PROGRAM-RELATED INVESTING

DARREN B. MOORE

Bourland, Wall & Wenzel, P.C.
301 Commerce Street, Suite 1500
Fort Worth, Texas 76102
(817) 877-1088
E-mail: dmoore@bwwlaw.com

State Bar of Texas
GOVERNANCE OF NONPROFIT ORGANIZATIONS COURSE
August 18-19, 2011
Austin, Texas

DARREN B. MOORE
Bourland, Wall & Wenzel, P.C.
301 Commerce Street
Fort Worth, Texas 76102

phone: (817) 877-1088
dmoore@bwwlaw.com

Mr. Moore practices with Bourland, Wall & Wenzel, P.C., a Fort Worth, Texas law firm which represents individuals, closely held and family businesses, professional practices and charitable organizations within its areas of legal practice. Mr. Moore was born in Lubbock, Texas on December 11, 1973. He earned a B.A., cum laude, from Texas A&M University and his J.D., magna cum laude, from Baylor Law School where he served as Editor in Chief of the Baylor Law Review.

Mr. Moore was admitted to practice law in Texas in 2000 and before the United States District Court, Northern District of Texas and United States Tax Court in 2001. He is a member of the State Bar of Texas and Tarrant County Bar Association and is a Fellow of the Texas Bar Foundation. He has been named a "Rising Star" by Texas Super Lawyers in 2009, 2010 and 2011.

Mr. Moore's practice focuses on two areas: general civil litigation and representation of tax-exempt organizations and their donors with an emphasis on corporate governance matters and tax and legal compliance issues. Mr. Moore’s exempt organization practice includes advising clients on issues including organization of various types of exempt entities, obtaining and maintaining tax-exempt status, risk management, employment issues, good governance, and other business issues.

Mr. Moore is an adjunct professor at Baylor Law School where he has taught Nonprofit Organizations since 2001. Additionally, he writes and speaks regularly on tax and legal compliance issues including co-authoring the third edition of Bourland, Wall & & Wenzel, P.C.'s publication, Keeping Your Church Out of Court.

TABLE OF CONTENTS

I. Introduction.

Capacity building, sustainability, impact investing, and leverage have increasingly become buzz words in the nonprofit community. With the ongoing struggles of the national economy, private foundations have given a fresh look to the tools in their funding toolbox. A program-related investment ("PRI") is an exception to the rule prohibiting private foundations from making jeopardizing investments. PRIs have been described as a hybrid between grants and investments—investments made with the primary purpose of accomplishing a charitable purpose (and meeting certain other requirements more fully discussed below). As such, PRIs provide an alternative form of financing to flow capital to charitable programs, a form that allows for (and anticipates) repayment thereby enabling reinvestment of that same capital in other charitable programs. Ultimately, PRIs are a tool allowing the funder to leverage its philanthropic dollars to achieve greater impact. This paper will take the program-related investment tool out of the toolbox for an examination of the treatment of PRIs under federal and state law.

II. Law Related to PRIs.

The term "program-related investment" appears in the Internal Revenue Code at section 4944(c) as an exception to the general prohibition against private foundations investing in such a manner as to jeopardize the carrying out of their exempt purposes. Section 4944(c) provides as follows:

> (c) Exception For Program-Related Investments. – For purposes of this section, investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.

TREASURY REGULATION Section 53.4944-3 provides additional specificity as to what constitutes a PRI.

> A "program-related investment" is an investment which possesses the following characteristics:
>
> (i) The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B);
>
> (ii) No significant purpose of the investment is the production of income or the appreciation of property; and
>
> (iii) No purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(B)(2)(D) [political purposes].

As a result of the definitions set forth in the above cited TREASURY REGULATION, PRIs are said to be subject to three tests: (1) the primary purpose test; (2) the no significant investment purpose test; and (3) the no political purpose test.

A. The Primary Purpose Test.

Section 53.4944-3(a)(2)(i) provides that an investment is made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) (i.e. charitable or other exempt purposes) if it *significantly furthers* the accomplishment of the private foundation's exempt activities and if the investment would not have been made *but for* the investment's relationship to the foundation's exempt activities.

