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Program-Related Equity Investments

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Classically, a private foundation makes investments to increase or maintain the size of its endowment and to generate income so that it may make grants and otherwise engage in charitable programs and activities. Increasingly, foundations seek investments that further their charitable work (i.e., impact investments or mission-related investments in specific companies that actively promote social welfare and further the foundation's mission). They also shy away from making investments in companies they deem socially irresponsible such as those that manufacture tobacco, firearms, or alcohol.

However, in addition to making "social purpose" investments from its endowment, a private foundation can consider making a program-related investment or "PRI" in commercial ventures from its grantmaking budget.

PRIs are mission-driven investments that are not subject to the normal prudent investment standards. For legal purposes, PRIs are considered to be more akin to grants because they are made purely to further a charitable purpose without regard to any return on investment. PRIs, by definition, do not have to be prudent, and they are not subject to an excise tax for jeopardizing investments.

There are three typical types of PRIs: loans, loan guarantees, and equity investments in for-profit organizations, such as corporations, limited partnerships, and limited liability companies. This article will focus on PRI equity investments because it is less understood than the other two varieties.

Under what conditions can a foundation make a PRI in a for-profit entity?

In order to make a PRI, the foundation must meet three requirements:

- The primary purpose of the investment must be to further one or more charitable purposes of the foundation. In larger measure, this is a determination specific to each foundation, its mission, and the proposed PRI.

For example:

> *A foundation's mission is to improve the health and wellbeing of people living in poverty. The foundation invests in an organic fruit and vegetable stand that would not otherwise be built in a very poor neighborhood. Although there is nothing inherently charitable about operating a fruit stand, having the fruit stand in this neighborhood furthers the foundation's charitable purpose.*

- The production of income or the appreciation of property may not be a significant purpose of the investment. In the above example, note that the foundation is not investing in the fruit stand because it expects to turn a profit.

- As is true of any foundation grant, the PRI cannot be used to fund electioneering or lobbying activity. As this is not generally a concern with PRI equity investments, this is not further addressed in this paper.

How does the IRS determine whether an investment in a for-profit entity furthers a foundation's charitable purpose?

Not every investment that furthers a charitable purpose automatically qualifies as a PRI. In order to do so, an investment must pass the primary exempt purpose test. There are two parts to this test: First, the investment must *significantly further* the accomplishment of the foundation's charitable purpose. Second, the investment must be such that it would not have been made *but for* its relationship to the foundation's charitable purpose.

Note that the for-profit entity receiving the PRI does not itself have to intend to engage in a charitable activity; rather, its activity must further a charitable purpose of the foundation. Consider an example:

> *The foundation is dedicated to eradicating a rare disease. A large pharmaceutical company is close to developing a promising vaccine, but because there isn't a sizeable market for it, the vaccine will not be fully developed and submitted for the long and costly FDA approval process, and it will therefore never be made available. To induce the pharmaceutical company to develop the vaccine, the foundation purchases shares of the common stock of a subsidiary of the pharmaceutical company established explicitly for researching and developing the vaccine.*

Because the foundation's investment in this vaccine is directly aligned with its charitable purpose, the development of the vaccine would significantly further the foundation's mission, and the foundation is making the investment *only* because doing so could help it fulfill its mission, the investment would pass the primary exempt purpose test. However, if the foundation were to make an investment in the same subsidiary without the intent of thereby advancing its mission, it would probably fail to pass this test.

Practice Points:

- Where a for-profit entity has only one activity for which it is seeking funding (e.g., building a fruit stand in a poor neighborhood), the foundation must evaluate the activity to ensure that it furthers its charitable purpose. Where the entity has multiple activities (e.g., the large pharmaceutical company, which presumably has multiple product lines), the foundation must ensure that its funds are going toward one or more of the activities that actually furthers its charitable purpose.

- The foundation's own purpose, as set forth in its articles or certificate of incorporation, is also relevant in determining whether any given PRI furthers the foundation's particular charitable purpose or purposes. If a private foundation has a very broad mission (e.g., "to bring about a happier, verdant, and peaceful world"), it will have a broader array of PRIs that it might fund. A foundation with a narrow purpose (e.g. "to find a cure for cancer"), could only fund PRIs that furthers its narrow charitable purpose.

