment conditional on the corporation's receipt of other concurrent investments sufficient to satisfy its capital requirements so that it may overcome its uneven earnings record, the investment will not be a jeopardizing investment (Treas. Reg. 53.4944-1(c) Ex. 2)
- Example 2: Providing **venture** capital to a new corporation that will produce a promising new product that must compete with an established alternative product that serves the same purpose (Treas. Reg. 53.4944-1(c) Ex. 1)
  - However, not a jeopardizing investment if management has a demonstrated capacity for getting new businesses started successfully and the investee has received substantial orders for the product (Treas. Reg. 53.4944-1(c) Ex. 2)

# IRS Example of Non-Jeopardizing Investment (cont'd)

- Example 3: Investment of 75% of foundation's assets in publicly traded stock that was not of blue chip quality. Foundation used borrowed funds to make the investment (TAM 8631004; GCM 39537)

# IRS Example of Non-Jeopardizing Investment

- Foundation proposed to invest 1% of its assets in each of four limited partnerships. The first partnership held distressed real estate; the second was a hedge fund for U.S. stocks; the third traded commodities; and the fourth invested in small and mid-sized energy companies. The IRS found that none of these investments would give rise to tax under Section 4944 because: (1) they were relatively small investments; (2) they were diversified; and (3) they were made on the basis of professional advice. In addition, the IRS approved the investment of up to 10% of the foundation's assets in a market-neutral fund because such an investment would serve to diversify the foundation's risk and was made with professional advice (PLR 9451067)

# State Regulation of MRIs: UPMIFA

- UPMIFA regulates MRI investments
  - UPMIFA is a uniform act that imposes requirements when managing and investing charitable funds
  - Has been adopted in 49 states
  - Pennsylvania has not adopted UPMIFA but imposes its own prudence requirement
- UPMIFA requirements when managing and investing an endowment:
  - Consider the charitable purposes of the institution and the purposes of the endowment
  - Act in good faith
  - Use care an ordinarily prudent person in a like position would exercise under similar circumstances
  - Consider specific enumerated factors in making investments



# UPMIFA Factors for Consideration

- UPMIFA lists the following factors for consideration when making investments:
  - General economic conditions
  - Possible effect of inflation or deflation
  - Expected tax consequences, if any, of investment decisions or strategies
  - Role that each investment plays within overall investment portfolio of the fund
  - Expected total return from income and the appreciation of investments
  - Other resources of the institution
  - Needs of the institution to make distributions and preserve capital
  - **An asset's special relationship or value, if any, to the charitable purposes of the foundation**
- State AGs have stated publicly that documentation of prudent investment process and mission relationship is key to demonstrating UPMIFA compliance for MRIs

# IRS Notice 2015-62: Aligning Section 4944 and UPMIFA

- Last year, IRS issued Notice 2015-62, providing guidance on the standards under Section 4944 for investments made for charitable purposes
  - Aligns rules under Section 4944 with UPMIFA/state law standards
  - Confirms that foundation managers can consider, as one factor, whether the investment furthers the foundation's charitable purpose
  - Cites UPMIFA investment standards
- Notice 2015-62 states that: "a private foundation will not be subject to tax under Section 4944 if foundation managers who have exercised ordinary business care and prudence make an investment that furthers the foundation's charitable purposes at an expected rate of return that is less than what the foundation might obtain from an investment that is unrelated to its charitable purposes"

# Practical Considerations In Designing MRI Programs

- Initial Planning and Program Design
  - Determine goals and success measures
  - Determine how investment and program staff will collaborate
  - Amend investment policy (if necessary) to include UPMIFA standards, including consideration of compatibility of investments with charitable purposes
  - Define process for identifying, reviewing and approving MRI investments
  - Establish form of documentation to show compliance with UPMIFA and Section 4944
- Implementation
  - Integrate review and approval of MRIs into regular investment review and approval process
  - Determine process for monitoring MRIs and for measuring mission impact

# Program-Related Investments

- PRIs are another form of impact investing
- PRIs allow foundations to make charitable investments that are treated, for most purposes, like grants
  - PRIs are treated as qualifying distributions under Section 4942 but must be added to the minimum distribution requirements in the year repaid
  - PRIs are exempt from the excess business holding rules under Section 4943
  - PRIs are exempt from the jeopardy investment rules under Section 4944 if they meet specific requirements
  - PRIs made to organizations other than public charities are subject to the expenditure responsibility requirements under Section 4945
  - PRIs are excluded from the definition of “institutional funds” under UPMIFA

# Common Types of PRIs

- PRIs can take many forms, including any of the following:
  - Below market loans
  - Equity investments in public or private companies
  - Convertible debt or equity
  - Loan guarantees, including guarantees of loans by commercial lenders
    - Note: guarantees will be treated as qualifying distributions only if called and paid
- PRIs can be made to public charities, private foundations, public and private companies, LLCs and limited partnerships, and investment funds

