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# NEW STRATEGIES FOR LEVERAGING FOUNDATION ASSETS

*There are many options, and the choices can seem overwhelming at times.*

JAMES P. JOSEPH AND ANDRAS KOSARAS[*]

**22* In recent years, a small but ever-growing number of foundation boards and advisors have been exploring new ways to deploy and leverage foundation assets for greater and more sustainable impact. They are looking beyond traditional grantmaking and asking how foundations' assets can be invested to support their charitable missions. These strategies, known as mission investments or mission-related investments (MRIs), are broadly defined as "using financial investments as tools to further a foundation's mission."[1] They can encompass both market-rate and below-market-rate investments. A recent study found that mission investing grew at an average annual rate of 16.2% in the last five years, compared to just 3% during the past three decades. Foundations with assets under $200 million are the fastest growing segment of the philanthropic sector participating in mission investing.[2]

Although mission-related investing is still an emerging area, the options and strategies available to foundations can seem limitless and overwhelming. A foundation can engage in MRIs, and become familiar with their advantages and costs, by making program-related investments (PRIs), a common form, or cousin, of MRIs. PRIs have been a part of the Code applicable to private foundations since the Tax Reform Act of 1969. Generally made as below-market-rate investments, they are currently enjoying a renaissance and being put to creative uses by foundations. In addition, PRIs and MRIs are not limited to private foundations. Public charities with assets from endowments to invest can also engage in these strategies.[3]

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[1] Cooch et al, *Compounding Impact: Mission Investing by U.S. Foundations* (FSG Social Impact Advisors, 2007), 7. MRIs are distinguishable from socially responsible investing, which primarily focuses on screening of investments and proxy voting in public companies based on social, environmental, and governance criteria.

[2] *Id*.

[3] Public charities, such as community foundations, are not subject to the private foundation rules. However, public charities may find that the private foundation rules can serve as useful guideposts when structuring transactions similar to PRIs. For examples of how community foundations have used PRIs, see Nober, *Economic Development: A Legal Guide for Grantmakers* (Council on Foundations, 2005).

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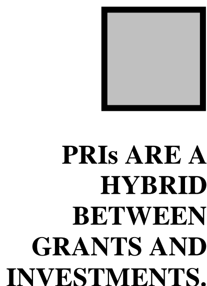
For foundations looking beyond PRIs to market-rate investments, a direct and practical way to find mission-related investments is to use "integrated project planning" (IPP). This is a way to increase the likelihood of grant projects creating sustainable outcomes. Just as a foundation may provide technical assistance to a grantee to enhance its capacity to carry out a program for which it received funding, a foundation may look for market-rate investments in the broader community in which a grantee operates. The nexus between the proposed investment and the grantee's program supported by the foundation would serve as the criteria for selecting the specific investments.

## What are PRIs?

PRIs are a hybrid between grants and investments. They are investments made with the primary purpose of accomplishing a charitable purpose. PRIs are defined in Section 4944 as an exception to the rule that prohibits a private foundation from making risky investments that jeopardize carrying out the foundation's exempt purposes.[4] Like grants, PRIs count toward the foundation's minimum payout requirement and are subject to the taxable expenditure rules in Section 4945. Because of PRIs' hybrid nature, foundations will have the most success with PRIs if their investment managers ***23** and program staff collaborate in developing them.

PRIs come in many different types. The vast majority are below-market-rate loans made to charitable organizations. Some are loan guarantees. Others are deposits or linked deposits in a community development bank that lends money to minority-owned small businesses. PRIs can also be made as equity investments.



**PRIs ARE A HYBRID BETWEEN GRANTS AND INVESTMENTS.**

PRIs have been used to further a diverse array of charitable purposes. The traditional use of PRIs was, and continues to be, economic development. Housing and, in recent years, environmental causes[5] have received an increasing share of PRIs, however. They have also been used to support the growth of independent media in countries formerly ruled by dictatorships,[6] and more recently to support microfinance.[7]

The majority of PRIs are made to U.S.-based organizations. Although reports show a steady increase in international grantmaking, the administrative burdens of strict due diligence and oversight requirements may preclude some foundations from making investments in foreign entities.[8] Foundations that lack the capacity and resources to make international PRIs on their own may, however, be able to do so by using intermediaries (discussed below).

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[4] Section 4944(c).

[5] E.g., Ltr. Rul. 200136026; see also Cavalieri, "Motivating Environmental Change With Program-Related Investments," 10 JTEO 25 (Jul/Aug 1998).

[6] E.g., Ltr. Rul. 200034037 (low-interest or no-interest loans in nonprofit and for-profit media organizations in Central and Eastern Europe, Latin America, Southeast Asia and Africa).

[7] Ltr. Rul. 200325005 (ruling that public charity's investments in foreign financial institutions providing microcredit to poor entrepreneurs in developing countries qualified as a charitable activity). Supporting microfinance is not an entirely new activity for foundations. The Ford Foundation was one of the first to support Muhammad Yunus' Grameen Bank, initially with grants and then, in 1981, with a PRI loan guarantee. See "Investing for Social Gain: Reflections on Two Decades of Program-Related Investments"' (Ford Foundation, 1991), 34-36.