A determination of whether the investment significantly furthers the accomplishment of the private foundation's exempt activities requires an initial examination of the foundation's own governing documents to determine the scope of the foundation's exempt purposes (i.e. are those purposes broad—"charitable, religious, and educational purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code," or are those purposes more narrow, such as limiting the exempt purposes to medical research). To understand if a specific investment will significantly further an exempt purpose of the foundation, the beginning point must be what are those purposes of the foundation? After determining the purposes of the foundation, the governing board must determine that the proposed investment is consistent with those purposes. If a proposed investment is consistent with general charitable or other exempt purposes under sections 501(c)(3) and

170(c)(2)(B), but is inconsistent with more restrictive purposes in the foundation's own governing documents, the foundation should either pass on the investment or take steps to expand its purposes.

Determining whether the proposed investment is made to further an exempt purpose should be focused on the exempt purpose (such as relief of the poor and distressed or underprivileged) and not on whether or not the organization that is going to carry out that purpose is itself an exempt organization. Specifically, section 53.4944-3(a)(2)(i) provides that "[f]or purposes of section 4944 and §§ 53.4944-1 through 53.4944-6 the term "purposes described in section 170(c)(2)(B)" shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c)." It is this clarification that allows private foundations to make program-related investments to non-exempt organizations. Put simply, it is not the recipient of the funds that is most significant, but rather the use of the funds and how that use of the funds furthers one or more exempt purposes *of the foundation*.[1] Accordingly, each investment must be separately analyzed to determine that the investment does, in fact, significantly further the foundation's charitable purposes, and that but for such relationship between the investment and the accomplishment of the foundation's exempt activities, the investment would not have been made. Foundations may find it useful to have contemporaneous documentation showing the purposes of the investment and how the investment is intended to further the foundation's exempt purposes. This type of documentation strengthens the foundation's position that the investment would not have been made but for its relationship to the foundation's exempt purposes.

B. No Significant Investment Purpose Test.

To qualify an investment as a program-related investment, the private foundation must show that no significant purpose of the investment is the production of income or the appreciation of property. Pursuant to the regulations, the IRS will consider it relevant whether investors solely engaged in for profit investment activities would be likely to make the investment on the same terms as the private foundation. *See* TREAS. REGS. § 53.4944-3(a)(2)(iii). Similarly, where a foundation has an investment policy (which prudent foundations should have), analyzing whether such investment policy would allow for the proposed investment with the terms being considered is also a relevant factor in showing that the foundation is making the investment without a significant purpose of producing income or causing the appreciation of property. The regulations point out, however, that the fact that the investment produces income or capital appreciation, even where significant will not, standing alone, be conclusive evidence of a significant purpose involving the production of income or appreciation of property. *See id*. Rather, the analysis is at the front end of the investment, whether the terms (interest rate, risk level, level of security, etc.) would be attractive to for profit investors and commercial lenders.[2]

The majority of PRIs that are the subject of private letter rulings are made as loans or guarantees. These can be, and are, typically made at below-market interest rates thereby allowing the foundation to demonstrate that the loan is one whose terms would not be attractive to for profit investors or commercial lenders. Again, however, the interest rate is not the only factor to be considered. Loans may be made with inadequate security, to recipients with no credit history or poor credit, or with other terms that cause the loan to carry higher risk. In these cases, the foundation can show that the loan would not be attractive to a for profit investor. Where PRIs take other forms (equity investments, loan guarantees, linked deposits, etc.) the terms of the proposed investment must be closely analyzed to determine whether such terms demonstrate a lack of a for profit motive. There are myriad private letter rulings discussing PRIs and considering this second test. Those rulings are not precedential authority, but do provide a helpful look at other situations that the IRS has found to demonstrate a lack of a production of income/appreciation of property motive. Where the investment terms are not clearly outside of the scope of what a for profit investor would consider, a foundation should review such private letter rulings and consider obtaining a private letter ruling or opinion of counsel letter related to this issue.

