

KEY POINTS

What is the issue?

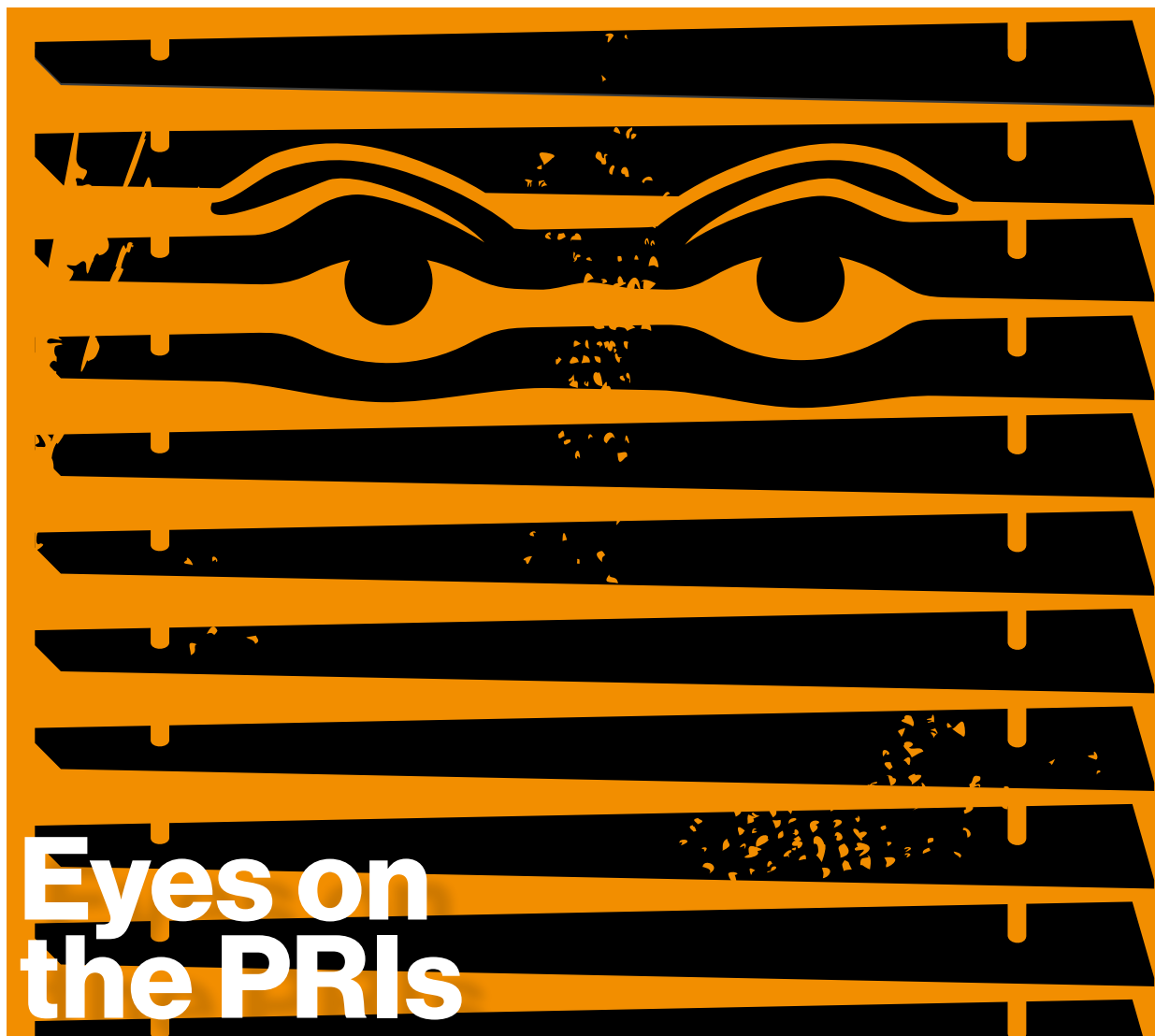
A recent ruling permitted a US private foundation to treat an investment as a programme-related investment (PRI).

What does it mean for me?

Practitioners would be well served by gaining an understanding of how to structure a fund so that the investments are PRIs and therefore subject to greater tax efficiency.

What can I take away?