[8] Renz and Atienza, "International Grantmaking Update" (Foundation Center, October 2006).

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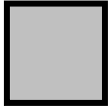
## Benefits of PRIs under the private foundation rules



**PRIs ARE EXCLUDED FROM THE ASSET BASE USED TO CALCULATE THE MINIMUM PAYOUT AMOUNT.**

PRIs are free of some restrictions that apply to a foundation's grants and investments.

**Payout requirement.** Section 4942 requires a private foundation to pay out annually at least 5% of its net investment income in "qualifying distributions" for exempt purposes. If the foundation fails to satisfy this requirement, it is subject to a penalty tax. Qualifying distributions include grants as well as reasonable and necessary administrative expenses paid for exempt purposes. PRIs and administrative expenses incurred in making them also count toward meeting a foundation's minimum distribution requirement.[9] However, funds must actually be invested for the investment to count toward the required payout. Foundations should therefore examine each type of investment carefully. There are many types of PRIs and not all of them require actual payment at the time the investment qualifies as a PRI. A loan guaranty, for example, will only count toward the foundation's payout requirement when the grantee defaults and the foundation makes a payment under its guarantee.[10]

Although foundations carry them as assets on their financial statements, PRIs are excluded from the foundation's asset base used to calculate the minimum payout amount.[11] If and when the PRI is repaid, the entire amount of the PRI is added to the asset base used to calculate the distributable amount. In addition, the foundation's distributable amount is increased for the tax year by the amount of the PRI when it is repaid.

**Tax on net investment income.** Section 4940 requires private foundations to pay an annual excise tax on their net investment incomes. The tax rate is 2%, which may be reduced to 1% if a foundation progressively increases its annual payout amount. Net investment income is defined as the sum of gross investment income ***24** and net capital gains, taking into account allowable deductions. Interest and dividend income from PRIs constitute gross investment income for purposes of calculating the tax,[12] and capital gains or losses from PRIs are now also included in calculating net capital gains.[13]

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[9] Reg. 53.4942(a)-3(a)(2)(i).

[10] Ltr. Rul. 8105112. On the other hand, a link deposit should qualify as part of a foundation's qualifying distributions. See Ltr. Rul. 200043050 (foundation supported financing of child care facilities by working with commercial banks to make loan guarantees, deposits to be used as collateral, and link deposits to induce bank to make loans at market or below-market rates).

[11] Reg. 53.4942(a)-2(c)(3)(ii)(d).

[12] See Ltr. Rul. 200036050. Here, a private foundation was making PRIs in a foreign country to promote economic development. The PRIs included loans to businesses with interest payable in the local currency, not U.S. dollars. The Service ruled that interest and dividends would be includable in the foundation's gross investment income, but held that foreign currency gains would not constitute gross investment income.

[13] See section 1221(b) of the Pension Protection Act of 2006, P.L. 109-280, 8/17/06, and section 3(f) of the Tax Technical Corrections Act of 2007, P.L. 110-172, 12/29/07. See also Staff of the Joint Committee on Taxation, *"Technical Explanation of H.R. 4, the 'Pension Protection Act of 2006," as Passed by the House on July 28, 2008, and as Considered by the Senate on August 3, 2006"* (JCX-38-06) (8/3/06), at 320-324; Staff of the Joint Committee on Taxation, *"Description of the Tax Technical Correction Act of 2007, as Passed by the House of Representatives"* (JCX-119-07) (12/18/07), at 3. Note, however, that Reg. 53.4940-1(f)(1) does not reflect these changes.

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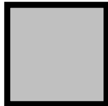
**Limits on excess business holdings.** In general, private foundations may not hold more than 20% of the ownership interest, together with disqualified persons, in a business enterprise. PRIs are not considered business holdings under Section 4943, and therefore are not subject to this limitation.[14]

## Programmatic benefits of PRIs

PRIs offer a number of programmatic benefits to both the foundation making them and the grantee receiving them. PRIs allow a foundation to recover its investment (potentially with a profit) and to recycle its assets for future grants or investments. PRIs tend to be larger in amount than grants because they allow a foundation to make larger commitments than it would be comfortable making with a grant. Frequently, foundations also like the increased accountability created by providing assets to a grantee that may be recovered. Investments should not completely replace grants, but in some cases, a PRI may help a grantee develop management expertise that it may not support when receiving only a grant. A foundation may also be willing to provide additional support to help a grantee take this step. PRIs also can help establish a credit history for the grantee that may allow it to secure loans from commercial sources in the future. Finally, PRIs offer foundations the flexibility of making qualifying distributions to for-profit entities, thus increasing the pool of eligible recipients who can receive charitable funds and have a positive social impact.



**SHOWING A PRIMARILY CHARITABLE PURPOSE INVOLVES A "BUT FOR" TEST.**

## Qualifying as a PRI

An investment will qualify as a PRI if the following three conditions are met:[15]

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--i.e., activities that private foundations are forbidden from pursuing.

