Equity Investments and Loans Furthering Charitable Purposes

By Alan S. Halperin, Esq. and Rachel J. Harris, Esq.

A NEW GENERATION of philanthropists has emerged. Many of these charitably-minded individuals — investment fund managers, entrepreneurs, and investment bankers — seek to apply their investment talents to further charitable goals. In this article, we discuss Program Related Investments, or PRIs, which have become increasingly popular among private foundation managers.

A PRI generally is in the form of a loan, loan guarantee, line of credit or an equity investment in charitable use property. A PRI therefore enables a private foundation to retain an economic interest in the recipient entity. If a foundation's investment is recognized as a PRI, it is treated as a charitable grant.

Recent rulings suggest that the IRS may be allowing for increased flexibility for foundation investors to pursue non-traditional initiatives, including investments in certain philanthropic venture funds, in the form of PRIs.

PRI Requirements

To qualify as a PRI, an investment must meet three requirements. It must: (1) have as its primary purpose a charitable or other exempt purpose; (2) have neither the production of income nor the appreciation of property as a significant purpose; and (3) not have any lobbying or political purpose.

An investment is made primarily for an exempt purpose — the first prong of the PRI test — where it furthers the foundation's exempt purposes significantly and would not have been made but for the relationship between the investment and the accomplishment of exempt purposes. This "but for" portion of the primary purpose test can be supported by foundation investors through contemporaneous documentation of the reasons for an investment. Such documentation will be particularly useful if the investment, intended to serve a charitable purpose, becomes profitable.

The second definitional requirement, that a PRI have no significant income-producing purpose, is generally met by a showing that the investment's projected rate of return is insufficient by itself to compensate for the risk. The fact that an investment produces significant income or capital appreciation is not, by itself, dispositive. The facts and circumstances at the time the investment is made are critical, rather than at a later time when the investment may have become profitable. Nevertheless, profitability is evidence of purpose. The IRS also considers it relevant whether a private, profit-seeking investor would have been likely to make the investment on the same terms.

Alan S. Halperin

The last requirement of a PRI mandates that an investment must not be made in an attempt to influence legislation or intervene in a political campaign. The focus of this requirement is on the actions of the recipient of the investment, rather than on the function of the foundation.

Examples of PRIs

Traditionally, PRIs have been used to address economic and community development initiatives. Although PRIs have traditionally been used by foundations to help financially struggling, disadvantaged businesses develop and remain viable, proprietary recipients of PRIs need not be small or start-up enterprises.

Some examples of PRIs include: loans for the construction of a hotel in a downtown area suffering from economic deterioration; loans to blind individuals unable to obtain financing through commercial sources; acquisition of stock in corporations located in deteriorated areas and owned by members of disadvantaged groups; development of a low-income housing project with special assistance for the elderly and handicapped, where commercial financing was unavailable and the foundation would receive no profit; purchase of preferred stock in a minority bank; low-interest loans made in connection with urban development; below-market loans for the construction of low-income housing; a below-market rate loan to a financially secure, publicly traded company, if made to induce the company to establish a new plant in a deteriorated area where the company otherwise would be unwilling to locate; guarantee obligations of either an exempt organization or a for-profit entity to facilitate commercial loans to finance the construction of child care facilities; and the acquisition of land and construction of buildings for leasing such property to a church for a nominal rent.

Rachel J. Harris

Environmental Venture Capital Fund

The IRS, in a 2001 private letter ruling, recognized as program-related a private foundation's investment in an international venture capital fund operated with dual financial and environmental objectives. One of the purposes of the foundation was to support economic development plans that were mindful of conservation issues. The venture capital fund was created to coordinate the funding efforts of socially conscious investors who were interested in investing in businesses, all located in a particular foreign country, that were committed to the sustainable use of natural resources, the preservation of biological diversity, or organic agriculture. The foundation stated that the projected rate of return for the fund was lower than that of comparable venture capital funds and lower than the rate of return it would normally require for its investments.

Significantly, the foundation had entered into a separate agreement with the fund's governing body. This agreement allowed

– Continued on page 4

Equity Investments & Loans

Continued from page 2

the foundation to monitor the programs funded with its investment and to receive back any portion of its investment that was determined not to be committed directly to environmental purposes.

