



# Capital With a Conscience

Private foundations must distinguish carefully their investments' purpose, character and strategy.

by Jane M. Searing

While skittish investors chase elusive returns amid the risks of the credit market meltdown, a calmer class of investors has been steadily growing in number and influence. They regard an investment's performance only after giving careful consideration to its greater purpose. Socially responsible investing (SRI)—sometimes also known as mission-related investing—is centuries old but came to the fore in the latter half of the last century, in the struggles of South African apartheid and other causes. Now its growth has accelerated.

Between 1995 and 2007, the value of SRI assets grew 324% in the United States, compared with the 260% growth of assets under professional management generally, reports the Social Investment Forum. And between 2005 and 2007, SRI increased 18%, far outstripping overall assets' 3% growth (2007 *Report on Socially Responsible Investing Trends in the United States*). While much of that growth has been in mutual funds that screen their investments according to social and environmental values, a major force has been “mission-driven institutions such as foundations,” the Social Investment Forum report says. And that's not surprising, given that private foundations are becoming more prominent, especially in charitable giving by families (“Advising Private Foundations,” *JofA*, April 08, page 36).

CPAs advising charitable organizations must reckon with the rules that come into play when investing seeks both a return to the investor and the higher good. Although a private foundation usually seeks to make its income-producing investments in a socially responsible manner, only program-related investments (PRIs) are defined in the Internal Revenue Code (IRC § 4944(c) and related *Treas. Reg.* § 53.4944-3).

## EXECUTIVE SUMMARY

■ **Private foundations must distinguish between** what are sometimes called mission-related investments and program-related investments (PRIs). PRIs enable private foundations to make venture capital-type investments that might otherwise be penalized under the IRC as “jeopardizing,” that is, risky.

■ **Mission-related investments, although not technically defined,** nonetheless have their distinct purposes, too,

mainly growing the foundation's assets in a socially responsible manner.

■ **PRIs also help private foundations meet requirements** for qualified distributions, similar to its grants, and are recorded as charitable-use assets. As such, they are excluded from assets considered when calculating a minimum investment return of 5% that underlies the foundation's minimum distribution requirements.

■ **Private foundations must observe expenditure responsibility (ER)** rules governing PRIs or grants made to an entity that is not a qualified public charity under IRC § 501(c)(3). Two states, North Carolina and Vermont, have introduced legislation authorizing a hybrid entity known as a low-profit limited liability company (L3C), and others are considering doing so. Advocates are urging Congress to exempt foundations from ER

requirements in making PRIs to L3Cs.

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## A DISTINCTION WITH A DIFFERENCE

PRIs and mission-related investments may sound similar. But they serve crucially different purposes within a private foundation, which may well rely upon a CPA adviser to help it distinguish between them. Most notably, PRIs allow the foundation to make venture-capital and other beneficial investments without running afoul of rules prohibiting high-risk, or “jeopardizing,” investments. Jeopardizing investments include selling short and similarly risky strategies or asset classes. See Treas. Reg. § 53.4944-1(a)(2) for specific prohibitions. Generally, a PRI:

- Has as its primary purpose the charitable purposes described in IRC § 170(c)(2)(B) (religious, charitable, scientific, literary or educational, fostering amateur sports competition or preventing cruelty to children or animals);
- Does not have as a significant purpose income production or property appreciation; and
- Does not have as its purpose any of the disqualifying purposes described in IRC § 170(c)(2)(D) (attempting to influence legislation; participating in, opposing or intervening in a political campaign of a candidate for public office).

A PRI is often in a risk category that could otherwise result in a jeopardizing investment excise tax penalty. Those penalties are 10% of the amount so invested for each year of a “taxable period,” assessed against the private foundation. In addition, 10% can be assessed against any foundation manager who knowingly, willfully and without reasonable cause participates in such an investment. A taxable period begins with the making of the jeopardizing investment and ends on the mailing date of a notice of deficiency for the initial tax, the date the initial tax is assessed, or the date the investment is removed from jeopardy, whichever is earliest. An additional 25% penalty is imposed on the foundation and 5% on the manager if such investments are not removed from jeopardy within the taxable period.

Mission-related investments, on the other hand, can be subject to jeopardizing investment penalties. They are part of a private foundation’s overall investment portfolio that fits with its values and principles. These investments are aimed primarily at property appreciation and income production.

Perhaps the difference can be best illustrated by examples (10 are given in Treas. Reg. § 53.4944-3(b)). Consider a hypothetical foundation with an exempt purpose of improving the lives of and developing the infrastructure supporting the citizens of Big City, USA. This foundation might invest a portion of its investment portfolio (noncharitable-use assets) in a private equity fund composed primarily of real estate investments. Such an investment would be consistent with the foundation’s mission and values. However, the same foundation might also make a PRI in an organization building a new community center in downtown Big City. Both investments are in real estate and are in line with the mission and values of the foundation. However, the private equity fund is part of the foundation’s investment portfolio, while the PRI to develop the community center is treated as a qualified distribution and a charitable-use asset for the duration of the investment. The development of a community center is likely not an economically viable investment when evaluated on the likely return on investment the foundation will receive.