While the regulations provide that no significant purpose of the investment is the production of income and appreciation of property, regulations do

[1] Appendix A sets out the ten examples provided in the TREASURY REGULATIONS. Nine of the ten examples deal with PRIs made to entities other than public charities.

[2] Because the analysis is done at the front end of the investment, the contemporaneous documentation addressed above regarding the foundation's purposes at the outset can further prove useful in showing that the foundation did not have a significant purpose involving the production of income or the appreciation of property.

not prohibit the foundation from making PRIs that produce income or result in the appreciation of property or even making PRIs where the production of income or the appreciation of property is a purpose—it must merely refrain from making such investments where these goals are a *significant* purpose. PRIs are, by definition, not grants. In setting up these types of investments, foundations generally build in interest along with a return of the principal. It is this ability to get a return on investment that makes PRIs an attractive alternative to grants, allowing foundations to recycle their philanthropic dollars over and over again. A foundation is willing to accept terms that would not be acceptable to for profit investors and commercial lenders of the relationship between the investment and the accomplishment of the foundation's exempt purposes. In this way, the foundation is receiving (in the event that there is no default) a monetary return on its investment as well as social return on this same investment.

C. No Political Purpose Test.

The final test that must be met for a foundation to demonstrate that an investment qualifies as a program-related investment is a showing that no purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(D), such purposes including attempting to influence legislation and participating in, or intervening in political campaigns on behalf of or in opposition to a candidate for elective public office.[3] This is an absolute prohibition for PRIs as compared to a private foundation being allowed to seek to influence legislation so long as it does so to an insubstantial degree.

Satisfaction of this test is most often accomplished through the inclusion of commitments on the part of the recipient or representations and warranties on the part of the recipient that the funds will not be used for such purposes. These types of commitments, representations and warranties can easily be included in loan documentation, guarantee documentation, etc. Where the foundation is making an equity investment, the foundation must take care to obtain a representation that the recipient will not engage in such practices or will otherwise segregate the foundation's funds to ensure that such funds are not used to accomplish such prohibited purposes. Such a representation can be handled in a side agreement which can also serve as a useful place to recite and memorialize the foundation's purposes in making the PRI at the outset of the investment, showing from the outset that the purpose is furtherance of the foundation's exempt purposes and not production of income or appreciation of property.

D. Changes in Terms.

Terms of investments often change over time. This can be true of program-related investments as well. Because the determination of whether an investment qualifies as a PRI is made at the outset of the investment, care should be given as to whether changes in the terms of the investment will cause the investment to cease to qualify as a PRI. Section 53.4944-3(a)(3)(i) answers this question. That section provides that a PRI does not cease to qualify as such "provided the changes, if any, in the form or terms of the investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property." Where changes are "made in the form or terms of a program-related investment for the prudent protection of the foundation's investment," such changes will not ordinarily cause the investment to no longer qualify as a PRI. *See id*. Where a change is made other than for the prudent protection of the foundation's investment, the foundation should analyze the need for such change and document that the change is made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property. The foundation may wish to obtain a written legal opinion regarding such issue.

If a change is determined to be a "critical change in circumstances," the investment will cease to be program-related. *See id*. As an example of a "critical change of circumstances," the regulations point to an investment that is shown to be serving an illegal purpose or the private purpose of the foundation or its managers; however, these are not the only types of "critical changes" and each proposed change must be independently examined. Where the change is considered a "critical change" which causes the investment to cease to be program-related, the foundation and the foundation managers will be subject to the excise tax on jeopardizing investments unless the investment is terminated within thirty (30) days after the date on which the foundation (or any of

[3] There is a limited exception related to a PRI recipient appearing before or communicating with legislative body with respect to legislation or proposed legislation of direct interest to the recipient where the expense of engaging in such activities would qualify as a business deduction under section 162 of the Code. However, PRI funds cannot be earmarked for such use.

its managers) obtains actual knowledge of the critical change in circumstances.

