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# BEYOND GRANTMAKING: ADDITIONAL MECHANISMS FOR MISSION

January 13, 2017

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# OVERVIEW

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- Many foundations, public charities and individual donors are looking for the biggest “bang for their buck;” they want to increase the impact of their charitable activities; they want to change the world, in big or small ways.
- Foundations want to achieve their missions by going beyond or supplementing their traditional grantmaking activities.
- Another title for this program could be “thinking outside the box, while working within the rules.”
- We will discuss:
  - The basic parameters of the private foundation rules.
  - Alternatives to traditional private foundations, including foundations that engage in direct charitable activities, medical research organizations, charitable joint ventures and more.
  - Program and Mission Related Investments.

# PRIVATE FOUNDATION REQUIREMENTS

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To remain tax-exempt, and/or avoid penalties, private foundations (unlike public charities) must comply with numerous requirements when making grants or investments, including:

- Avoiding investments that “jeopardize” their charitable purpose (§ 4944)
- Distributing annually at least 5 percent of net investment income in “qualifying distributions” for exempt purposes (§ 4942)
- Exercising “expenditure responsibility” when making a grant to or “charitable” investment in for-profit or other non-c3 entities (§ 4945)

## PRIVATE FOUNDATION REQUIREMENTS (CONT'D)

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- Avoiding more than 20 percent of ownership interests (together with disqualified persons) in a business enterprise (§ 4943)
- Avoiding self-dealing transactions between a private foundation and disqualified persons (§ 4941)
- Avoid private inurement and private benefit (§ 501(c)(3))
- Paying a 1 or 2 percent excise tax on net investment income (§ 4940)

# FIVE PERCENT ANNUAL DISTRIBUTION REQUIREMENT

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- § 4942 requires a private foundation to pay out annually at least 5 percent of its net investment income in qualifying distributions for exempt purposes.
- What are qualifying distributions?
  - All grants to 509(a)(1) & (a)(2) charities, non-charities (for profits), and eligible individuals, as long as IRS rules are followed
  - Reasonable & necessary administrative expenses related to grantmaking
  - Assets used to conduct charitable purpose (such as buying a computer for grant-tracking)
  - Charitable set-asides
  - Program Related Investments (PRIs) (more on this later), and
  - DIRECT CHARITABLE ACTIVITIES

## WHAT CONSTITUTES DIRECT CHARITABLE ACTIVITIES?

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A private non-operating foundation can engage in direct charitable activities to supplement its traditional grantmaking, and such direct charitable expenditures will be qualifying expenditures for section 4942's 5% payout requirement. A foundation can also engage almost exclusively in direct charitable activities and qualify as a private operating foundation.

The Instructions to Part IX-A of Form 990-PF provides a non-comprehensive list of examples of direct charitable activities:

- Acquire or maintain the operating assets of a museum, library, or historic site or to operate the facility;
- Provide goods, shelter, or clothing to indigent or disaster victims if the foundation maintains some significant involvement in the activity rather than merely making grants to the recipients;
- Conduct educational conferences and seminars;
- Operate a home for the elderly or disabled;

# WHAT CONSTITUTES DIRECT CHARITABLE ACTIVITIES (CONT'D)

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- Conduct scientific, historic, public policy, or other research with significance beyond the foundation's grant program that does not constitute a prohibited attempt to influence legislation;
- Publish and disseminate the results of such research, reports of educational conferences, or similar educational material;
- Support the service of foundation staff on boards or advisory committees of other charitable organizations or on public commissions or task forces;
- Provide technical advice or assistance to a governmental body, a governmental committee, or subdivision of either, in response to a written request by the governmental body, committee, or subdivision;
- Conduct performing arts performances; or

# WHAT CONSTITUTES DIRECT CHARITABLE ACTIVITIES (CONT'D)

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- Provide technical assistance to grantees and other charitable organizations. This assistance must have significance beyond the purposes of the grants made to the grantees and must not consist merely of monitoring or advising the grantees in their use of the grant funds. Technical assistance involves the furnishing of expert advice and related assistance regarding, for example:
  - Compliance with governmental regulations,
  - Reducing operating costs or increasing program accomplishments,
  - Fundraising methods, and
  - Maintaining complete and accurate financial records.