If an investment meets the requirements, it can qualify as a PRI. IRS approval is not required but foundations considering more complex PRIs may find it prudent--despite the time and costs involved--to seek approval from the IRS, given the lack of precedential guidance on PRIs.[16]

**Charitable purpose is primary.** Satisfying the first requirement--a primarily charitable purpose--involves a "but for" test. The regulations state that an investment will be considered to be made "primarily" to accomplish one or more charitable purposes if it "significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have

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[14] Reg. 53.4943-10(b).

[15] Reg. 53.4944-3(a)(1). The last requirement is generally met if the PRI is not earmarked for political activities. See, e.g., Ltr. Rul. 8429069.

[16] Much of the 'law' on PRIs comes from private letter rulings that offer some insights into how the Service may treat a particular investment. However, letter rulings can be relied on only by the taxpayer requesting the ruling and have no precedential authority. Some useful resources on PRIs have been collected by PRI Makers, available at www.primakers.net.

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been made but for [the] relationship between the investment and the accomplishment of the foundation's exempt activities."[17] A PRI must support an activity that qualifies as charitable. That term includes a number of purposes often associated with PRI activity, including "relief of the poor and distressed," "lessening the burdens of the government," and "promotion of social welfare by organizations designed to . . . lessen neighborhood tensions . . . or combat community deterioration and juvenile delinquency."[18] Beyond the determination of charitability, the activity also must fit within the foundation's purposes. For example, if the foundation's organizing documents limit its grantmaking to a particular geographic area, it may not be able to make PRIs in a foreign charity or for-profit entity to support economic development internationally.

*25 **Investment return is not significant purpose.** The second, and sometimes more difficult, criteria requires a foundation to show that neither the production of income nor the appreciation of property is a "significant" purpose of the investment. The regulations indicate that the relevant factor in making this determination is whether investors solely engaged in investing for profit would be likely to make the investment on the same terms as the foundation. An investment will not fail to qualify as a PRI simply because, absent other factors, it produces significant income or capital appreciation.[19]

A below-market-rate loan is relatively easy to qualify as a PRI because it usually is not difficult to show that someone investing for profit would not make loans under similar terms.[20] On the other hand, equity investments may require some additional planning. If a risky investment pays off and the foundation realizes substantial profits, will the investment lose its status as a PRI? The regulations recognize that equity investments may appreciate in value without risking the status of a PRI.[21] The regulations do not, however, indicate if there is a threshold beyond which the investment may fail to qualify as a PRI. In the case of appreciating investments, a foundation could try to safeguard its PRI by imposing a cap on the returns it may receive.[22]

PRIs in foreign organizations may also pose some unique challenges. A foundation will want to argue that the benchmarks for determining interest rates or return on investments for an international PRI should be based on the prevailing market rates and conditions in the foreign country. These could be substantially higher than their counterparts in the U.S. However, the lack of well-developed financial institutions or infrastructure in some developing countries may make using such an approach challenging.[23]

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[17] Reg. 53.4944-3(a)(2)(i).

[18] Reg. 1.501(c)(3)-1(d)(2).

[19] Reg. 53.4944-3(a)(2)(iii).

[20] Foundations have some flexibility when determining the interest rate of a potential loan. The Service evaluates a PRI based on all the facts and circumstances. For example, in Ltr. Rul. 8301110, the IRS permitted a foundation to receive 15% interest on its loan, more than the then-current "prime rate."

[21] Reg. 53.4944-3(b), Example 3.

[22] See, e.g., Ltr. Rul. 8807048 (foundation's rate of return on investments capped at 5%); Ltr. Rul. 200610020 (foundation investing in an angel investment fund had right to terminate its investment in a particular investee if the investment had reached a certain level of financial success; in the alternative, the foundation could accept a cap on its investment return).

[23] See generally Chernoff, "Outdated Regulations Hamper Foundations Making Foreign Program-Related Investments," 12 JTEO 249 (May/Jun 2001).

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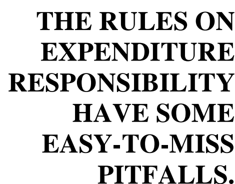
**Changes to investment terms.** After a PRI is made, a change in its form or terms for the "prudent protection" of the investment will not ordinarily cause the investment to cease to qualify as a PRI. By contrast, if a change is made for the significant purpose of the production of income or appreciation of property, and not primarily for exempt purposes, the investment may no longer qualify as a PRI. A "critical change" in the nature or purposes of the investment also may cause the investment to fail as a PRI, for example, if the investment is serving an "illegal purpose or benefiting the private purpose of the foundation or its managers."[24]

**Penalties.** If the Service concludes on examination that an investment does not qualify as a PRI and should instead be treated as a jeopardizing investment, the foundation is subject to a 10% penalty tax on the amount of the investment (subject to a $10,000 cap per investment). If foundation managers approved the investment "knowing" that it is a jeopardizing investment, the managers are also subject to a 10% penalty tax on the amount of the investment. Additional taxes are imposed on the foundation and managers if the investment is not corrected to make it prudent.[25] Foundation managers will not be subject to the penalty taxes if they relied on a reasonable written opinion of counsel concluding that the investment qualified as a PRI.[26] In addition, the Service has discretionary authority to abate the first-tier taxes on the foundation if the jeopardy investment was due to a reasonable cause and not to willful neglect and if the investment is corrected within the required time.[27]

## Additional requirements for PRIs

While some of the private foundation rules do not apply to PRIs, others do and some require careful observance.