III. Examples and Uses of Program-Related Investments

Appendix 1 sets out the ten (10) examples provided in the Treasury Regulations related to PRIs (all but number 7 qualify as PRIs). These examples demonstrate the most common types of PRIs – loans at below market interest and equity investments. Other types of PRIs include loans with other risks (such as lack of security), cash equivalent deposits at below market rates of return (certificate of deposits or linked deposits), and loan guarantees (note that loan guarantees may entitle the foundation to a fee but will not be a qualifying distribution unless and until called).

In 2006-2007, approximately 83% of the 494 PRIs surveyed by the Foundation Center consisted of loans, 4.1% were equity investments, and between 1.0 and 1.6% each were business startups/expansion, loan guarantees, cash equivalent deposits, and lines of credit. *See* Lawrence, Steven "Doing Good with Foundation Assets: An Updated Look at Program-Related Investments" (available online at http://foundationcenter.org/gainknowledge/research/pdf/pri_directory_excerpt.pdf). While these figures represent the majority of PRIs, so long as the investment meets the 3-prong test set forth above, the investment may qualify as a PRI without falling into one of these categories.

PRIs are used for many purposes. They have a unique ability to address areas where the for profit market fails to operate due to lack of financial incentive, for example, PRIs can be used to incentivize for profit companies to create vaccines and medicines in developing countries where the market would not support such activities. Likewise, PRIs are often employed to support economic development in deteriorated urban areas, undeveloped rural areas, or to support businesses owned by economically disadvantaged groups. PRIs can even be used to provide financial support to socially and economically disadvantaged individuals allowing them to go to college or find gainful employment. PRIs are becoming increasingly popular in the context of microfinance allowing foundations to make investments either directly for microfinance or through the use of intermediaries such as MicroCredit Enterprises, a public charity that provides microfinancing to alleviate poverty. In each example, the key is finding an exempt purpose to be accomplished by the investment that is consistent with the foundation's exempt purpose. Where such an exempt purpose can be found and where the parties are willing to structure the investment to meet the other two tests set forth in the Code, PRIs can be a tremendous source of private capital to accomplish socially-beneficial goals.

IV. Program-Related Investments and the Private Foundation Prohibitions.

A. Minimum Distribution Requirement.

A private foundation must generally distribute at least five percent (5%) of its assets on an annual basis in qualifying distributions. These assets are its investment assets (i.e. those not used in furtherance of the exempt purposes of the foundation, such as the building in which the foundation offices and where its capital equipment and fixtures are located), generally including cash, stocks, bonds, and other investment assets. This minimum distribution is required to prevent foundations from holding gifts, investing the assets and never spending the assets on charitable purposes. While many foundations think only in terms of grants to public charities as qualifying distributions, the rules are broader. Qualifying distributions also include grants to non-charities for "charitable purposes," costs of all direct charitable activities, amounts paid to acquire assets used directly in carrying out charitable purposes, certain set-asides, reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation, and, significant to the context of this paper, program-related investments.

Because program-related investments count as qualifying distributions in the year made and thus count "against" the five percent (5%) requirement, some foundations view this as a "built-in" five percent (5%) return in addition to what other rate of return the foundation generates from the PRI. In other words, if a private foundation makes a $500,000.00 PRI, that PRI counts as a qualifying distribution in the year made (i.e. it counts as a part of the 5%). Additionally, the PRI reduces the foundation's asset base upon which the five percent (5%) annual distribution requirement is applied by $500,000.00 for each year that the PRI is outstanding. Thus if the foundation is earning two percent (2%) interest on a $500,000.00 loan that is outstanding for five (5) years, the foundation treats the $500,000.00 as a qualifying distribution in the year made and applies the five percent (5%) payout requirement against the

foundation's assets after the asset base has been reduced by the principal amount over the remaining term of the loan. In the year in which the loan is repaid, there is a "recapture" which operates as an income modification under section 4942(f)(2)(c) of the Code, with the principal repayment effectively being added to the minimum distribution requirement of the year in which the recapture is made.

B. Self-Dealing Prohibition.

Because of the retention of control involved with private foundations, there are restrictions upon acts of self-dealing under section 4941(d) of the Code by certain disqualified persons of the foundation. Disqualified persons with respect to private foundations include substantial contributors to the foundation, foundation managers, a member of the family of either of the foregoing, and corporations in which persons described in any of the foregoing categories have more than thirty-five percent (35%) of the total combined voting power.