Knowledge of a little-known structure with benefits including potentially recyclable capital and certain tax exemptions.



Eyes on the PRIs

SUZANNE M REISMAN ASSESSES THE EFFECT OF THE PROGRAMME-RELATED INVESTMENT ON THE CROSS-BORDER IMPACT INVESTING LANDSCAPE, WITH AN EMPHASIS ON THE US

The US Department of the Treasury (the Treasury) has issued a private letter ruling permitting a US 'private foundation' to treat an investment in a non-US impact fund¹ as a programme-related investment (PRI).² The fund was created to build resilience and deliver positive social outcomes by making loans to for-profit and not-for-profit organisations.

The ruling may be of interest to philanthropists and their advisors, non-US charities, financial institutions developing cross-border impact investment products, and social enterprises and other projects or organisations hoping to attract loans, credit guarantees or other investments from US foundations. Superficially, the ruling involves a US private foundation making an investment in a foreign loan fund. However, structuring a fund so that the investments are PRIs optimises the tax efficiency of the investment for US private foundations

because their investments are classified as grants for US tax purposes. However, the PRI, unlike a grant, is potentially recyclable capital. If the loan is repaid, it can be used to fund other charitable activities in the future, which is not true in the case of a pure grant. The PRI also satisfies a portion of the foundation's annual requirement to make distributions for 'exempt' purposes, which is not true in the case of an investment that is not a PRI.

Historically, investing and grant making were often viewed as separate functions. Environmental, social and governance (ESG) and other ethical investing criteria are intended to offer socially conscious investors with an opportunity to invest in entities that align with (or do not engage in practices that are incompatible with) their values. Mission-related investments may further positive societal goals but are primarily investments (e.g., vertical farming may combat food insecurity but an investment in a commercial agriculture tech company would be a mission-related investment rather than a PRI in most cases).^{3,4} Conceptually, PRIs may be viewed



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as a hybrid of grants and investments. The furtherance of a foundation's exempt purposes must be the primary purpose of a private foundation's investment in a PRI.

Exempt purposes include charitable, religious, educational, scientific and literary purposes, testing for public safety, fostering national or international amateur sports competition and preventing cruelty to children or animals.⁵

The creation of a 'social impact' or 'impact investment' fund that satisfies the US PRI criteria requires a willingness on the part of the fund and other core investors to tailor the fund's governing documents, and bring the administration of the fund into compliance with the US PRI rules. Depending on how the fund is structured, fund managers and other investors may be required to make accommodations in relation to the investments made by the fund and the terms of those investments. In some cases, that may mean forgoing loans or investments that might be attractive to the fund's other investors. The appeal of a PRI fund is the enhanced ability to attract investments from US private foundations.

US PRIVATE FOUNDATIONS IN GENERAL

US charities are regulated by both US state and federal law. US charities that are eligible to receive tax-deductible contributions are often referred to as '501(c)(3) organisations'.⁶

Most US charities are presumed to be private foundations unless they can demonstrate that they normally receive significant public support or are characterised as supporting organisations.⁷

Private foundations are subject to an excise tax regime known as the 'private foundation rules'.⁸ Mandatory distribution requirements (to encourage the use, rather than the unlimited accumulation of, tax-exempt funds)⁹ and prohibitions against investments that jeopardise the charity's assets are key provisions of the private foundation rules.¹⁰

The prohibition against jeopardising investments includes an exception for PRIs.¹¹ An investment will be a PRI if:

- The primary purpose of the investment is to accomplish one or more of the foundation's exempt purposes. The primary purposes test is met if an investment:
 - 'significantly furthers the accomplishment of the private foundation's exempt activities'; and
 - 'would not have been made but for the fact that it furthers the foundation's accomplishment of its exempt activities'.¹²

The fact that the investment is made to a for-profit entity does not preclude PRI status, provided that the

'Depending on how the fund is structured, fund managers and other investors may be required to make accommodations in relation to the investments made by the fund and the terms of those investments'

investment furthers the foundation's exempt purposes.¹³

- No significant purpose of the investment is the production of income or the appreciation of property. In making this determination, whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation is a relevant factor. A high rate of return is not, absent other factors, 'conclusive evidence of a significant purpose involving the production of income or the appreciation of property'.¹⁴
- No purpose of the investment is to accomplish certain lobbying activities or to intervene in political campaigns.¹⁵

The initial US PRI regulations were promulgated in 1969. For many years, private foundations utilised PRIs most frequently to engage in micro-finance projects or to otherwise assist economically disadvantaged populations without falling foul of the prohibition against jeopardising investments. In 2016, the Treasury updated and expanded the PRI regulations.