**26* **Investments in for-profits and foreign charities.** PRIs are treated like grants under Section 4945, and a penalty tax will be imposed on the foundation and its managers if a PRI is made that is deemed to be a "taxable expenditure."[28] In general, distributions to publicly supported charities are not taxable expenditures. In contrast, distributions to for-profit organizations or foreign charities usually will be considered taxable expenditures unless the foundation exercises "expenditure responsibility." One of the advantages of using a public charity intermediary to make PRIs in for-profits and foreign charities is that a foundation will not have to exercise expenditure responsibility over the investment.



**THE RULES ON EXPENDITURE RESPONSIBILITY HAVE SOME EASY-TO-MISS PITFALLS.**

Expenditure responsibility requires a foundation to conduct a pre-grant due diligence of the grantee, execute a written grant agreement that specifies the charitable purposes of the grant or investment, obtain periodic reporting from the grantee indicating how the funds were spent (and take certain steps if funds are diverted), and provide reporting to the IRS about its expenditure

[24] Reg. 53.4944-3(a)(3)(i).
[25] Sections 4944(a), (b).
[26] Reg. 53.3944-1(b)(2)(v); see also TAM 200218038 (Service ruled that investment did not qualify as a PRI and was a jeopardizing investment, but abated penalty taxes because foundation relied on a reasoned written legal opinion that concluded that investment qualified as a PRI).
[27] Section 4962(a).
[28] Regs. 53.4945-4(a)(2), -5(a)(2).

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responsibility grants until the funds are expended or during the life of the investment.[29]

Private foundations should follow the requirements for expenditure responsibility carefully, as even minor compliance errors can result in penalties on the foundation and/or its managers. The rules also have some easy-to-miss pitfalls. For example, in the case of grants or investments for capital expenditures, a private foundation has to require reporting from a grantee that would qualify as a private foundation only for the year in which the investment is made and for two succeeding years. If the grantee is not a private foundation, the grantor must require reporting for the life of the investment. In addition, a foundation has to provide reporting to the IRS as long as it is required to obtain reports from its grantee.[30]

If the grantee is a foreign charity, a foundation may instead use an alternative procedure if it can make a "good faith determination" that the grantee is the "equivalent" of a U.S. public charity.[31] The steps and documentation required to make an equivalency determination are described in Rev. Proc. 92-94, 1992-2 CB 507. They include detailed information about how the grantee is organized and operated and financial information that will allow a foundation to determine whether the grantee would qualify as a public charity under the public support test. The grantee affidavit and all supporting documents must be in English, although the financial information need not be in U.S. dollars. The foundation may rely on a written opinion of its own legal counsel or an affidavit from a grantee in its determination.

**Prohibition on self-dealing.** Although PRIs are excepted from many of the restrictions of the private foundation rules, they are subject to the prohibition of Section 4941 on self-dealing transactions between a private foundation and its disqualified persons.[32] Disqualified persons broadly include substantial contributors to the foundation, foundation managers, and their family members and entities controlled by them. A foundation must avoid not only direct self-dealing, but also indirect self-dealing that, under the relevant facts and circumstances, may result in more than incidental and tenuous benefit to disqualified persons. One way in which a foundation may inadvertently engage in self-dealing when making investments is if a disqualified person makes side-by-side investments with the foundation. For example, a disqualified person interested in socially responsible investing may wish to invest alongside a foundation's equity investments that qualify as PRIs or, more

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[29] Regs. 53.4945-5(b)-(e). The expenditure responsibility rules apply to both grants and PRIs, but the regulations tailor some of the provisions and requirements for PRIs. See Reg. 53.4945-5(b)(4). For example, instead of providing grant reports to the foundation that show how the funds were expended and the progress made in fulfilling the purposes of the grant, a grantee receiving a PRI that is subject to expenditure responsibility must provide the foundation with financial reports of the "type ordinarily required by commercial investors under similar circumstances," and must maintain books and records that provide information "ordinarily required by commercial investors under similar circumstances."

[30] Regs. 53.4945-5(b)(4)(ii), -5(c)(2), -5(d); see also Charles Stewart Mott Foundation, 938 F.2d 58, 68 AFTR2d 91-5131 (CA-6, 1991) (affirming Service's assessment of penalty tax on foundation's failure to complete expenditure responsibility reports for life of PRI used for capital expenditures where the grantee was not a private foundation).

[31] Reg. 53.4945-5(a)(5).

[32] See, e.g., Ltr. Rul. 200222034 (no self-dealing where foundation made PRIs to for-profit developers that were not disqualified persons).

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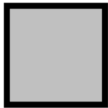
broadly, as mission-related investments. In such a case, self-dealing may occur if (1) the disqualified person would not have access to the investment opportunity, as in the case of a hedge fund, but for the additional investment made by the foundation, or (2) if the disqualified person is able to reduce *27 his or her investment costs because of the foundation's investment.