The Code provides six categories of self-dealing: (1) sale or exchange or leasing of property between the private foundation and a disqualified person; (2) lending of money or extension of credit between the private foundation and a disqualified person; (3) furnishing of goods, services, or facilities between the private foundation and a disqualified person, unless such goods, services, or facilities are made available to the general public on at least as favorable a basis as they are made available to the disqualified person; (4) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person, unless compensation is payment for personal services, is reasonable, necessary and not excessive; (5) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and (6) agreement by a private foundation to make any payment of money or other property to a government official (except in limited circumstances).

In the context of PRIs, these same self-dealing rules apply and should be analyzed to ensure that the investment does not result in a self-dealing violation. Assuming that the analysis has already been performed to determine that the making of the investment is within the foundation's exempt purposes and that the investment is being made to further those exempt purposes, a secondary analysis should be made to ensure that the result of the investment will not be direct, or perhaps more likely indirect, self-dealing with a disqualified person. For example, care should be taken to ensure that if a private foundation takes a substantial equity position in an entity, such that the entity becomes a "controlled organization" (as that term is defined in section 53.4941(d)-1(b)(5) of the Regulations) with respect to the foundation, that such organization does not thereafter enter into a transaction with a disqualified person which would constitute indirect self-dealing. Additionally, any time a private foundation co-invests with a foundation manager, care should be taken to scrutinize the investment to ensure that self-dealing is not occurring through the "use by or for the benefit of, a disqualified person of the income or assets of a private foundation." Examples of such self-dealing could be access to investments that the foundation manager might otherwise be denied, (for example, where there is a minimum investment amount), reduced fees, or other benefits to which the foundation manager would not be entitled absent the additional investment by the foundation.

C. Excess Business Holdings.

Section 4943 of the Code restricts a foundation's ability to take an ownership interest in a business enterprise above certain permitted holdings to prevent private foundations from having an advantage over other businesses which operate in the taxable income sector. Specifically, a foundation may own twenty percent (20%) of the voting interest in a business enterprise, reduced by the percentage of voting stock held by all disqualified persons. Where the control of the entity can be shown to be held by non-disqualified persons, the foundation and the disqualified persons may own up to thirty-five (35%) of the entity's voting interest. The foundation may hold a non-voting interest, but only if all disqualified persons together hold no more than twenty percent (20%) of the voting interest or no more than thirty-five percent (35%) of the voting interest if effective control is with a non-disqualified person. The foundation may own a *de minimis* two percent (2%) of the voting stock or value. Section 4943 includes a period of time within which a private foundation must dispose of excess business holdings where such excess business holdings were acquired by gift or bequest. Where a foundation has excess business holdings, it is subject to an excise tax related to same.

In order to be considered a "business holding" for purposes of the excess business holdings rules, holdings must be of a "business enterprise." Section 4943(d)(3) provides that the term "business enterprise" does not include a functionally related business or a trade or business at least ninety-five percent (95%) of the gross income of which is derived

from passive sources. TREASURY REGULATION Section 53.4943-10(b) further clarifies that "business holdings do not include program-related investments." Accordingly, whereas foundations are significantly limited in their ability to hold stock of a business enterprise, that limitation does not apply where the investment qualifies as a program-related investment.[4]

D. Jeopardizing Investments.

As addressed above, private foundations must not make investments which would jeopardize the carrying out of the exempt purpose of the foundation. Section 4944 of the Code provides that there is no *per se* type of jeopardizing investment. Rather, the rule requires close scrutiny of the foundation manager's standard of care, holding such managers to a "prudent investor" standard of care and requiring that care be exercised in the consideration of investments looking to both the long-term and short-term interests of the foundation.

