

**PRESENTED AT**

37th Annual Nonprofit Organizations Institute

January 23-24, 2020  
Austin, TX

## **Not Your Grandmother's Impact Investing**

### **Additional Materials**

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# PROPOSED REGULATIONS WOULD BRING PROGRAM-RELATED INVESTMENTS INTO THE 21ST CENTURY

BY DAVID A. LEVITT AND ROBERT A. WEXLER

After decades in which the existing Regulations remained unchanged, Treasury and the IRS have responded to suggestions by the tax and private foundation communities and have issued updated guidance for special types of investments that are related to a foundation's purpose. While not every suggestion was adopted and while some questions remain unanswered, the overall impact of the new Proposed Regulations should be favorable.

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"The Treasury Department and the IRS are aware that the private foundation community would find it helpful if the regulations could include additional PRI examples that reflect current investment practices and illustrate certain principles...."<sup>1</sup> After prompting from the private foundation community and the ABA Tax Section, among others, Treasury and the IRS published a very thoughtful and well-crafted set of nine new modern-day examples of program-related investments (PRIs) that satisfy the tests of Section 4944. These new examples, in the form of Proposed Regulations (REG-144267-11, 4/19/12) as well as the statements of principle articulated in the Preamble, are welcome as much for their specific findings as for the signal that they send to private foundations that IRS does indeed consider PRIs to be a valid tool for private foundation charitable activity.

Currently there are probably less than 100 attorneys in the U.S. who are truly comfortable advising private foundation clients on complex PRIs, and there are probably even a fewer number of private foundations that are comfortable in making complex PRIs. We write this article, in part, to encourage private foundations and their attorneys to consider PRIs as an excellent alternative to grant-making where the circumstances warrant. PRIs provide a great way to ex-

pand a foundation's work while potentially recycling dollars and increasing the pool of funds available for future grants or investments. It is our hope that these new Proposed Regulations will encourage more PRI activity.

## BACKGROUND

The PRI rules are applicable technically only to Section 501(c)(3) organizations that are characterized as private foundations under Section 509 and therefore are potentially subject to the excise taxes set forth in Sections 4940 through 4946. PRIs are an exception to the Section 4944 excise tax on jeopardizing investments. Section 4944(c), which defines PRIs, has not changed since it was first enacted as part of TRA '69. The PRI Regulations, which were promulgated in 1972,<sup>2</sup> have not been amended or supplemented until now. Virtually all of the guidance since the 1972 Regulations has been in the form of nonprecedential private letter rulings.

Prior to 1969, Congress had made only limited distinctions between private foundations and public charities under Section 501(c)(3) and its predecessors.<sup>3</sup> Indeed, all charitable organizations generally were treated the same until the Revenue Act of 1943, when Congress provided for the first time that certain exempt organizations were re-



quired to file annual information returns.<sup>4</sup> Private foundations were not defined, per se, in 1943, but because they are not religious organizations, schools, fraternal organizations, government entities, or publicly supported charitable organizations, they were required, after 1943, to file annual information returns.

The Revenue Act of 1950 extended the preference for publicly supported charities over organizations that generally were referred to as private foundations.<sup>5</sup> At this point there was still no definition of private foundation, but the 1950 legislation added loss of exemption as a possible penalty for, among other actions, investment of income in a manner that jeopardizes the achievement of exempt purposes.<sup>6</sup>

The 1954 Code first articulated a distinction, for purposes of the charitable contribution deduction, between public charities and private foundations. Before 1954, the percentage-of-AGI ceiling on total contributions to Section 501(c)(3) entities that was deductible was 20%. In 1954, Congress increased the percentage limitation to 30%, but the increase was available only for contributions to religious, educational, or certain hospital organizations.

Congress again expanded the preference in the Revenue Act of 1964, by extending the 30%-of-AGI limitation to organizations that were publicly or governmentally supported. The legislative history of the 1964 Act suggests that Congress

viewed privately funded charities as being less worthy of tax benefits.<sup>7</sup>

During the 1950s and 1960s, Congress also commissioned several reports on the conduct and behavior of private foundations.<sup>8</sup> Ultimately, the private foundation provisions of TRA '69 were enacted in light of the findings of all of these reports, particularly the various reports from the 1960s. Most of the key changes focused on anti-self-dealing provisions, mandatory payouts, and prohibitions on excess business holdings.