# Federal Tax Regulation of PRIs: Section 4944

- PRIs are investments made primarily to serve as a foundation's charitable purposes
- PRIs must meet three requirements:
  - The primary purpose must be to accomplish charitable purposes
  - No significant purpose can be the production of income or the appreciate of assets
  - No purpose can be for lobbying or political campaign intervention
- PRIs can be made to charitable or non-charitable organizations
  - On April 21, 2016, the IRS issued final regulations containing nine new examples showing that PRIs can fund a wide range of charitable programs, including commercial businesses that serve as intermediaries to reach the intended charitable beneficiaries
- The determination as to whether a PRI constitutes a jeopardizing investment is made at the time of the PRI and not based on hindsight

# New PRI Regulations: Examples

- New PRI regulations illustrate the following permissible PRI investment terms and structures:
  - A PRI recipient is required to distribute drugs to the poor at affordable prices and may also sell the drug to other individuals at a market rate (Ex. 11)
  - A PRI recipient is required to promptly (after necessary patent protection) publish the results of research to cure a disease (Ex. 11)
  - An equity investment in a subsidiary of a commercial enterprise where the subsidiary was established to carry on the activities that further charitable purposes (Ex. 11)
  - A potentially high rate of return if the PRI recipient is successful in its business (Ex. 12)
  - An equity investment (or loan with an equity component) in a commercial business whose business activity will support the charitable purposes (Ex. 12 and 13)

# New PRI Regulations: Examples (cont'd)

- A foundation holds stock in a PRI recipient even after the PRI recipient's profitability, or lack thereof, is established (Ex. 13)
- A loan to a distressed business enterprise that will enable it to continue its business operations (Ex. 14)
- A loan to poor individuals that will enable them to start small businesses (Ex. 15)
- A loan to a business where the loan proceeds are required to be used for training the poor suppliers of the borrower (Ex. 16)
- A credit support which may be collateralized (Ex. 18) or subject to a reimbursement agreement (Ex. 19)



# New PRI Regulations: Guiding Principles

- The IRS posted seven guiding principles on its website on the same day that it issued the final regulations
  - An activity conducted in a non-US country furthers an exempt purpose if the same activity would further an exempt purpose if conducted in the United States
  - The exempt purposes served by a PRI may include any charitable purposes and are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas
  - The recipients of PRIs need not be within a charitable class if they are the instruments for furthering an exempt purpose
  - A potentially high rate of return does not automatically prevent an investment from qualifying as a PRI
  - PRIs can be achieved through a variety of investments, including loans to individuals, tax-exempt organizations and for-profit organizations
  - A credit enhancement arrangement may qualify as a PRI
  - 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

# New PRI Regulations: Guiding Principles (cont'd)

- Additional principles discussed in the preamble to the final regulations include the following
  - PRIs often involve some private benefit to one more persons that are not part of a charitable class
  - This may include the PRI recipient itself and this is permissible so long as the private benefit is incidental to the PRI's exempt purposes
  - Foundations may use a PRI to assume certain risks (e.g., in a deposit agreement or a guarantee) to catalyze the entry of private investment capital to further exempt purposes

# Federal Tax Regulation of PRIs: Section 4945

- Section 4945 requires foundations to exercise “expenditure responsibility” over PRIs made to non-charitable organizations
- Expenditure responsibility involves several steps:
  - Conducting a pre-grant inquiry to determine that the PRI recipient can be expected to carry out the charitable activity for which the PRI will be made
  - Entering into a written PRI agreement meeting certain requirements throughout the term of the PRI, including the following:
    - Requiring the PRI recipient to provide annual narrative and financial reports
    - Requiring the PRI recipient to maintain books and records about the PRI and make them available for inspection upon reasonable request
    - Requiring the PRI recipient to repay the investment if the charity requirements are not met
  - Obtaining reports on the use of the PRI funds
  - Making reports to the IRS on Form 990-PF

# Additional Tax Considerations for PRIs

- Qualifying distributions (Section 4942)
  - PRIs are treated as qualifying distributions when made and must be “recaptured” when repaid
- Excess business holdings (Section 4943)
  - PRIs are exempted from the excess business holding rules
- Unrelated business income tax (Sections 511 through 514)
  - Earnings on PRIs are generally not unrelated business income, although there may be certain exceptions
- Form 990-PF reporting
  - PRIs must be separately reported on IRS Form 990-PF and included in 990-PF expenditure responsibility reporting if the PRI recipients are non-charitable organizations

# Practical Considerations In Designing a PRI Program

- Initial planning and program design
  - Determine goals and success measures
  - Determine how investment and program staff will collaborate
  - Define process for identifying, reviewing and approving PRIs
    - Prepare a PRI term sheet to use in initial discussions
    - Require investee to comply with charitable indicators and to provide additional duties to meet the foundation's programmatic needs
    - Establish a process for exercising expenditure responsibility, including the preparation of appropriate form of documentation
    - Consider obtaining a legal opinion for PRIs to noncharitable organizations
- Implementation
  - Develop a system for monitoring the PRI recipients' compliance with PRI agreements
  - Collect data from PRI recipients to evaluate success in achieving intended objectives