As referenced above, the concept of the program-related investment is found in section 4944(c) and is specifically noted to be an exception to the jeopardizing investment prohibition. In other words, the Code recognizes that investments that qualify as program-related investments (i.e. no significant purpose is the generation of income or appreciation of property) would otherwise constitute jeopardizing investments. Congress made a policy decision to allow foundations to make such investments because these investments are made specifically for the purpose of accomplishing the foundation's exempt purposes. As such, where an investment qualifies as a program-related investment it will not be a taxable expenditure. However, caution is urged to ensure that an investment will qualify as a program-related investment, as failing PRI status, these types of investments would often otherwise constitute jeopardizing investments. For example, an investment that is not on commercial terms and carries significant risk (one that might otherwise qualify as a PRI) that allows for the funds to be used for political intervention (thereby destroying qualification as a PRI) would likely constitute a jeopardizing investment.

E. Taxable Expenditures.

Private foundations are prohibited from making taxable expenditures which are expenditures not in furtherance of the foundation's exempt purposes. Taxable expenditures include amounts paid or incurred by a private foundation to carry on propaganda or otherwise attempt to influence legislation or the outcome of any public election. Additionally, if the foundation makes a distribution to a for profit entity, it must monitor the distribution in order to avoid a penalty (such monitoring being referred to as "expenditure responsibility").

As addressed above, when an investment qualifies as a PRI, it constitutes a qualifying distribution and not a taxable expenditure. However, this is only true where the foundation provides appropriate oversight. Section 4945(h) provides for expenditure responsibility related to grants. Section 4945-5(b)(3) of the Regulations provides for expenditure responsibility related to grants. Section 53.4945-5(b)(4) provides for expenditure responsibility related to PRIs. PRIs made to organizations other than public charities (or exempt operating foundations) including other private foundations, other types of exempt organizations that are not public charities, for profit organizations or foreign organizations require that the foundation comply with the expenditure responsibility requirements under Section 53.4945-5(b)(4) to avoid having the expenditure treated as a taxable expenditure thereby resulting in the imposition of an excise tax.

That section provides that when making a program-related investment, in order to satisfy the expenditure responsibility requirements of section 4945(h) of the Code, the private foundation must require that each such investment (where expenditure responsibility must be exercised) must be made subject to a written commitment signed by an appropriate officer, director or trustee of the recipient organization specifying the purpose of the investment and including the following agreements on behalf of the organization:

> (i) To use all of the funds received from the private foundation (as determined under paragraph (c) of this section) only for the purposes of the investment and to repay any portion not used for such purposes, provided that, with respect to equity investments, such repayment shall be made

[4] Again, as addressed in the section on self-dealing above, if the foundation owns voting control of the business, that business will be treated as a controlled organization and the foundation must take great care to avoid indirect self-dealing.

only to the extent permitted by applicable law concerning distributions to holders of equity interests;

(ii) At least once a year during the existence of the program-related investment, to submit 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;

(iii) To maintain books and records adequate to provide information ordinarily required by commercial investors under similar circumstances and to make such books and records available to the private foundation at reasonable times; and

(iv) Not to use any of the funds—

(a) To carry on propaganda, or otherwise attempt, to influence legislation (within the meaning of section 4945(d)(1));

(b) To influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive (within the meaning of section 4945(d)(2)); or

(c) With respect to any recipient which is a private foundation (as defined in section 509(a)) to make any grant which does not comply with the requirements of section 4945(d)(3) or (4).

V. Other Treatment of Program-Related Investments.

A. Tax on Net Investment Income.

Pursuant to section 4940(a) of the Code, private non-operating foundations are subject to an excise tax of two percent (2%) on their net investment income. This excise tax on net investment income is not avoidable; however, it can be reduced to one percent (1%) where the foundation can demonstrate that its qualifying distributions paid out before the end of the tax year equal or exceed the sum of (a) the five-year average payout times current year assets, plus (b) one percent (1%) of net investment income. *See* § 4940(e)(2). Net investment income equals gross investment income (the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties, and income from other sources similar to those in the preceding list) plus net capital gain, minus all ordinary and necessary expenses paid or incurred for the production or collection of such income, including brokerage fees, investment management fees and director fees applicable to managing the investments.