# DIRECT CHARITABLE ACTIVITIES

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- Private Foundations can engage in direct charitable activities to supplement their grantmaking or as a separate component of their charitable programs.
- If a private foundation engages mostly in direct charitable activities, it make qualify as a private operating foundation.

# PRIVATE OPERATING FOUNDATIONS

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A private operating foundation (POF) is any private foundation that spends at least 85% of its income on direct charitable activities. A POF is treated as a hybrid between a private foundation and public charity, subject to most private foundation rules, but treated as a public charity for others.

- POFs are not subject to the 5% annual distribution requirements applicable to other private foundations.
- Nonoperating private foundations may treat qualifying distributions to POFs as if they are made to public charities, if the nonoperating foundation exercises expenditure responsibility and the private foundation does not control the POF.
- Donors to POFs are subject to a 50% charitable contribution deduction limitation rather than the 30% limit that applies to nonoperating foundations.
- POFs are still subject to the 1 or 2% net investment income tax.
- POFs are still subject to the self-dealing rules.

# PRIVATE OPERATING FOUNDATIONS (CONT'D)

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To qualify as a POF, a foundation must satisfy an income test and one of three additional tests: the asset test, endowment test, or support test for three out of the last four tax years.

- INCOME TEST

- To satisfy this test the organization must make spend at least 85% of its adjusted net income or minimum investment return, whichever is less, on direct charitable activities.
  - “Adjusted net income” is gross income, including from related and unrelated trades or business, less expenses; net income does not include gifts, grants or contributions.
  - Minimum investment return is 5% of the excess of the FMV of all assets, other than those used or held for use for the foundation’s exempt purposes, over the amount of indebtedness incurred to buy those assets.

# PRIVATE OPERATING FOUNDATIONS (CONT'D)

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## ■ ASSET TEST

- A private foundation will meet the assets test if 65% or more of its assets:
  - Are devoted directly to the active conduct of its exempt activity, a functionally related business, or a combination of the two,
  - Consist of stock of a corporation that is controlled by the foundation (by ownership of at least 80% of the total voting power of all classes of stock entitled to vote and at least 80% of the total shares of all other classes of stock) and at least 85% of the assets of which are devoted to a business functionally related to the POF's charitable purposes, or
  - Are any combination of (1) and (2).

# PRIVATE OPERATING FOUNDATIONS (CONT'D)

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- ENDOWMENT TEST

- To satisfy this test the organization must make qualifying distributions directly for the active conduct of the charitable activity amounting to not less than two-thirds of its minimum investment return—in other words,  $3\frac{1}{3}$  percent of its endowment.
- Direct Charitable Activities  $\geq (5\% \times \text{Endowment}) \times \frac{2}{3}$ .

- SUPPORT TEST

- To satisfy this test the organization must receive at least 85% of its support (other than gross investment income) from the general public and unrelated exempt organizations, but can also receive up to 50% of its total support from gross investment income.
- This test is generally used by a POF that receives support from the general public, government grants, or other foundations to operate its programs, but has a significant endowment that would cause it to fail the public charity support tests under IRC section 509(a)(2).

# Program-Related Investments: Legal Elements

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- To qualify as a PRI (IRS approval not required, but may be prudent), the investment must meet 3 conditions (Reg. 53.4944-3(a)(1)):
  1. The primary purpose of the investment is to accomplish one or more charitable purposes.
  2. Neither the production of income nor the appreciation of property is a significant purpose of the investment.
  3. The purposes of the investment do not include engaging in lobbying or advocacy, or supporting or opposing a candidate for public office.
- Examples: below-market-rate loans, loan guarantees, deposits or linked deposits in community development bank, or equity investments.

# 1. Primary Purpose is to Accomplish Charitable Purposes

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- Investment is considered to be made “primarily” to accomplish charitable purposes:
  - if it “[s]ignificantly furthers the accomplishment of the private foundation’s exempt activities and
  - if the investment would not have been made *but for* [the] relationship between the investment and the accomplishment of the foundation’s exempt activities” (Reg. 53.4944-3(a)(2)(i)).

