PROGRAM-RELATED INVESTMENTS:
A USER-FRIENDLY GUIDE

By: David S. Chernoff, Esq.

Introduction

Since the time of the English Common Law, trustees, executors and other fiduciaries holding or managing money or property for the benefit of third persons have been subject to personal liability if they made truly bad investments with those assets. In 1969, this concept found its way into the Internal Revenue Code's then new "private foundation rules".[1]

Sections 4944(a) and (b) of the Internal Revenue Code (the "Code") impose excise taxes on investments that jeopardize the carrying out of the exempt purposes of a private foundation. Such taxes may be imposed by the Internal Revenue Service (the "Service") on the errant foundation, its managers, or both. Additional taxes may be imposed if the improper investment is not remedied within the prescribed time.

Jeopardizing investments generally are those that show a lack of reasonable business care and prudence in providing for the long- and short-term needs of a foundation for it to carry out its exempt function. We need not look to the Code or Common Law for examples of bad investments. Common *sense* tells us that an unsecured, long term, low interest rate loan to a financially struggling non-profit organization is usually not a good business investment -- although it may be very good programmatically.

Section 4944(c) of the Code makes an exception to the jeopardizing investment prohibition for "program-related investments" made by private foundations.[2] Through program-related investments, a private foundation can invest money in ventures that help to achieve the foundation's charitable purposes but do not otherwise meet the criteria to be a permissible business investment.

In a report on program-related investments, The Foundation Center said:[3]

> *While most foundations make grants to support their programmatic interests, some funders also use alternative forms of financing to supply capital to the nonprofit sector. Taking the form of loans, loan guarantees, and other investments made for charitable purposes, program-related investments (PRIs) are commonly used to support community revitalization, low-income housing, micro-enterprise development, and also historic preservation, human services, education, church renovations <u>and many other types of projects</u>.* *(emphasis added)*

The three tests of program-related investments

To be a program-related investment, and thus not a *jeopardizing investment*, an investment must possess the following three characteristics:

- The primary purpose of the investment is to accomplish one or more of the charitable, religious, scientific, literary, educational and other exempt purposes described in section 170(c)(2)(B) of the Code;[4]

- No significant purpose of the investment is the production of income or the appreciation of property;[5] and

- No purpose of the investment is to lobby, support or oppose candidates for public office or to accomplish any of the other political purposes forbidden to private foundations by section 170(c)(2)(D) of the Code.[6]

The Regulations tell us that an investment will be considered as made primarily to accomplish one or more 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 relationship between the investment and the accomplishment of the foundation's exempt activities.[7]

The second test is often (but not always) easy to satisfy. If the program-related investment takes the form of a loan to a U.S. entity -- which they frequently do -- a below-market interest rate is usually within the control of the foundation. Even if made at a market interest rate, there may be greater risk or other less favorable conditions that make the loan, viewed as a whole, less attractive to investors with a profit motive. All aspects of domestic equity investments need to be analyzed, not just the projected return.

Interest rates and projected returns on foreign loans and investments are usually much higher than in the U.S. If the foundation receives less than the market interest rate prevailing in the foreign country, or otherwise makes the foreign investment on terms that would not be acceptable to an investor for profit, then, in the absence of other factors showing a profit motive, the investment should qualify as a program-related investment. This is an evolving area of the law.[8]

The Regulations[9] advise that in determining whether a significant purpose of an investment is the production of income or the appreciation of property, it is relevant to consider whether investors solely engaged in investment for profit would be likely to make that investment on the same terms as the private foundation. However, the fact that an investment produces significant income or capital appreciation will not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property. In such situations, it is important to analyze any other factors which may be present.

The remaining test -- no lobbying or political purposes -- is usually satisfied by carefully reviewing the borrower's activities and including appropriate language in the loan documents prohibiting the use of any of the proceeds of the investment for such activities.

<u>Forms of program-related investments</u>

Program-related investments often take one of the following forms:

- interest-free or below market-rate loan to non-profit organization (most common);
- purchase of promissory note of non-profit organization;
- purchase of "participation" in loan to non-profit organization;
- low interest rate deposit with a bank or other financial institution "linked" to lending for a charitable purpose (often housing or economic redevelopment); or
- equity investment in for-profit entity;

but always with a clear charitable or other exempt purpose.