Another reason for distinguishing program-related from mission-related investments is the different purpose they play in the often complex administrative requirements for private foundations.

## ACTS OF KINDNESS NOT RANDOM

A private foundation must also distribute a minimum amount of its assets each year. The minimum distribution amount is based upon a minimum investment return of 5% on the average fair market value of noncharitable-use assets—generally those that are not currently used for a charitable purpose. Charitable-use assets include all assets purchased for exempt purposes, program-related investments and 1.5% of the average value of cash and

marketable securities that are not program–related investments. Modifications and exclusions apply, but at the gross level, non–operating private foundations must distribute 5% of the average value of non–charitable–use assets by the close of the following tax year through qualified distributions. PRIs are qualified distributions that can be used to satisfy this requirement. See Treas. Reg. § 53.4942(a)–3(a)(2).

PRIs can be either equity or debt investments and share similarities with recoverable grants. A grant is recoverable when it can be fully or partially recovered by the grantor if its terms are not met. This is different from a unilateral grant, which is not generally recoverable so long as the organization keeps its exempt status and doesn't use the grant for a prohibited purpose. Both PRIs and recoverable grants are usually managed by the foundation's grant managers. Both are treated as qualified distributions when the cash leaves the foundation, and both are added to the required distributable amount if they are recovered in a subsequent tax period. In contrast to PRIs, recoverable grants—as with unilateral grants—are an expense on the foundation's income statement. A PRI appears on the foundation's balance sheet, not the income statement.

When a PRI is made, cash is transferred to the investee organization either in the form of a debt or equity investment, and a corresponding receivable or charitable–use investment is recorded on the foundation's balance sheet. When the PRI returns some portion of the principal investment, the foundation has until the close of the following year to redistribute these funds.

When it makes a recoverable grant, a private foundation records an expense. If the grant is recovered, it is treated the same as repayment of principal on a PRI. Both are included in the current year's distribution requirement to be satisfied by the close of the following tax year. The amount that is counted as the qualified distribution with respect to a grant or PRI is the amount of cash or assets transferred out of the foundation.

Each year, private foundations must determine the amount of asset distributions required. In making this calculation, a foundation must determine which assets are charitable–use assets and which are non–charitable–use or investment assets. Only the investment assets are included in the 5% minimum investment return calculation. Although this calculation is the topic of many pages of the IRC and Treasury Regulations, it can be briefly summarized: First, different assets are valued, based upon different averaging periods. Some asset values may be discounted, while others are excluded altogether from the non–charitable–use asset base. Second, PRIs are treated as charitable–use assets and therefore excluded from the 5% minimum investment return calculation. Third, mission–related investments are not treated as charitable–use assets and are included in the non–charitable asset base for purposes of calculating the minimum investment return.

### **INCOME TREATMENT THE SAME**

The treatment of income generated by a PRI and mission–related investment is the same. To the extent the investment generates interest, dividends, rents, capital gains or other types of income listed in IRC § 4940, the foundation pays tax at a rate of either 1% or 2% on the net income after expenses. Similarly, total capital losses are limited to capital gains in calculating net investment income for the year. In other words, a private foundation may not dispose of either a program– or mission–related investment and use the capital loss to offset other types of investment income, such as interest or dividend income.

Another peculiarity of net investment income calculation for private foundations is that any net capital losses generated in one tax year may not be carried to either prior or later tax periods to offset capital gains in these other tax periods. Foundation investment advisers should monitor the overall net investment income recognized in any tax period and consider recognizing gains on investments to offset any anticipated losses, which will be lost once the tax year closes. See Exhibit 1 for a comparison of characteristics of PRIs and mission–related investments.

### **EXERCISING EXPENDITURE RESPONSIBILITY**

Under current law, private foundations can make a grant or PRI to any type of entity, so long as it is made

exclusively for charitable purposes. If the grant or PRI is to a qualified 501(c)(3) public charity, the foundation must verify that the receiving organization has a current public charity status and that the funds will be used exclusively for a qualified charitable purpose. A grant or PRI to a non-501(c)(3) organization or private foundation, however, requires the grantor foundation to exercise expenditure responsibility (ER) oversight, which requires it to make an inquiry before the grant or PRI. See Treas. Reg. § 53.4945-5. The grantor or investor foundation must also:

- Execute a written agreement,
- Require the grantee or investee to keep a separate accounting for funds from the foundation,
- Require regular reports from the grantee or PRI organization, and
- Attach an expenditure responsibility report to the foundation’s annual excise tax return.