The section 4940 excise tax on net investment income applies to income generated from all investments, including PRIs. As such, where PRIs generate interest, dividends, rents, royalties, or similar income, such amounts will be subject to the net investment income tax. Additionally, where a PRI is structured as an equity investment and results in capital gains, such gains are also taxable under section 4940 of the Code. Foundations should take note that section 4940(c)(4)(D) provides that there is an exclusion from gross investment income from capital gains or losses resulting from property used for a foundation's exempt purposes for at least one year if the entire property is exchanged immediately following such period of use solely for property of like kind which is also to be used primarily for the foundation's exempt purposes.

B. Unrelated Business Taxable Income.

PRIs are not subject to the tax on unrelated business income. Unrelated business taxable income ("UBTI") generally arises in two situations; (1) when the charitable organization has income from an unrelated trade or business; or, (2) when the charitable organization has income incurred with respect to debt-financed property. *See* §§ 512(a)(1), 514(a)(1)(2). With respect to the first of these two situations, section 512 provides that "unrelated business taxable

income" means gross income that is derived by an organization from an unrelated trade or business which is regularly carried on by the organization less certain allowable deductions. Because the definition requires that the income be generated from an "unrelated trade or business," and because PRIs are, by definition, for the primary purpose of furthering one or more of the exempt purposes of the foundation, PRIs are excluded from UBTI. With respect to the second situation, section 514(b)(1)(A)(1) excludes from the definition of "debt-financed property" property substantially all the use of which is substantially related to the organization's exempt purposes. Again, because PRIs, by definition, have a primary purpose of furthering one or more of the exempt purposes of the foundation, PRIs are excluded from the definition of debt-financed property.

C. UPMIFA.

In 2007, Texas adopted the UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT ("UPMIFA"), codified at Chapter 163 of the TEXAS PROPERTY CODE. Developed by the National Conference of Commissioners on Uniform State Laws in 2006, UPMIFA is intended to provide updates to endowment fund investment and management standards. UPMIFA provides modern articulations of the prudent standards for the management and investment of charitable funds and for endowment spending. UPMIFA sets forth standards of conduct in managing and investing institutional funds, promulgates spending rates for endowment funds, addresses an institution's ability to delegate management and investment functions, and provides for release or modification of certain restrictions on management, investment, or the purpose of an institutional fund.

UPMIFA applies to "institutional funds" as that term is defined in Section 163.003. Section 163.003(5) defines an "institutional fund" as "a fund held by an institution exclusively for charitable purposes," but excludes from such definition program-related assets. Section 163.003(7) defines a "program-related asset" as an asset held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment." Because PRIs have a primary purpose of accomplishing one or more of the foundation's exempt purposes, a PRI qualifies as a "program-related asset" under the terms of Chapter 163. Because PRIs are program-related assets which are specifically excluded from the definition of institutional funds, a foundation does not need to meet the prudent investment standards set forth under UPMIFA. This does not mean that foundation managers may abdicate their standard fiduciary duties of care, loyalty and obedience in overseeing the foundation's activities including its program-related investing activities, but rather that the specific provisions set forth in Chapter 163 of the TEXAS PROPERTY CODE are not applicable to these specific types of investments.

VI. Conclusion.

For private foundations that are willing to exercise the due diligence on the front end and who are committed to following an investment, PRIs are an effective way to make additional impact. Many organizations, both charitable and non-charitable, are engaging in projects with great social benefit but lack either the equity or the ability to tap into commercial credit to pursue those goals. It is in those areas that foundations willing to consider PRIs can come alongside the PRI recipients to further these charitable missions. As with any new undertaking, private foundations and their managers should take care to understand the rules relating to PRIs to ensure that the investment is treated as program-related to allow it the full benefits and protections addressed in this paper.

Appendix 1
PRI Examples: 26 C.F.R. § 53.4944-3

Example (1). 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 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. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.

Example (2). Assume the facts as stated in Example (1), except that after the date of execution of the loan Y extends the due date of the loan. The extension is granted in order to permit X to achieve greater financial stability before it is required to repay the loan. Since the change in the terms of the loan is made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property, the loan shall continue to qualify as a program-related investment.