Program-related investments may take other forms, provided they comply with relevant provisions of the Code and Regulations. For example, foundations *may* but do not often guaranty a loan or give a letter of credit ("L/C") to enhance a charity's creditworthiness in a third-party loan transaction.[10] The argument against is that there is no *present* qualifying distribution for a guaranty or L/C. The only time a foundation can take grant distribution credit on a guaranty or L/C is *after* the deal dies and the foundation is called upon to honor its guaranty or L/C.

The counter argument is that a loan guaranty or L/C not only allows a non-profit borrower to make an otherwise unavailable or unaffordable commercial borrowing, but also gives them an opportunity to build a favorable credit history. Further, the foundation guarantying the loan or issuing the L/C will enjoy infinite "leverage" of its assets at no out-of-pocket cost (assuming the transaction is successful). Moreover, a foundation may charge a small fee for giving its guaranty or L/C.[11]

The amount loaned, otherwise invested or actually *paid* under a guaranty or L/C constitutes a qualifying distribution[12] and thus is not a taxable expenditure; rather, it is credited against the private foundation's mandatory annual 5.0% distribution requirement. Grant distribution credit cannot, however, be taken for a loan guaranty or L/C furnished by a foundation unless and until such instrument is called or drawn upon and a payment is made by the foundation.

Customary documentation

Program-related investments are not complicated. They are far less complicated than the purchase of a home, row house or condominium unit -- something most of you have done, perhaps several times, and do not regard as complicated. For the purposes of this article, I'll divide the documents I typically prepare or require from the borrower (or from borrower's legal counsel or appropriate Secretary of State) in most program-related investments taking the form of loans, into two categories.

Background documents:

- *Request or proposal*. It's always good to see in the borrower's own words just what they propose to do with the money, and how and when they say they will pay it back.

• *Questionnaire*. It is important to ascertain -- before making a loan -- whether or not the proposed borrower has pledged, assigned or given a security interest in its assets to a third-party. If so, a bank or other pre-existing lender might be able to impose a lien upon or attempt to seize the loan proceeds, thereby frustrating the intended charitable purpose of the PRI.

• *Proof of tax-exempt status*. A copy of a favorable determination letter from the Service will usually suffice. A second letter may be required if the initial letter contained only an "advance determination period" with respect to non-private foundation status.

• *Certified articles of incorporation*. These will tell you the organization's purposes and legal name; all too often non-profits use a name different from their legal name.

• *Certified by-laws*. The by-laws will tell you what officers an organization has and which ones are authorized to sign contracts and promissory notes. If the party who runs the organization and will be signing the loan documents has the title "Executive Director", make sure the by-laws provide for that office (they usually don't!).

• *Certified borrowing resolutions*. You want to make sure that the loan transaction was properly authorized by the borrower's board of directors, and, unless so provided in the organization's by-laws, the parties signing the loan documents are specifically authorized to do so.

• *Corporate "good standing" certificate*. You want to be sure the organization is still legally in existence and was not dissolved (typically for failure to file an annual report or pay a nominal annual fee).

<u>Loan and closing documents</u>:

• *Commitment letter*. Similar to the letter a bank or other lender customarily issues. Usually four to five pages long and outlines the terms of the loan transaction. The commitment letter describes the charitable purposes for which the loan is being made; confirms the borrower's tax-exempt, non-private foundation status; requires that books and records be maintained and that annual financial and narrative reports and certificates of compliance be furnished; restricts the use of the loan proceeds only for charitable (and other exempt) purposes; prohibits their use for attempting to influence legislation or intervening in political campaigns; contemplates the execution of a long-form loan agreement; and provides for closing at a later date.

• *Loan Agreement*. Usually 15-18 pages long. It expands upon the commitment letter and also contains warranties, representations, prohibitions on the misuse of PRI funds and other covenants, default language, notice requirements and other provisions one would expect to see in an agreement governing a loan in the range of $500,000 to $3,000,000.