In promulgating the 2016 regulations, the US Internal Revenue Service highlighted the fact that:

- PRIs can be used in situations that do not involve urban regeneration, supporting economically disadvantaged individuals and deteriorated urban areas;
- activities undertaken in foreign countries will be judged on the same terms as activities undertaken in the US; and
- loans to not-for-profit organisations, individuals and for-profit entities, as well as credit enhancements and equity investments in for-profit organisations, may all qualify as PRIs.

Examples of PRIs included in the 2016 regulations include:

- **Healthcare:** an investment in a for-profit pharmaceutical company to induce it to:
 - develop a vaccine for a disease that predominantly impacts people in developing countries;

- publish its research; and
- distribute the vaccine at an affordable price.

The anticipated return is less than market rate for the risk involved. The primary purpose is to fund research that is in the public interest.¹⁶

- **Conservation:** an equity investment in a for-profit solid waste recycling company in a developing country that will prevent the pollution and environmental deterioration caused by continuing to dispose of solid waste in landfills. The investment is high risk and may produce a high rate of return. The primary purpose is to combat environmental deterioration.¹⁷
- **Agricultural training:** a below-market loan to a partnership that purchases coffee from farmers and cooperatives in a developing country to be used to train the farmers in advanced agricultural methods.¹⁸
- **Promotion of the arts:** a private foundation created to support the arts made a below-market loan to a social welfare organisation to help purchase a large exhibition space.¹⁹

In each of these cases, the transaction significantly furthered the foundations' exempt purposes; no significant purpose of the loans or investments was the production of income and the appreciation of assets; and conventional sources of funding were not available on economically feasible terms.

The examples in the regulations are neither exclusive nor exhaustive. PRIs may be used to further a wide variety of projects, structured as individual transactions, as funds or other vehicles.

#CHARITIES #FOUNDATIONS #INVESTMENT #PHILANTHROPY #US

¹ The current debate over whether and how environmental, social and governance (ESG) and mission investments should be regulated, green-washing and related issues are outside the scope of this article. ² *Priv. Ltr. Rul.* 202123004 (11 June 11 2021) ³ See *IRS Notice 2015-62, 2015-39 I.R.B. 411 (09/28/2015)* ⁴ An investment in a for-profit entity may be a vehicle for accomplishing a charitable purpose and qualify as a PRI in certain limited circumstances. ⁵ *Treas. Reg.* 1.501(c)(3)-1 ⁶ The scope of the organisations that are eligible to receive deductible contributions is similar but not precisely the same under the income, gift and estate tax rules. (Compare §§170, 2055 and 2522 of the *Internal Revenue Code* (IRC)). ⁷ The following types of organisations may be classified as public charities regardless of their normal sources of support: certain churches and other religious organisations; schools and other educational organisations; medical institutions; governmental units; and agricultural research organisations. See *IRC* 170(b)(1)(A). Privately funded entities that function as 'supporting organisations' for public charities are not subject to the private foundation rules. ⁸ *IRC* §§4940-4946, 4948 ⁹ See *IRC* §4942 ¹⁰ *IRC* §4944 ¹¹ *IRC* §4944(c); *Treas. Reg.* §53.4944-3 ¹² *IRC* §53.4944-3(a)(2)(i) ¹³ *Id.* Similarly, investments in functionally related businesses may be PRIs. See *IRC* §4942(j)(4)(B) defining functionally related business. ¹⁴ *Treas. Reg.* §53.5944-3(a)(2)(iii) ¹⁵ See *IRC* §170(c)(2)(D) ¹⁶ *Treas. Reg.* §53.5944-3(b) Ex. 11 ¹⁷ *Treas. Reg.* §53.5944-3(b) Ex. 12 ¹⁸ *Treas. Reg.* §53.5944-3(b) Ex. 16 ¹⁹ *Treas. Reg.* §53.5944-3(b) Ex. 17