How does a foundation know if a PRI has no significant purpose of generating income or the appreciation of property?

As there can be a significant opportunity for generating a profit, a foundation needs to be careful when making a PRI equity investment. The single test here is whether *no significant purpose* of the investment is the production of income or the appreciation of property. As a practical implication, a PRI should be less attractive to traditional investors. 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. However, the fact that an investment actually 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, and therefore does not preclude the investment from being a valid PRI.

Consider the vaccine for the rare disease in the previous example. What if, during the FDA approval process, the pharmaceutical company discovered that the vaccine also happened to prevent the common cold? Now, instead of having an unprofitable vaccine on their hands, they've got a potential goldmine, and investors are taking notice. Although the foundation didn't invest in the vaccine for a financial return, it now stands to reap a substantial return on its investment. The fact that this "bad investment for a good cause" ultimately proved to be an excellent investment does not render the PRI invalid.

A private foundation could make its motives manifestly clear by developing an exit strategy that would cash it out of its investment as soon as it appears to be profitable, removing itself from participation in any financial gain. However, the foundation should consider the private benefit that may be bestowed upon other investors if the foundation gives up its share. (See discussion of private benefit below.) In addition, while investing without the potential for any financial gain may help demonstrate the lack of financial motive, a foundation should not rely exclusively on divestment to justify a PRI that is expected to generate a return for others; the foundation's analysis of the investment should still support a conclusion that an investor would not make the same investment if the production of income or the appreciation of property was a significant purpose.

Although the *no significant investment purpose* test is easily satisfied if a PRI is made in the form of a loan at below-market interest rates, when a foundation makes an equity investment PRI, it must consider, among other things:

- Whether there are already individual and corporate investors ready to invest or the likelihood that the company could find other investors.
- Whether the lack of liquidity and/or high-risk nature of the investment would fail to meet the foundation's investment policy criteria for its normal investment portfolio. (Remember: to qualify as a PRI, it needs to be unattractive as a financial investment.)

Must the PRI recipient demonstrate that it was unable to secure financing from traditional sources before the foundation makes its investment?

A common fact pattern in PRI examples provided by the IRS is that funding would be unavailable if the foundation did not invest, because other investors were either unable or unwilling to participate. A lack of alternative funding can be a significant factor in demonstrating that other investors solely concerned with profit would not invest on the same terms as the foundation. However, neither the Internal Revenue Code nor the Regulations *require* a lack of alternative funding to qualify as a PRI. A foundation may wish to be an early investor, rather than the investor of last resort, in order to influence the way in which a business will develop or to provide credibility or expertise that will help attract other investors. The IRS has not provided examples that clearly support this fact pattern; however, many practitioners would not limit PRIs only to recipients that already have tried and failed to obtain funding from traditional sources.

Does a foundation need to be concerned about whether a PRI equity investment creates a private benefit?

Wholly apart from the private foundation rules, general principles under Section 501(c)(3) prohibit any charity, foundation or otherwise, from providing an undue private benefit to individuals or for-profit entities. The foundation needs to be cautious if it is being asked to invest on terms that are significantly less favorable than terms that are being offered to other investors. Are for-profit investors likely to do very well as a result of the foundation taking less favorable terms? Could the foundation's charitable purpose in making the investment be accomplished without providing this benefit to private parties? In other words, is the private benefit to private parties avoidable?

As an example:

Assume a start-up drug company that will develop and sell a vaccine that will eradicate Ebola is offering two classes of stock, one for foundations and one for individual investors, the foundation should not accept a class of stock with less favorable terms just to satisfy the "no significant purpose" test or because the foundation is not interested in making a profit, but it may accept a less favorable class of stock if doing so is reasonably necessary in order to attract other investors to properly capitalize the company.

How do the other private foundation rules come into play?

As a PRI is a *qualifying distribution* that counts toward meeting the foundation's annual minimum distribution requirement, the foundation will need to plan for appropriate accounting of PRIs, both when investments are made and also when they are repaid. When the foundation exits a PRI, either by being redeemed by the recipient or by selling its interest to a third party, the foundation's tax liability is computed on any resulting capital gain at the usual one or two percent tax rate. Moreover, any such recovery of a PRI will result in a commensurate increase in next year's annual minimum distribution requirement.