• *Promissory Note*. A typical promissory note -- about three pages long, including the notary certificate. You can tailor the interest rate and payment dates and amounts to the transaction. For example, as we often do, there may be quarterly payments of interest only, with a "balloon" payment of all principal at the end of the term. The loan payments might instead be self-amortizing, that is, equal monthly installments containing both principal and interest -- or anything else that works for the parties.

- *Officer's certificate*. Confirms that no "event of default" exists under the Loan Agreement and that all warranties and representations of the borrower in the Loan Agreement continue to be true and correct as of the closing date.

- *Certificate of Incumbency*. A certification by the corporate secretary as to the current officers of the borrower. This assures you that persons the signing the loan documents are current officers and provides specimen signatures.

- *Legal opinions*. I usually require two opinion letters at closing:

  (1) *Corporate* - Due authorization, execution and enforceability of the loan documents. This is a very standard opinion letter required in most commercial loan transactions and is something with which corporate and transactional lawyers are familiar. Such letters are usually three to five pages in length and are prepared by borrower's counsel.

  (2) *Tax* - A reasoned written legal opinion that the loan is a "program related investment" by the Foundation within the meaning of section 4944(c) and will constitute a "qualifying distribution" by the Foundation for purposes of section 4942(g) of the Code. These letters typically run five to 10 pages in length. Depending on the transaction, sometimes I prepare this letter and other times I require borrower's counsel to prepare it.

  In addition to assuring the lender that the transaction constitutes a "program-related investment" under Code section 4944(c), such letters serve a second purpose. If the Service sought to impose an excise tax upon the "foundation managers" who knowingly participated in making an allegedly improper investment, according to the Regulations[13], prior reliance by those foundation managers upon a "reasoned written legal opinion" of the type described in paragraph (2) may provide them with protection.

The above list is not exhaustive; depending on the exact transaction, other documents may be appropriate.[14]

<u>*Some examples of program-related investments*</u>

The Regulations contain a number of *Examples* of loans and investments -- many in or to for-profit entities -- that constitute program-related investments.[15]

Example (1), which is illustrative of the Service's analysis of program-related investments, reads as follows:

> *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.*[16]

The following are just two of many investments in for-profit entities which were the subject of favorable private letter rulings by the Service.[17]

A private foundation made a $1.0 million, 5.0%, 10-year loan to First Non-Profit Risk Pooling Trust, a creature of the Illinois insurance statutes. It was intended to expand First Trust's capital base in order to (a) lower insurance costs to its members (who are all 501(c)(3) tax-exempt organizations), (b) provide greater availability of reinsurance to First Trust, (c) allow First Trust to expand its insurance coverage of tax-exempt organizations, and (d) eventually allow First Trust to become a mutual insurance company (which it subsequently did) and thereby serve a larger portion of the tax-exempt community.

Limitations were imposed on both the profits to be made and dividends to be paid by a 50% owned for-profit subsidiary which performed underwriting and administrative functions for First Trust for a fee. The loan was repayable solely out of earned surplus of First Trust and only with the approval of the Director of the Illinois Department of Insurance.

In Private Letter Ruling 8810026 (December 8, 1987), the Service ruled that the foundation's surplus loan to First Trust constituted a "program-related investment" within the meaning of Code section 4944(c) and as such was not a jeopardizing investment. The Service further ruled that the $1.0 million loan constituted a "qualifying distribution" within the meaning of section 4942(g).

Another informative Letter Ruling described an equity investment in Northeast Venture Corporation, a for-profit holding company in Duluth, Minnesota, by a local private foundation.

Northeast Venture Corporation had two affiliates, one of which was a for-profit enterprise which made equity investments in new or expanding businesses in northern Minnesota, an area with high unemployment and whose depressed economy had for many years been dependent almost exclusively on iron ore. The parent's rate of return on its investment in the for-profit subsidiary was "capped" at 5.0% for a minimum of five years. The other affiliate was a non-profit enterprise which provided access to debt financing to small businesses in that economically-depressed region, together with ongoing business development and management assistance.

In Private Letter Ruling 8807048 (November 23, 1987), the Service ruled that the foundation's equity investment in Northeast Venture Corporation constituted a "program-related investment" within the meaning of section 4944(c) and was a "qualifying distribution" within the meaning of Section 4942(g) of the Code.[18]

Investments in for-profit entities

It does not matter (except for purposes of expenditure responsibility, discussed below) whether or not the recipient is tax-exempt or even if it is a for-profit business. For the transaction to be considered a program-related investment, the type of entity, tax status and even domicile country of the recipient does not matter. What is crucial is that a charitable or other exempt purpose will be served -- not who is the messenger.