**Exhibit 1** Comparison of Program- and Mission-Related Investments

Characteristic or Requirement	Program-Related Investment	Mission-Related Investment
Codified definition	Yes	No
Investment counts as a qualified distribution for the 5% distribution requirement	Yes	No
Subject to jeopardy investment restrictions	No	Yes
Invested principal subject to 5% minimum investment return calculation	No	Yes
Investment income generated subject to IRC § 4940 excise tax on net investment income	Yes	Yes
Return of principal subject to redistribution rules under IRC § 4942	Yes	No
Subject to expenditure responsibility reporting rules	Yes *	No
Subject to UPIA, UMIFA and/or UPMIFA	No	Yes

\* If "investing" in a non-501(c)(3) organization.

Mission-related investments do not require ER oversight because they are not qualified distributions. As part of the foundation’s overall investment portfolio, however, they are subject to the prudent investor acts of the states where these investment management standards have been adopted. These acts are: Uniform Prudent Investor Act (UPIA), Uniform Management of Institutional Funds Act (UMIFA) and Uniform Prudent Management of Institutional Funds Act (UPMIFA).

### L3C: DESIGNED TO RECEIVE PRIs?

A new hybrid organization is intended to ease the administrative burden for both foundations and the recipient of a PRI. The low-profit limited liability company, or “L3C,” is a type of LLC organized under state law to engage in socially beneficial activities (see sidebar “L3Cs on the Rise”). A number of states are considering this new entity, but as of late 2007, only two, North Carolina and Vermont, had introduced legislation to establish them.

Although an L3C would not be exempt from federal tax, its organizational structure mirrors the language in the Treasury Regulations describing PRIs, namely:

- It is formed primarily for charitable or educational purposes,
- No significant purpose of the entity is the production of income or the appreciation of property, and
- No purpose of the entity is to conduct legislative or political activities.

Although one or more states may allow the creation of the L3C as a new entity type, what regulatory body will ensure that the three required principles are adhered to and revoke L3C status if the principles are violated? Since the current Tax Code and Regulations allow private foundations to make a PRI for any charitable purpose, the Council on Foundations (COF) announced in its 2007 legislative agenda that it would encourage Congress to allow foundations to make PRIs in L3C organizations without requiring expenditure responsibility oversight. Such a measure would seem to require a determination whether an L3C qualifies as a charitable organization under IRC § 501(c)(3) and either the IRS or the states to oversee it.

If the private foundations are required to determine the charitable status of an L3C, they most likely would handle it the same way as an equivalency determination a private foundation makes when making a grant to a foreign charitable organization. However, since this option puts the burden on the private foundation, most private foundations would simply elect to perform ER reporting to eliminate the significant penalties potentially incurred if it turns out their original determination was incorrect.

## EFFICIENT AND PENALTY-FREE

Appreciating the differences between PRIs and mission-related investments and the need for both is essential for private foundations and their managers to avoid significant penalties and to manage the foundation's assets

efficiently. CPAs advising private foundations can play a crucial role in making sure these two forms of investments are properly distinguished from one another. And those in public practice who may have dealings only in passing with foundations and exempt organizations generally are increasingly likely to be called upon to explicate their often labyrinthine governing rules.

### L3Cs on the Rise

On April 30, Vermont's governor signed the first legislation (H 775) creating low-profit limited liability companies (L3Cs). North Carolina introduced similar legislation in the summer of 2007. As of this spring, the North Carolina legislation was with the Senate Committee on Finance, where it had been for nearly a year.

A Vermont L3C will be subject to federal income taxes under subchapter K unless it elects tax treatment as a corporation by filing the check-the-box election on Form 8832, *Entity Classification Election*. Members of the L3C are not required to be Vermont residents. What's more, currently an LLC, and almost certainly soon an L3C, can be created over the Internet. Therefore, anyone can create an L3C, no matter where they reside. The legislation contains several specific classification requirements:

1. The company:
  - a. Significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of IRC § 170(c)(2)(B), and
  - b. Would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.
2. No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of the other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.
3. No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of IRC § 170(c)(2)(D). Failure to meet these L3C requirements but continuing to meet the LLC requirements will result in classification as a Vermont LLC. The name of the organization must be changed from L3C to LLC at the time of conversion.

The primary reason for enacting this legislation was to stimulate foundation and institutional investment in these charitable, member-owned organizations. However, until the IRS changes the rules regarding expenditure responsibility reporting for program-related investments in non-public-charity organizations, significant private foundation investment in these organizations is unlikely. If Congress makes this change, the use of L3C organizations will likely grow dramatically across the nation.

## AICPA RESOURCES

### Articles

- "Advising Private Foundations," JofA, April 08, page 36
- "Private Foundations: Achieving Maximum Use of Excess Qualifying Distributions," *The Tax Adviser*, April 02, page 225

## OTHER RESOURCES

### Publication

*Private Foundations: Tax Law and Compliance* (3rd ed.), by Bruce R. Hopkins and Jody Blazek, Wiley, 2008

### Web site

Social Investment Forum, [www.socialinvest.org](http://www.socialinvest.org)