**Reporting.** PRIs are separately reported on a foundation's annual information return (Form 990-PF).[33] PRIs are carried on the foundation's balance sheet (Part II, line 15) and the sections used to calculate the foundation's payout requirement (Parts V, XI (line 4a), XII, and XIII). The foundation must also provide brief summaries of the investments in Part IX-B. This is in addition to the reporting required if the foundation is also exercising expenditure responsibility over a PRI.

## Use of PRIs

Foundations may use a variety of vehicles for making PRIs.

**Targeting market failures by direct investments.** There is long history of the nonprofit sector and the philanthropic community stepping in to fill the gaps when the markets fail or the government cannot act. As part of that history, one of the first uses of PRIs was to support economic development in deteriorating urban communities. They provided loans or equity investments for low-income and minority businesses that could not secure conventional sources of financing at reasonable rates, if at all.[34] PRIs can also be used to induce successful businesses either to remain in a deteriorating community hoping to spur growth or to establish new plants, stores, or business ventures in deteriorating communities that they would not otherwise invest in because of the high risks involved.[35]



**PRIs ARE USED TO ADDRESS MARKET FAILURES.**

PRIs are used to address market failures when for-profit businesses lack the financial incentives to develop various products and technologies that can be used for charitable purposes. Recently, the Service issued a ruling that will allow a private foundation to make PRIs in commercial pharmaceutical and biotechnology companies to spur participation of private industry in discovering, developing, and implementing vaccines, drugs, diagnostics, and other solutions to prevent or eradicate diseases that disproportionately affect the developing world.[36] Under the facts of the ruling, before the foundation will make an investment that qualifies as a PRI, any proposed project will have to satisfy three criteria: (1) target a major global health problem or inequity, (2) create solutions that can be adopted in developing countries, and (3) ensure availability of solutions on an affordable basis to people in developing countries who could not otherwise afford them.

**Using intermediaries.** A growing number of intermediary organizations are making it easier for foundations to find opportunities to make

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[33] The Form 990, filed by public charities, also requires some reporting of program-related investments.

[34] See "Investing for Social Gain: Reflections on Two Decades of Program-Related Investments," supra note 7; see also Reg. 53.4944-3(b), Examples 1-3 (economic development investments structured as either loans or investments).

[35] 53.4944-3(b), Examples 4-5.

[36] Ltr. Rul. 200603031. The ruling does not indicate whether the PRIs will consist of loans, equity investments, or both.

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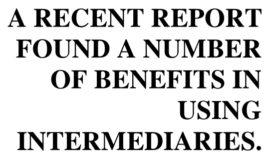
PRIs. Intermediaries also create economies of scale by aggregating investors and investees with the hope of achieving greater impact. First, however, foundations should assess the costs and benefits of using intermediaries.

A recent report on the use of investment intermediaries by foundations to facilitate mission-related investing found a number of benefits in using intermediaries. These included making use of specialized expertise to improve performance, lowering transaction costs through economies of scale, reducing financial and reputational risk, leveraging tax credits and private (non-philanthropic) capital, and broadening the pipeline of potential investments.[37] At the same time, the disadvantages of using intermediaries include the risk of misaligned goals (the foundation gives up a certain level of control over the selection of investees), less direct interaction with investees, and overhead costs in management fees (to be balanced against the costs the foundation would incur by hiring its own staff to source and oversee PRI activity).[38]



**A RECENT REPORT FOUND A NUMBER OF BENEFITS IN USING INTERMEDIARIES.**

There are many types of intermediaries. They can be organized as for-profit or nonprofit entities and include, for example, community development financial institutions, loan funds, and equity funds.[39] In recent years, venture capital funds have also served as intermediaries for PRIs.

In 2005, The David and Lucile Packard Foundation invested $10 million of PRI loans in the Sea Change Investment Fund, a venture ***28** capital fund established by Sea Change Management, LLC, a for-profit private equity firm. With the Packard Foundation's investment, the Fund was able to raise an additional $10 million from private investors. The purpose of the Fund is “to promote market access to seafood from environmentally-preferable sources..”[40] The Fund assists sustainable fisheries to reduce barriers in distribution networks that prevent these businesses from reaching customers.

Not all intermediaries are for-profit ventures. The recently established MicroCredit Enterprises is a public charity that leverages private capital for microfinancing to alleviate poverty.[41] A foundation can provide an interest-bearing secured line of credit to MicroCredit Enterprises or guarantee the loans that other investors (foundations, individuals, businesses) make to MicroCredit Enterprises. Each option supports thousands of microcredit business loans administered by microfinance organizations in developing countries. The loans count toward the foundation's payout requirement at the time they are made, while the loan guarantees count toward the payout requirement only if the guarantee is called upon.

Foundations are also using angel investment funds to support economic development. In a recent ruling, the Service approved a PRI in an angel investment fund, organized as a limited liability company, in which the private

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[37] Cooch and Kramer, *Aggregating Impact: A Funder's Guide to Mission Investment Intermediaries* (FSG Social Impact Advisors, November 2007), 5.

[38] *Id*. at 24.