**For some private foundations, PRIs can be an excellent alternative to grant-making where the circumstances warrant.**

Prior to 1969, a private foundation could potentially lose its tax-exempt status if its accumulated income was invested in a manner that jeopardized the carrying out of its charitable purposes. Nevertheless, there was no rule limiting or restricting the investment of principal. Based largely on a few perceived problem foundations, Congress determined that investments of principal that jeopardize exempt purposes may reduce benefits to charity just as much as jeopardizing investments of accumulated income. There is virtu-

ally no discussion in the legislative history, however, on the PRI exception.

Where did the PRI exception come from? During the 1960s, and perhaps earlier, large private foundations, particularly the Ford Foundation, were already making PRIs in the form of below-market loans to businesses in deteriorating urban communities. It is generally accepted by seasoned tax practitioners that the Ford Foundation's activities in this area became the basis for the PRI exception in Section 4944 and indeed for the specific examples set forth in the 1972 Regulations.

Between 1972 and 2002, what worked and did not work as a PRI was largely determined by a couple of dozen private letter rulings and by the willingness of private foundations to make below-market loans and less-than-attractive equity investments, based largely on the advice or legal opinions of counsel. In 2002, sensing the frustration of the private foundation community in not having updated formal guidance, David Chernoff of the John D. and Catherine T. MacArthur Foundation led the efforts of the ABA Tax Section to ask Treasury to update the Regulations to contain more modern examples of PRIs.<sup>9</sup>

In 2009-2010, Treasury and the IRS included on their combined work plan a project to update the PRI Regulations.<sup>10</sup> In response, in 2010 the ABA Tax Section decided to re-work its 2002 submission and

#### NOTES

<sup>1</sup> Preamble to REG-144267-11, 4/19/12.

<sup>2</sup> Reg. 53.4944-3; TD 7240, 12/28/72.

<sup>3</sup> For an excellent summary of the history of private foundation legislation, see Staff of the Joint Committee on Taxation, *Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations* (JCT-29-05, 4/19/05), page 85 et seq. ("2005 JCT Report").

<sup>4</sup> *Id.*, page 85, citing P.L. 78-235 (2/25/44), section 117(a).

<sup>5</sup> *Id.*, citing P.L. 81-814 (9/23/50), section 331.

<sup>6</sup> *Id.*, page 86.

<sup>7</sup> *Id.*, citing H. Rep't No. 749, 88th Cong. 1st Sess. 53 (1964).

<sup>8</sup> The reports from these various committees are fascinating, but beyond the scope of this Article. See the discussion in the 2005 JCT Report, *supra* note 3, pages 87-89, describing the following hearings. The Cox Commit-

tee held hearings in November and December of 1952 and reported on January 1, 1953. See *Tax-Exempt Foundations: Hearings before the House Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations*, 82d Cong., 2d Sess. (1952); H. Rep't No. 2514, 82d Cong., 2d Sess. (1953). The Reece Committee conducted hearings in 1954 and issued a report on 12/16/54. See *Tax-Exempt Foundations: Hearings before the House Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations*, 83d Cong., 2d Sess., on H. Res. 217 (1954); H. Rep't No. 2681, 83d Cong., 2d Sess. (1954). Various reports were issued beginning in the 1960s by Congressman Wright Patman: *Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy*, Report to the House Select Committee on Small Business, First Installment, 87th Cong. 2d Sess. (1962); Second Installment, 88th Cong. 1st Sess. (1963);

Third Installment, 88th Cong. 2d Sess. (1964); Fourth Installment, 89th Cong., 2d Sess. (1966); Fifth Installment, 90th Cong., 1st Sess. (1967); Sixth Installment, 90th Cong., 2d Sess. (1968); Seventh Installment, 91st Cong., 1st Sess. (1969); Eighth Installment, 92d Cong., 2d Sess. (1972). Finally, see the *Treasury Department Report on Private Foundations*, Senate Finance Committee, 89th Cong., 1st Sess. (2/2/65), pages 2, 5, and 13-14.

<sup>9</sup> See ABA Section of Taxation Comments, "Draft Examples of Program-Related Investments (For Addition to Treasury Reg. Sec. 53.4944-3(b)) and Analysis of Each," available at [www.abanet.org/tax/pubpolicy/2002/020515pri.pdf](http://www.abanet.org/tax/pubpolicy/2002/020515pri.pdf).

<sup>10</sup> See Treasury Office of Tax Policy and Internal Revenue Service 2009-2010 Priority Guidance Plan (11/24/09) (for "Exempt Organizations," item 6, "Guidance under Section 4944 on program-related investments").

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First appeared as part of the conference materials for the  
37<sup>th</sup> Annual Nonprofit Organizations Institute session  
"Not Your Grandmother's Impact Investing"