The Regulations provide that in determining whether an investment qualifies as a program-related investment[19]:

> *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).*

Revenue Ruling 74-587, 1974-2 C.B. 162, makes the same point, but in plain English! In approving an exempt organization's program providing financial assistance to for-profit businesses located in economically depressed areas, the Ruling said:

> *Although some of the individuals receiving financial assistance in their business endeavors ... may not themselves qualify for charitable assistance as such, that fact does not detract from the charitable character of the organization's program. The recipients of loans and working capital in such cases are merely the instruments by which the charitable purposes are sought to be accomplished. (emphasis added)*

International program-related investments

Charitable activities know no international bounds. It has long been established that activities which are considered to be charitable when carried on within the United States are similarly charitable when carried on in foreign countries. Thus, program-related investments may be made to organizations anywhere in the world -- subject to U.S. embargoes, currency restrictions and anti-terrorism laws and orders.

For example, the Service has held that raising the living standards of needy families in developing countries, facilitating access to markets and credit, teaching modern farming methods and furnishing other technical assistance furthers charitable and educational purposes.[20] Similarly, loans by a private foundation to businesses to induce them to operate in an economically depressed foreign country furthers the charitable purpose of providing relief to the poor, and thus constitutes a program-related investment within the meaning of the Code.[21]

Another interesting example permits making loans to newspapers and T.V. and radio stations in Central and Eastern Europe and in the former Soviet Union to assist in the development of non-governmental, non-partisan, pluralistic, tolerant and non-extremist media in societies that have historically been "closed" (*i.e.*, non-democratic).[22]

The Service has also ruled that the investment by a private foundation (which was a strong supporter of biodiversity and environmental diversity) in a foreign for-profit corporation that acts as a financial intermediary for environmentally oriented foreign businesses was a program-related investment.[23]

Expenditure responsibility

Do not forget, with a few exceptions (which you will seldom encounter) program-related investments can *not* be made to any organization other than a domestic section 501(c)(3) tax-exempt organization which is classified as a public charity under Code section 509(a), *unless* the private foundation exercises "expenditure responsibility".

In particular, the expenditure responsibility requirements will apply to program-related investments in or to:

- other private foundations;
- not-for-profit corporations which are *not* tax exempt under Code Section 501(c)(3);
- for-profit corporations, partnerships and limited liability companies; and
- foreign organizations.

Those requirements, which are beyond the scope of this article, are set forth in Regulations §53.4945-4.

Other good reasons to make program-related investments

There are a number of added inducements for foundations to make program-related investments, including the following:

First, in most cases the funding for a program-related investment will come out of the organization's *grant* budget, not from its portfolio. Grant dollars are not usually recovered and do not earn any interest for the grantor organization, whereas program-related investments (a) will earn modest interest, (b) will be repaid (hopefully), and (c) can be recycled many times.

Second, there is a "hidden" 5.0% return because the amount of a foundation's program-related investment reduces the asset base upon which the 5.0% annual distribution requirement is applied. For example, instead of a stated 2.0% or 3.0% rate of return on a loan, a foundation will *in effect* get a 7.0% or 8.0% rate of return.

The 5.0% "minimum investment return" is *not* calculated upon assets of a foundation "which are used (or held for use) directly in carrying out the foundation's exempt purpose".[24] The Regulations[25] give as an example of assets which are used (or held for use) directly in carrying out the foundation's exempt purpose:

any interest in a ... program-related investment (as defined in section 4944(c)).

Third, program-related investments count towards the organization's grant distribution requirements in the year made (they are not "taxable expenditures"). They are a "qualifying distribution" within the meaning of Code[26] because they are:

[an] amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in section 170(c)(2)(B).

There will, however, be a "recapture" in the year of repayment, and the amount of any principal repayment will be effectively added to that year's minimum distribution requirement.[27]

Fourth, Program-related investments are exempted from the "excess business holdings" prohibitions of Code section 4943. For this purpose, they are considered *not* to be a "business enterprise".[28]

Fifth, it does not take much financial acumen to realize that, over a period of time, an ongoing system of low-interest rate program-related investments will not only pay for itself but will also provide increased funds for grants.