Because a PRI is reported as an "exempt function" or charitable asset on the foundation's balance sheet, the PRI is excluded from the investment asset base referenced to calculate the foundation's annual minimum distribution requirement. For example, an investment of $1 million in a traditional stock that does not appreciate or depreciate in value would give rise each year to a $50,000 minimum distribution requirement. By contrast, an investment of $1 million in an equity PRI that likewise does not fluctuate in value would not give rise to any annual minimum distribution requirement because the PRI would be excluded from the asset base referenced to calculate the requirement.

A PRI is not included in the calculation of excess business holdings, so a foundation may own more than 20% of an entity if its investment is a PRI.

A foundation needs to be very careful to avoid self-dealing if it co-invests in any company, including via a PRI, with its substantial contributors or its officers or directors.

When a foundation invests in a for-profit entity, it must exercise expenditure responsibility, including:

- A pre-grant inquiry
- A written contract containing the PRI and expenditure responsibility terms set forth in IRS Regulations, including the right to have the PRI repaid if the PRI recipient does not use the PRI funds properly
- Proper reports and certifications back from the PRI recipient
- Proper reporting of the PRI to the IRS

What do the investment documents look like?

In a PRI involving a loan, all of the proper PRI contract language can go in a carefully drafted loan agreement. In an equity investment, the entity seeking the PRI typically will provide the foundation with an offering document, a subscription agreement, and perhaps a shareholder agreement or a partnership or LLC operating agreement. None of these documents is likely to contain proper PRI language or meet the expenditure responsibility requirements described above, and so, the foundation often ends up drafting and negotiating a "side letter" agreement with the entity. Without this side letter, in most cases, the PRI will fail to meet the PRI requirements. In addition, in some situations where the organizing documents of the recipient entity are not limited to furthering a charitable purpose of the foundation, the side letter will contain affirmative covenants and obligations of the PRI recipient to make sure that PRI furthers the charitable purpose of the foundation. For example, a side letter in connection with an investment in the stock of a drug company that is developing a vaccine might clearly require the drug company to offer the vaccine to the poor and to sell the vaccine to them at a low cost.

How can a foundation insist on getting repaid if the recipient misuses PRI funds?

One of the PRI requirements is that (with limited exceptions) the foundation will get its investment repaid if the recipient fails to use the funds for the purposes stated, fails to provide proper reports, or uses the funds for something inappropriate, such as lobbying. With equity investments, it can sometimes be difficult to convince the recipient to put repayment language in the side letter, but foundations must have this language, and they often underestimate their bargaining power in the deal. There are also subtle issues to consider in repayment: Does the foundation merely get its principal investment back? What if the investment has appreciated? Questions also may arise regarding how quickly the investment must be repaid, or whether another investor could be found to purchase the equity interest instead of the company returning foundation funds. When and how a PRI must be repaid are often the most highly negotiated terms of the investment.

How can a foundation keep track of all of this?

PRIs can be handled effectively and efficiently and are a great way to further the foundation's charitable purpose. It is important, however, to have a dedicated and knowledgeable staff member or an outside expert, such as Foundation Source, on hand to monitor the paperwork, reporting, and compliance requirements.

About Foundation Source (www.foundationsource.com)

Foundation Source is the nation's largest provider of comprehensive support services for private foundations. The company can set up a new private foundation quickly and easily, and for established foundations, our administrative services, proprietary online foundation management tools, and philanthropic advisory services provide a complete outsourced solution. Our clients provide the philanthropic vision; we supply everything else.

Now in our second decade, Foundation Source provides its services to more than 1,200 family, corporate, and professionally staffed foundations, of all sizes, nationwide. We work in partnership with wealth management firms, law firms, and accounting firms, as well as directly with individuals and families. Foundation Source is headquartered in Fairfield, Connecticut, with offices in Boston, Los Angeles, New York City, Philadelphia, San Francisco, Seattle, South Florida, Washington, D.C., and Winston-Salem.

About Adler & Colvin (www.adlercolvin.com)

Adler & Colvin is a law firm based in San Francisco, California, committed to serving the legal needs of the nonprofit sector. The firm represents tax-exempt organizations, nonprofit service providers, and individual and corporate donors.

Foundation Source

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