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## **Tax Exemption Considerations in Impact Investing**

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## *Tax Exemption Considerations in Impact Investing<sup>1</sup>*

### *Key Topics*

1. When are tax exemption considerations relevant in impact investing?
2. Does an impact investing activity further a charitable purpose – “relatedness”?
3. Does the activity confer an impermissible private benefit on private persons?
4. Unrelated business taxable income (“UBTI”) considerations
5. Can the organization maintain public charity status (if relevant)?

### *When Are Tax Exemption Considerations Relevant in Impact Investing?*

1. Investment of charitable funds – if the investment is not a prudent investment solely from a financial point of view, is it a mission-related or program-related investment?
  - a. Important to the charity and to the investment sponsor
2. Formation of a new impact fund – whether to structure for and seek tax exemption
3. Formation of a new fund sponsor – whether to structure for and seek tax exemption
4. Financial, service, or other relationships between a charity and a non-charitable impact fund or fund sponsor

### *Review of Basic Tax Exemption Requirements*

1. In order to be eligible for tax-exempt status, an organization must be organized and operated “exclusively” for tax-exempt purposes, and no part of its earnings may inure to the benefit of private shareholders or individuals.<sup>2</sup>
2. “Exclusively” means “primarily.” An organization will be operated for tax-exempt purposes only if it engages “primarily” in activities that accomplish one or more of the exempt purposes specified in Section 501(c)(3).<sup>3</sup>
  - a. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.
  - b. Substantiality is determined based on facts and circumstances.
3. Accordingly, the existence of a single substantial nonexempt purpose, regardless of the number or importance of exempt purposes, will cause failure of the operational test.<sup>4</sup>
  - a. For an organization engaging in impact investing activities, if those activities do not further exempt purposes, the organization:
    - i. Risks its tax exemption, if the activity is substantial in relation to the organization’s overall activities
    - ii. Risks realizing UBTI (but not its tax exemption), if the activity is insubstantial in relation to the organization’s overall activities

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<sup>2</sup> In addition, no substantial part of its activities may consist of lobbying, and the organization may not intervene in a political campaign by endorsing or opposing a candidate for public office. Code Section 501(c)(3).

<sup>3</sup> Treas. Reg. § 1.501(c)(3)-1(c)(1).

<sup>4</sup> *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279 (1945).

4. The requirement to operate “exclusively” for exempt purposes also means that tax-exempt organizations are prohibited benefiting private interests as more than an “insubstantial part” of their activities.<sup>5</sup>
  - a. GCM 37789:
    - i. A private benefit may be “insubstantial” if it is an indirect private benefit, provided as “a necessary concomitant of the activity which benefits the public at large” in the sense that “the benefit to the public cannot be achieved without necessarily benefiting certain private individuals.”
    - ii. A private benefit should be incidental both qualitatively (i.e., it should be an indirect rather than a direct benefit) and qualitatively (i.e., it should be insubstantial in comparison to the public benefit provided) in order to be permissible.
  - b. Rev. Rul. 70-186: While lakefront property owners would benefit from a tax-exempt organization’s efforts to clean up pollution in the lake, “Any private benefits derived by the lake front property owners do not lessen the public benefits flowing from the organization's operations. In fact, it would be impossible for the organization to accomplish its purposes without providing benefits to the lake front property owners.”

### ***Recognized Charitable Purposes***

1. Section 501(c)(3) recognizes the following charitable purposes: religious, charitable, scientific, testing for public safety, literary, and educational purposes, or to foster national or international sports competition or prevent cruelty to children or animals.
2. Under the regulations, the term “charitable” is to be construed in its generally accepted legal sense (i.e., taking into account the common law of charity)<sup>6</sup> and has been recognized to encompass several concepts relevant to impact investing (among others listed in the regulations):
  - a. Relief of the poor and distressed or of the underprivileged
    - i. A person is “needy,” i.e., poor or distressed, if the person “lacks the necessities of life involving physical, mental or emotional well being, as a result of poverty or temporary distress.”<sup>7</sup>
      1. Includes financial impoverishment as a result of low income and lack of financial resources, temporary disaster or crisis situations, refugee or immigrant status accompanied by language, cultural or financial difficulties, status as a minor child not cared for by a parent or guardian, and status as a person who is not self-sufficient as a result of previous institutionalization.
  - b. Lessening of neighborhood tensions
  - c. Elimination of prejudice and discrimination
  - d. Defending human and civil rights secured by law
  - e. Combatting community deterioration and juvenile delinquency<sup>8</sup>

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<sup>5</sup> Treas. Reg. § 1.501(c)(3)-1(c)(1).

<sup>6</sup> Treas. Reg. § 1.501(c)(3)-1(d)(2).

<sup>7</sup> Treas. Reg. § 1.170A-4A(b)(2)(ii)(D).

<sup>8</sup> Treas. Reg. § 1.501(c)(3)-1(d)(2).

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