[39] *Id*. at 8-17.

[40] www.seachangefund.com.

[41] www.mcenterprises.org/foundations.aspx. Microfinance offers small loans to businesses and individuals living in poverty. Microfinance is typically targeted at populations in developing countries that do not have access to conventional financing.

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investors of the fund were professional athletes.[42] One of the purposes of the fund was to provide capital to new and growing minority-owned businesses in low-income communities with the aim of reducing poverty. The foundation believed that its investment in the fund was essential in securing funding from private investors.

Because venture capital funds often impose a number of restrictions on investors, one of the most common being limitations on withdrawal of capital, foundations that seek to make PRIs in such funds should note some of the safeguards that the foundation in the above ruling implemented to ensure that its investments continue to qualify as PRIs. In Ltr. Rul. 200610020, the foundation had a right to:

- Require the angel investment fund, under certain circumstances, to liquidate investments or to withdraw from investments or from the fund entirely, if the foundation believed that the investments were no longer consistent with the fund's purposes or if the investments would jeopardize the charitable status of the foundation or the status of its investment in the fund as a PRI.
- Terminate its participation in an investment of the fund if the investment had reached a certain level of financial success such that the investment would no longer qualify as a PRI. In the alternative, the foundation could accept a cap on its investment return.
- Require its approval to make any fundamental changes to the fund's operations and structure.[43]

In addition, foundations must ensure that PRIs meet all legal requirements when using intermediaries, including the requirement to exercise expenditure responsibility if an investment is made in a for-profit entity and the requirement either to exercise expenditure responsibility or make an equivalency determination if the investment is made in a foreign charity intermediary.

**Advising investments through a functionally related business.** Despite the lack of guidance from the IRS, private foundations have made considerable strides in using PRIs. In one case, a private foundation that was a leading provider of PRIs started a wholly owned, taxable subsidiary to (1) provide advice and consulting services related to PRIs and other double-bottom-line investments to other private foundations, exempt organizations, and socially motivated investors for a fee; (2) act as a fundraiser or as a "placement agent" to locate investors for community development venture capital funds; (3) provide certain asset-management services, such as setting up and administering a positive screen for investments ***29** in publicly traded companies whose activities and business practices support the foundation's mission; and (4) establish and manage a public mutual fund for the purpose

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[42] Ltr. Rul. 200610020. Angel investment funds or organizations pool the assets and experience of individual angel investors (high-net worth individuals or "accredited investors" who provide seed capital to start-up businesses) and facilitate matching entrepreneurs with investors. See information on Angel Capital Education Foundation, available at www.angelcapitaleducation.org.

[43] In Ltr. Rul. 200136026, a foundation that invested in an international for-profit venture capital fund that supported environmentally sound economic development in developing countries inserted a similar condition that it would have to approve any substantial changes.

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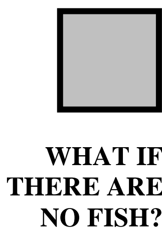
described in (3).[44] The Service approved the subsidiary as a "functionally related business" of the foundation within the meaning Section 4942(j)(4), and thereby exempted the foundation from having to divest its ownership in accordance with the excess business holdings rules.

**Low-profit limited liability companies (L[3]Cs).** Many foundations have stayed away from PRIs because they can be costly to design and implement and generally require review by expert counsel. Requesting advance approval from the IRS, especially for complex PRIs, can be even more expensive (in user fees alone) and time-consuming for a foundation. In an effort to make PRIs more accessible to foundations and to reduce transaction costs, Robert Lang, the CEO of the Mary Elizabeth & Gordon Mannweiler Foundation, went to the drawing board and proposed the idea of a low-profit limited liability company organized to serve socially beneficial purposes.[45] This new legal entity would be authorized by state statutes and would explicitly incorporate the federal tax requirements applicable to PRIs as part of its purposes. The intent is to create a standard vehicle that will automatically qualify a foundation's investment as a PRI.

Several states have expressed interest in L[3]Cs and some have introduced legislation to authorize them. Vermont was the first state to enact such legislation on 4/30/08.[46] What remains to be seen is whether a foundation can be assured that its investment qualifies as a PRI without some regulatory action by the IRS that would recognize L[3]Cs as "PRI compliant" or that would provide clear procedures for foundations to follow when investing in such entities, beyond just a reference to the PRI rules.[47]

## Beyond PRIs--Using integrated project planning to select mission-related investments

Foundations and philanthropists often quote the well-known proverb about teaching people to fish to draw a distinction between charity and philanthropy. "Give a man a fish and you feed him for a day. Teach him how to fish and you feed him for a lifetime." But what if there are no fish in the sea when the man becomes a fisherman?



**WHAT IF THERE ARE NO FISH?**

This question is not about environmental sustainability. Rather, it asks whether a foundation is integrating all the available tools to leverage its assets in pursuit of its charitable mission. A foundation may tackle one of the direct causes of poverty by providing large multi-year grants to build schools and hire teachers to educate poor children in Africa. But what will these children do when they graduate if there are no parallel and integrated investments in the local community that will develop a sustainable economy, create new businesses that need an educated work force, and build roads and infrastructure that support the community? Therefore, to increase the long-term impact of its African education grants, the foundation could make investments in business ventures in the region (from large-scale manufacturing to small arts and crafts

[44] Ltr. Rul. 200709065. "Double-bottom-line" investments are intended to produce financial returns and meet specific social criteria or outcomes.