The IRS concluded that the foundation's contribution to the international venture capital fund qualified as a PRI. The IRS emphasized a number of factors as particularly significant. First, the IRS noted that the foundation would not invest in the fund but for the relationship between the fund's investments and the foundation's exempt purposes. The IRS stated that this investment by the foundation was analogous to the examples given in the regulations of investments made to further charitable goals.

Second, the IRS stated that the investment was not motivated by the desire to produce income for the foundation, given the low expected rate of return. Additionally, the IRS found that the foundation's side agreement granted enough oversight by the foundation that the investment met the expenditure responsibility requirements (discussed below).

Assuming that this private letter ruling correctly reflects the law, it is significant for several reasons. While the examples of acceptable PRIs given in the regulations involve a charitable goal that would not be achievable without the foundation's PRI, there is no indication that the foundation's investment in the fund was necessary to achieve the fund's environmental objectives. In addition, it provides an example of a PRI that will be allowed notwithstanding the fact that private investors are willing to invest on the same terms as the foundation. Thus, the ruling indicates that if the IRS is satisfied that the financial return for the fund's investment is substantially less than the yield from other venture funds with comparable risk and the fund has a purpose aligned with that of a foundation, the fact that private investors are investing alongside the foundation will not disqualify the investment from PRI status.

Consequences of Qualifying as a PRI

Once recognized as a PRI, the investment will be deemed a "grant." The investment therefore will count towards the requirement that at least 5 percent of the value of a foundation's non-charitable assets be distributed annually. However, PRI-generated income and sale proceeds from a PRI must be distributed to charity or invested in another PRI. Thus, it is critical that foundation managers keep accurate records tracing receipts from PRIs.

Expenditure Responsibility

Foundation managers must keep accurate records of their oversight of any PRIs granted by their foundation. A foundation must use reasonable efforts and establish adequate procedures to ensure that a PRI is spent solely for the purpose for which it was made, obtain full and complete reports from the grantee on how the funds are spent, and make full and detailed reports with respect to such expenditures to the IRS. Furthermore,

a private foundation must require that each PRI be made subject to a written commitment specifying the purpose of the investment and limiting funds to that use, and prohibiting the use of the funds for lobbying and political activity.

Conclusion

Many individuals with charitable goals also have considerable investment expertise. PRIs provide unique opportunities for such individuals that have foundations to apply that expertise to their philanthropy. While the IRS has clearly signaled its willingness to accept a range of investments at PRIs, it is important to remember that each situation is unique and there can be tax penalties if the investment does not qualify as a PRI. Therefore, a PRI should be carefully reviewed in light of IRS guidelines.

Alan S. Halperin, Esq. is a Partner and Rachel J. Harris, Esq. is an associate in the Personal Representation Department of Paul, Weiss, Rifkind, Wharton & Garrison LLP. Alan can be reached at 212.373.3313 or by email at ahalperin@paulweiss.com. Rachel can be reached at 212.373.3511 or by email at rharris@paulweiss.com

Offshore Partnerships

Continued from page 8

eign partners, and does not generate U.S.-source income or ECI. The exception from filing provided under IRC Section 6031(e) and the regulations thereunder applies only to foreign partnerships, and no similar exception is provided for U.S. partnerships. Thus, a U.S. private equity partnership that generates no U.S.-source income and has no income that is effectively connected with the conduct of a trade or business in the United States will have a U.S. filing requirement under IRC Section 6031(a).

Furthermore, a U.S. private equity partnership that has both U.S. and foreign partners and generates U.S.-source income but no ECI will have a U.S. filing requirement and will have to issue Schedules K-1 to all its partners, including foreign partners. This is not the case with respect to an identical foreign partnership, which would similarly have to file a U.S. partnership return, but would not be required to prepare Schedules K-1 on behalf of its foreign partners due to the modified reporting rules. Thus, it would appear that, all other things being equal, it is more advantageous for a private equity fund to be structured as a foreign partnership than a U.S. partnership, as the U.S. reporting requirements are more favorable for a foreign partnership.

Jean Paul Schwarz, JD, LLM is a Manager in Marcum & Kliegman's Hedge Fund/Investment Partnership Group. He can be reached at 516.390.1020 or by email at jschwarz@mkllp.com.