

# Morgan Lewis

## IMPACT INVESTING DESKBOOK SERIES

### Overview: Mission-Related Investments & Program-Related Investments

As private foundation investors increasingly seek to use impact investing as a tool to accomplish their charitable objectives, impact fund managers may encounter private foundations using various investment approaches for these purposes in addition to standard mission-aligned market-rate investments, including mission-related investments (“MRIs”) and program-related investments (“PRIs”), both of which have unique legal considerations.

This overview provides a summary of the key characteristics of MRIs and PRIs for impact fund managers navigating these investments.

#### Background

Private foundations are a category of tax-exempt charitable organizations described in I.R.C. § 501(c)(3) that are affiliated or associated with a specific family, company or funder. Generally, federal law and state law impose fiduciary duties on private foundations and their managers to ensure that a private foundation’s funds are managed and invested prudently to provide for the long-term and short-term financial needs of the foundation to carry out its charitable purposes.

Under federal tax law, private foundations are prohibited from making jeopardizing investments that do not meet the requisite prudent investor standard of care noted above. Excise taxes may be imposed at both the foundation and management levels for violations of the jeopardizing investment rules.

#### Focus on Impact Investing

Although there is no strict legal definition, *impact investing* is commonly understood to mean investments made with the intention of producing a measurable social and/or environmental impact alongside a financial return. For private foundations, impact investments may take the form of MRIs (i.e., investments that both further the foundation’s mission and satisfy the requisite prudent investor standard of care) or PRIs (i.e., investments made to further the foundation’s charitable purpose in compliance with applicable federal regulatory requirements and not for the purposes of financial gain or profit), depending on the objectives of the investment.

#### *Sidebar on Impact*

Not all impact is charitable. The standard for accomplishing charitable purposes is defined under federal tax law and regulations and is a higher, more exacting standard than the broader impact (or mission-related) standard. Charitable purposes are a smaller subset of impact purposes.

## **MRIs Defined**

Like *impact investing*, the term *mission-related investment* is not defined under state or federal law. Generally, MRIs are prudent market-rate investments made by private foundations with an expectation of both financial return and mission-related (but not necessarily charitable) impact.

As such, MRIs must satisfy federal and state laws governing the prudent management and investment of charitable funds. Thus, MRIs must be considered financially prudent investments in the context of a private foundation's investment portfolio as a whole, while also offering mission-alignment to varying – but not statutorily mandated – degrees.

Compared to standard market-rate investments, MRIs may offer a potentially lower (but still prudent) financial return, while also offering a mission-related, impact component, which may be lacking from standard market-rate investments.

Unlike PRIs, MRIs may focus on a broader range of impact purposes that are supportive of, but may be tangential to (to a greater or lesser degree), a private foundation's charitable purposes.

## **PRIs Defined**

Defined under federal tax law and regulations, PRIs are investments made by private foundations to accomplish charitable purposes rather than to produce income. PRIs are an exception to the prohibition against jeopardizing investments described above.

To qualify as a PRI, the investment's primary purpose must be to accomplish one or more charitable purposes (*see Sidebar on Impact for additional discussion*) and the investment cannot have as a significant purpose the production of income or appreciation of property. In addition, no purpose of the investment can be for lobbying or political activity.

For PRIs to nonpublic charities (including, for purposes of this overview, impact funds), a private foundation is also required to exercise expenditure responsibility over the investment that, in part, requires the impact fund to make certain contractual commitments to the private foundation regarding use of funds, reporting and recordkeeping, and repayment in the event that the investment's stated charitable purpose is violated.

Although the PRI regulations discussed here specifically apply to private foundations, 501(c)(3) organizations classified as public charities may also make PRI-like charitably focused investments and are required to report this activity on their annual IRS Form 990 information return.

## **PRI Regulatory Requirements**

Under applicable federal regulations, a PRI to a nonpublic charity is required to be subject to a written agreement (often, a side letter) between the private foundation and impact fund that specifies the charitable purpose of the investment and requires the impact fund to use the investment only for that charitable purpose and to repay any portion not used for that purpose.

In addition, the written agreement must contain reporting requirements (including a certification of compliance and the submission of financial (and often narrative) reports, at least annually), recordkeeping requirements (including maintenance of books and records and a requirement to make them available to the private foundation at reasonable times), and a prohibition on use of funds for certain purposes (including lobbying, political activity, and certain voter registration activity). Compliance with these requirements is not necessary for an MRI.

Commonly, private foundations also include other side letter provisions that address non-PRI regulatory requirements that are specific to private foundation investors, such as rules against self-dealing and earmarking.

## Key Distinctions Between MRIs and PRIs

PRIs by private foundations are treated as grants for tax purposes. As such, PRIs are counted toward a foundation's minimum annual 5% charitable payout requirement. In addition, PRIs are not subject to excess business holdings rules, which generally prohibit a private foundation (aggregated with the holdings of its disqualified persons) from owning more than 20% of the voting stock of a corporation or profits interest of a partnership. Like grants, PRIs are required to be disclosed on a private foundation's annual Form 990-PF information return, which is a public document.

Unlike PRIs, MRIs do not count toward the minimum annual 5% charitable payout requirement, are subject to excess business holdings rules, and are not reported separately on the Form 990-PF.

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For more information on the issues discussed here, please contact your Morgan Lewis [Impact Investing](#) attorney.

### About Morgan Lewis's Impact Investing Practice

Morgan Lewis has one of the nation's leading Impact Investing practices and is ranked Band 1 by *Chambers* in its annual rankings for Impact Investing in the United States.

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