[45] Lang, "Charitable Returns," Worth (4/1/06).

[46] H.B. 775, 2007-2008 Leg. (Vt. 2008).

[47] Additional information about L[3]Cs is available from Americans for Community Development, available at www.americansforcommunitydevelopment.org.

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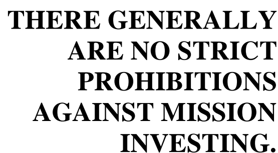
businesses), infrastructure projects (such as clean, sustainable energy and clean water projects), and businesses that link the community more broadly with the economic marketplace (wireless systems, transportation, and marketing tools).

Integrated project planning (IPP), like PRIs, recognizes that a foundation cannot always create a sustainable impact by grants alone. Unlike PRIs, however, IPP considers whether the outcome for which a foundation is striving can be achieved only by building social and economic infrastructures that are necessary to support a thriving community, and whether the foundation can use its assets to make investments in these necessary infrastructures as part of its grantmaking. IPP seeks to align a foundation's grantmaking with financially sound, market-rate investments to the extent that the investments increase the likelihood that a project supported by grants will be successful and sustainable in the long-term.

IPP takes a direct and practical approach to aligning a foundation's investment strategy with its grantmaking programs. It is concerned ***30** with building successful and sustainable programs, rather than with harmonizing a foundation's investments and its charitable mission--a subject that has been much discussed within the philanthropic community in recent years and has spilled into the public forum through the work of investigative reporters.[48] Recent articles have tried to highlight the apparent contradiction that may exist between a foundation's grants and its investments. For example, a foundation may be making grants to support sustainable energy, yet at the same time have holdings in traditional energy companies. Other commentators advocate that a foundation should use all of its investment assets, not just the 5% it pays out as grants, to further its charitable missions.



**THERE GENERALLY ARE NO STRICT PROHIBITIONS AGAINST MISSION INVESTING.**

**The role of non-financial factors in investment decisions.** The extent to which foundation managers may pursue investments in support of grant programs and take non-financial factors into account when making investment decisions will depend on state and federal law. All foundation fiduciaries (directors, trustees, and officers) have an obligation to act in the best interest of the foundation, rather than in their personal interests, and to make informed decisions in connection with the foundation's management and governance. Fiduciaries also have an obligation to manage and invest foundation assets in compliance with the requisite prudent standards applicable to investment decisions.

State law provides the primary mechanism for regulating the investment management of foundation assets.[49] In their basic formulations they generally are uniform and provide similar guidelines. They may vary, however, from state to state and according to whether the foundation is organized as a

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[48] See, e.g., panel discussion, "Aligning Investments with Grantmaking" (Hudson Institute, Bradley Center for Philanthropy and Civic Renewal, 2/12/07), transcript available at www.hudson.org; Emerson, "Where Money Meets Mission: Breaking Down the Firewall Between Foundation Investments and Programming," Stanford Social Innovation Review, Summer 2003, 38-47.

[49] For charities organized as nonprofit corporations, these state laws include the Uniform Management of Institutional Funds Act (UMIFA), 7A-III U.L.A. 1 (2006), and the Uniform Prudent Management of Institutional Funds Act (UPMIFA), 7A-III U.L.A. 2 (Supp. 2007), which is a recently completed update and revision of UMIFA (over 20 states have now adopted UPMIFA). For charities organized as trusts, the various statutory and common law rules that may apply are generally reflected in the Uniform Prudent Investor Act, 7B U.L.A. 20 (2006), and the Prudent Investor Rule of the *Restatement (Third) of Trusts* (American Law Institute, 1992).

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trust or a nonprofit corporation. Moreover, the standards are not static. The rules have undergone significant change over the last 50 years and will continue to evolve as the financial markets and investment tools and practices evolve.

Historically, the ability of trustees and charitable institutions to pursue diverse investment strategies was significantly curtailed by rigid rules that judged investment performance on individual investment decisions rather than on the performance of the portfolio as a whole, emphasized production of income and preservation of capital, and prohibited trustees from delegating investment decisions to third parties.[50] These rules continue to exert some lingering effect within the philanthropic community and may cause some foundation managers to be exceedingly cautious and conservative when making decisions about investments.

The current rules regulating investment management decisions follow the requirements of modern investing practices and require fiduciaries to manage and invest foundation assets in a manner consistent with how a prudent investor would act. The primary duty of foundation managers is to balance risk against return. The current rules generally provide that no investment is per se imprudent, permit fiduciaries to delegate investment decisions to professional advisors, and judge investment decisions based on the performance of the portfolio as a whole rather than each individual investment.[51]

There generally are no strict prohibitions against mission investing under appropriate circumstances, but the extent to which foundation managers may consider non-financial factors when investing foundation assets remains unclear. The official comments to the Prudent Investor Rule state that "social considerations may be taken into account in investing the funds of charitable trusts to the extent the charitable purposes would justify an expenditure of trust funds for the social issue or cause in question or ***31** to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust."[52] UPMIFA does not take a position on socially responsible investing, although it requires an organization to consider its charitable purposes in managing its investments.[53]

One of the concerns when making investment decisions based on social or other factors is that the foundation may no longer be properly diversified and may unreasonably increase its investment risk based on expected returns.[54] As

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[50] See generally *Restatement (Second) of Trusts* (American Law Institute Publishers, 1959), § 227.