Conclusion

There are many reasons why private foundations can and do make program-related investments. They are not complicated nor are they expensive or difficult to document, close or administer.

However, as typified by *Example (1)* quoted above, the current Regulations on program-related investments are based mostly upon what Ford Foundation and a few other foundations were doing in the 1950s and '60s. When the present Regulations were being drafted, President Lyndon Johnson's *Great Society* anti-poverty programs had reached their apex.

In the last 33 years, the *Examples* contained in the existing Regulations have become stale. They mostly pertain to urban renewal and inner-city redevelopment -- very worthwhile causes, but no longer "cutting edge". It is those *other types of projects* referred to by The Foundation Center that need more attention, specifically, cutting edge program-related investments that reflect the realities of 21st Century economics, forms of doing business and global grantmaking.[29]

Mr. Chernoff is Associate General Counsel of the Chicago-based John D. and Catherine T. MacArthur Foundation. The views and opinions expressed herein are solely those of the author and do not necessarily reflect those of the MacArthur Foundation. This article was adapted from a speech delivered at the 2005 Annual Conference of the Council on Foundations in San Diego, California.

<u>ENDNOTES</u>

1. Code sections 4940-4948.

2. Neither the jeopardizing investment prohibition nor the exception for program-related investments applies to public charities. However, when making "charitable loans", public charities often look to the Regulations on program-related investments and Private Letter Rulings issued to private foundations for guidance.

3. *News Release*, April, 2001.

4. Regs. §53.4944-3(a)(1)(i).

5. Regs. §53.4944-3(a)(1)(ii).

6. Regs. §53.4944-3(a)(1)(iii).

7. Regs. §53.4944-3(a)(2)(i).

8. *See, e.g.*, Ltr. Rul. 200136026 (June 11, 2001).

9. Regs. §53.4944-3(a)(2)(iii).

10. *See, e.g.*, Ltr. Rul. 200043050 (July 25, 2000).

11. *See, e.g.*, Ltr. Rul. 9033063 (May 24, 1990).

12. Code section 4942(g)(1); Regs. §53.4942(a)-3(a)(2)(i).

13. Regs. §53.4944-1(b)(2)(v).

14. For a discussion of documenting and closing program-related investments, *see* Chernoff, *Some Practical Observations About Making, Documenting and Closing Program-Related Investments*, PHILANTHROPY MONTHLY, 96 March 23.

15. Regs. §53.4944-3(b). I highly recommend reading all 10 of the *Examples*.

16. Regs. §53.4944-3(b), *Example (1)*.

17. According to Code section 6110(k)(3), private letter rulings may not be cited as authority. Nonetheless, they are useful and show the Service's reasoning in specific situations.

18. For two articles on interesting uses of program-related investments, *see* Milton Cerny, *Case Studies Illustrate New and Creative Uses of Program-Related Investments*, 9 JOURNAL OF TAX EXEMPT ORGANIZATIONS 72 (Sep/Oct 1997) and Vivian Cavalieri, *Motivating Environmental Change with Program-Related Investments*, 10 JTEO 25 (Jul/Aug 1998).

19. Regs. §53.4944-3(a)(2)(i).

20. Rev. Rul. 71-460, 1971-2 C.B. 231.

21. *See, e.g.*, Ltr. Rul. 199943058 (Aug. 6, 1999).

22. *See, e.g.*, Ltr. Rul. 9551005 (Sept. 15, 1995).

23. Ltr. Rul. 200136026 (June 11, 2001).

24. Code section 4942(e)(1)(A).

25. Regs. §53.4942(a)-2(c)(3)(ii)(*d*).

26. Code section 4942(g).

27. Code section 4942(f)(2)(C)(i).

28. Regs. §53.4943-10(b).

29. For a further discussion of this topic, *see* Chernoff, *Outdated Regulations Hamper Foundations Making Foreign Program-Related Investments*, 12 JOURNAL OF TAX EXEMPT ORGANIZATIONS 6 (May/June 2001).