## 2. Investment Return is Not a Significant Purpose

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- To determine whether a “significant purpose” of the investment is the production of income or appreciation of property, consider whether “investors solely engaged in the investment for profit would be likely to make the investment on the same terms” (Reg. 53.4944-3(a)(2)(iii)).
  - *i.e.*, below-market-rate loans are relatively easy to qualify, but equity investments may require additional planning (such as imposing a cap on returns, or structuring as tranche funds)
- An investment does *not* automatically fail to qualify as a PRI solely because it produces significant income or capital appreciation (but does fail to qualify as PRI if change to investment terms is made for that purpose).



### 3. Not Engaging in Lobbying or Advocacy, or Intervening in Campaign for Public Office

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- No purpose of the PRI may include attempting to influence legislation, or participating or intervening in candidates' campaigns for public office.
  - This requirement is generally met if the PRI is not earmarked for political activities (Reg. 53.4945-2(a)(4)).

## Variety of Vehicles for Making PRIs

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- Targeting market failures by direct investments.
  - Induces successful businesses to remain in deteriorating communities, or establishes new business ventures in communities with otherwise high investment risks.
- Using intermediaries.
  - Expands opportunities for PRIs; creates economies of scale by aggregating investors and investees; and reduces financial and reputational risk.
- Advising investments through a functionally related business.
  - Can be used to establish a “functionally related business” and thereby exempt the foundation from excess business holding rules (§ 4942(j)(4))
- Investing in benefit corporations.
  - Foundations may now look at investments in these emerging vehicles (such as social benefit corporations organized to serve socially beneficial purposes).

## MRIs: Another Tool

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- Mission Related Investments are market-based investments that compliment a charity's overall mission.
- Examples:
  - A foundation in City X makes grants to support cultural and educational institutions in the city. A portion of the foundation's investment portfolio is dedicated to market-based investments in for-profit business in the city.
  - An environmental charity invests in green technology companies, expecting a market-based return.
- Like any other investments in portfolio, must comply with private foundation and legal requirements.

## What are MRIs?

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- MRIs are made from investment assets (“the other 95 percent”) and constitute a commercial investment
  - Must comply with jeopardy investment rules, state and federal prudent investor standards, unlike PRIs which are not subject to these investment rules.
  - Be aware of Unrelated Business Income Tax (UBIT) rules, because MRIs are generally not “substantially related” to a foundation’s exempt purposes (§ 512).

## Recent MRI Guidance

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- Recently, in Notice 2015-62, the IRS analyzed the extent to which the mission impact of investments can be taken into account in satisfying the prudent investment standard.
- The IRS concluded:
  - “When exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation’s charitable purposes.”

## Ventures with For-Profits

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- Many nonprofits are joining forces with for-profit companies to achieve charitable goals, but in a profit-making environment.
- Here is a real life example:
  - A disease-specific scientific research organization engages in joint research projects with for-profit drug companies to develop treatments for patients with the disease. The nonprofit provides subject-matter expertise and some funds; the for-profits supply funds and researchers, have the ability to do clinical trials and, if successful, have the distribution networks to get the products to market, with the nonprofit sharing in the profits and the for-profits agreeing to make the products available for free or at favorable pricing to needy populations.

# Social Investments: Comparison of Applicable Private Foundation Rules

<b>Provision</b>	<b>PRI</b>	<b>MRI</b>	<b>JVs</b>
Investment Income Tax	✓	✓	✓
Self-Dealing	✓	✓	✓
Counts Toward Payout	✓	-	<b>Yes if PRI</b>
→ Part of Asset Base	-	✓	<b>Not if PRI</b>
Excess Business Holdings	-	✓	<b>Not if PRI</b>
Jeopardizing Investment	-	✓	<b>Not if PRI</b>
Expenditure Responsibility	✓	-	<b>Yes if PRI</b>
Prudent Investor Standards	-	✓	<b>Not if PRI</b>
UBIT Rules	-	✓	<b>Not if PRI</b>

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# QUESTIONS?