[51] The federal rules prohibiting private foundations from making jeopardy investments offer similar guidance. The regulations define a "jeopardizing investment" as one in which the foundation managers "have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes." Reg. 53.4944-1(a)(2)(i). The performance of the foundation's portfolio as a whole is considered, rather than the performance of each individual investment.

[52] *Restatement (Third) Trusts: Prudent Investor Rule* (American Law Institute Publishers, 1992), § 227, cmt. c.

[53] See UPMIFA, § 3(a) (2006); see also Gary, "Charities, Endowments, and Donor Intent: The Uniform Prudent Management of Institutional Funds Act," 41 Georgia Law Review 1277 (2007).

[54] See, e.g., Hawai'i Attorney General, Opinion No. 85-26, 1985 Haw. AG LEXIS 4, at 23 (11/23/85) (concluding that if the board of regents of the University of Hawaii "reasonably concludes that two investment alternatives are economically equivalent, the Board may choose between them on social grounds").

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long as the foundation undertakes proper due diligence and implements some practical safeguards, however, these risks can be managed.

## Practical considerations for mission-related investments

Mission-related investments span the continuum from the simple to the very complex. Regardless of how easy or complicated they may be, a few practical considerations will help a foundation engage in mission-related investing that is consistent with its charitable mission, size, and capacity, and that will achieve successful results.

- *Review the foundation's charitable mission.* Before engaging in any new activity, foundation managers should determine that it is permitted by and consistent with the foundation's organizing documents and charitable mission. For example, a foundation that is dedicated to supporting the arts should not to try to find mission investment deals in sustainable energy.
- *Involve both program and investment staff.* Because the foundation's charitable mission and objectives lie at the center of mission-related investing, these types of investments have the greatest chance of success if they are designed, implemented, and monitored by teams that include both program and investment staff. Program staff understand the nexus between the investments and the foundation's charitable mission, while investment staff can provide proper due diligence to ensure that the investments are prudent. A team of program and investment staff can be utilized to review foundation grants, analyze related areas that could benefit from investment funds, and--either directly or with the help of intermediaries--look for investments that satisfy the foundation's criteria.
- *Understand the foundation's limitations and capacity.* Although data indicate that mission-related investing has seen the fastest growth among foundations with less than $200 million in assets, smaller foundations should keep in mind that these types of investments require specialized skill to implement and monitor. Foundation managers may delegate some investment management to outside experts, but they continue to have an obligation to monitor and oversee the implementation of the investment plan and performance of outside managers.
- *Set aside a small dedicated pool of funds.* Foundations should allocate only a small portion of their assets to mission-related investments. The W.K. Kellogg Foundation recently announced that it had set aside $100 million of its $9 billion endowment for mission-related investments--just over 1% of the foundation's total assets.[55] By reserving a pool of funds for mission-related investing, foundation managers can better integrate mission-related investing as part of the foundation's long-term investment policy and limit the risks that arise from ad hoc investment decisions that just follow a trend.
- *Adopt a written investment policy.* A written investment policy is an effective tool to help foundation managers make prudent investment

[55] News Release, "W.K. Kellogg Foundation Announces the Launch of Mission-Driven Investment Work," 10/23/07, available at www.wkkf.org.

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management decisions. They set forth a foundation's investment goals, set long-term performance objectives, provide target asset *32 allocations, and set criteria by which managers are evaluated. A foundation that is planning to engage in mission-related investing should make this strategy an integral part of its investment policy, articulate why it is engaging in this type of investment activity, and document the decision-making process for each mission-related investment. These steps will help foundation managers show that their decisions were prudent, especially if an investment turns sour.

## Conclusion

A wealth of information, reports, and case studies is beginning to appear as an increasing number of foundations are asking how they can engage in mission-related investing.[56] There are many options, and the choices can seem overwhelming at times. PRIs, from the simple to the complex, offer one form of mission-related investments. For foundations that are interested in making market-rate mission-related investments, integrated project planning provides a practical tool to select investments. By linking investments to existing or proposed grant projects, IPP focuses and narrows the options a foundation needs to consider. By keeping a few practical considerations in mind, a foundation will be in a better position to make prudent decisions about its mission-related investing.

[56] Two of the more recent reports include *Philanthropy's New Passing Gear: Mission-Related Investing, A Policy and Implementation Guide for Foundation Trustees* (Rockefeller Philanthropy Advisors, 2008); *A Case Study: Expanding Philanthropy: Mission-Related Investing at the F.B. Heron Foundation* (School of Community Economic Development, Southern New Hampshire University, 2007).

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