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. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the purchase of the common stock is a program-related investment, even though Y may realize a profit if X is successful and the common stock appreciates in value.

Example (4). X is a business enterprise which 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. No significant purpose of the loan involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example (5). X is a business enterprise which is financially secure and 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. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, even though X is large and established, the investment is program-related.

Example (6). X is a business enterprise which is 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 which 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. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example (7). X, a private foundation, invests $100,000 in the common stock of corporation M. The dividends received from such investment are later applied by X in furtherance of its exempt purposes. Although there is a relationship between the return on the investment and the accomplishment of X's exempt activities, there is no relationship between the investment per se and such accomplishment. Therefore, the investment cannot be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) and cannot qualify as program-related.

Example (8). S, a private foundation, makes an investment in T, a business corporation, which qualifies as a program-related investment under section 4944(c) at the time that it is made. All of T's voting stock is owned by S. T experiences financial and management problems which, in the judgment of the foundation, require changes in management, in financial structure or in the form of the investment. The following three methods of resolving the problems appear feasible to S, but each of the three methods would result in reduction of the exempt purposes for which the program-related investment was initially made:

(a) Sale of stock or assets. The foundation sells its stock to an unrelated person. Payment is made in part at the time of sale; the balance is payable over an extended term of years with interest on the amount outstanding. The foundation receives a purchase-money mortgage.

(b) Lease. The corporation leases its assets for a term of years to an unrelated person, with an option in the lessee to buy the assets. If the option is exercised, the terms of payment are to be similar to those described in (a) of this example.

(c) Management contract. The corporation enters into a management contract which gives broad operating authority to one or more unrelated persons for a term of years. The foundation and the unrelated persons are obligated to contribute toward working capital requirements. The unrelated persons will be compensated by a fixed fee or a share of profits, and they will receive an option to buy the stock held by S or the assets of the corporation. If the option is exercised, the terms of payment are to be similar to those described in (a) of this example.

Each of the three methods involves a change in the form or terms of a program-related investment for the prudent protection of the foundation's investment. Thus, under § 53.4944-3(a)(3)(i), none of the three transactions (nor any debt instruments or other obligations held by S as a result of engaging in one of these transactions) would cause the investment to cease to qualify as program-related.

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. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

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. The investment has no significant purpose involving the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the investment is program-related.

Appendix 2
Due Diligence Checklist for PRIs[5]

1. Check foundation's governing documents, resolutions, and gift restrictions to ensure no restrictions on making PRIs

2. Obtain and review proposal from PRI applicant (determine is proposed investment is consistent with foundation's exempt purposes); identify programmatic rationale for proposed investment

3. Obtain and review information on proposed recipient and its key principals (annual report, brochures, press releases, management structure, reference checks, background checks, succession plan for key personnel, interviews, site visits, etc.)

4. Explore operational/business structure where necessary (such as where the recipient is a multi-tiered entity)

5. Obtain and review year end financials for at least past 3 years including audited financial statements where available

6. Analyze project plan and proposed terms of investment and consider various risks (consider exit strategies)

7. Determine impact of investment on foundation's portfolio (PRI portfolios should be treated separately from standard investment portfolio as measure of performance will differ based on balancing of social return with financial return)

8. Develop term sheet with financial terms including repayment terms and, as applicable, security, recourse, and loan position

9. Develop appropriate legal documentation with all necessary requirements of PRIs (determine need/desire for PLR or a well-reasoned opinion of counsel)

10. Develop agreed-upon measurable programmatic goals and financial indicators for ongoing monitoring (determine need to exercise formal expenditure responsibility)

11. After closing, monitor programmatic goals and financial indicators (where applicable, conduct formal expenditure responsibility)

12. Report PRIs on 990-PF

[5] *See* Diesslin, David H. "Fiduciary Responsibility for Alternative Investments: A Financial Advisor's Insights" Governance of Nonprofit Organizations Course (2009) for an excellent discussion of due diligence. While the due diligence discussed therein relates to investments that are not program-related, the discussion provides useful information to the foundation making PRIs as well.