April 25, 2016

New Regulations Expand Opportunities for Program-Related Investments

In recently released final regulations, the IRS and the Department of the Treasury have provided additional examples of investments that qualify as program-related investments ("PRIs") for private foundations. The final regulations, which largely track proposed regulations issued in 2012, provide a much-needed contemporary look at investment practices by foundations. All foundations should be aware of the nine examples in the final regulations that describe investment scenarios beyond those addressed in the PRI regulations issued in the early 1970s.

Background on PRIs

Among other restrictions imposed on private foundations by the Internal Revenue Code, a private foundation is prohibited from making investments that are so speculative or risky that they could prevent the foundation from having sufficient funds to carry out its exempt purposes (referred to as "jeopardizing investments"). PRIs are not considered to be jeopardizing investments. In general, an investment will qualify as a PRI if its primary purpose is to accomplish one or more charitable purposes and no significant purpose of the investment is the production of income or the appreciation of property. The concept of PRIs is also significant to private foundations because expenditures for PRIs count as "qualifying distributions" toward a private foundation's annual payout requirement and are not considered "excess business holdings" under the private foundation tax rules.

New Regulations

The regulations issued in the 1970s include nine examples of investments by private foundations that qualify as PRIs, and one example of an investment that does not qualify. While informative, these examples have not kept up with the times. They are exclusively focused on domestic investment opportunities by private foundations and predominantly address situations involving economically disadvantaged individuals and depressed communities.

The new examples, adopted effective April 25, 2016, illustrate that PRIs may take many different forms. Among the new examples are:

- investing in a private company owned by a pharmaceutical company that will conduct scientific research toward development of a vaccine that predominantly affects poor individuals in developing countries;
- making an equity investment in a business in a developing country focused on collecting recyclable solid waste materials and delivering those materials to recycling centers in order to improve the environment of that country;
- making below-market loans to poor individuals in developing countries to enable them to start small businesses; and
- entering into a deposit or guarantee agreement with a commercial bank to secure a loan made to a tax-exempt child care facility for the construction of a new facility where the child care facility's credit would otherwise not allow it to obtain the loan.

The examples illustrate that an investment may qualify as a PRI even if private parties benefit from the foundation's investment, as long as the private benefit is incidental to the investment's primary purpose of accomplishing an exempt purpose (and the PRI requirements are otherwise satisfied). The introduction to the regulations also includes the following helpful insights:

- an activity conducted in a foreign country furthers an exempt purpose if the same activity would further an exempt purpose if conducted in the United States;
- the exempt purposes served by a PRI are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas;
- the recipients of PRIs need not be within a charitable class if they are the instruments for furthering an exempt purpose;
- a potentially high rate of return does not automatically prevent an investment from qualifying as a PRI;
- PRIs can be achieved through a variety of investments, including loans to individuals, tax-exempt organizations and for-profit organizations, and equity investments in for-profit organizations;
- a credit enhancement arrangement may qualify as a PRI; and
- a private foundation's acceptance of an equity position in conjunction with making a loan does not necessarily prevent the investment from qualifying as a PRI.
- The IRS and Treasury declined requests from commenters to add an example to the final regulations illustrating a PRI equity investment in a partnership, but stated that they may address this issue in a future revenue ruling. The IRS and Treasury also declined to add examples involving investments in low-profit limited liability companies ("L3Cs") or benefit corporations, noting that the examples in which the PRI recipient is an LLC or corporation would apply equally if the recipient were an L3C or benefit corporation, respectively.

Despite the helpful new examples in the final regulations, whether an investment qualifies as a PRI ultimately depends on specific facts and circumstances, and foundations considering investment opportunities that depart from these examples will need to consider carefully whether the investment fits the legal definition of a PRI.

If you have questions about the new PRI regulations or about PRIs in general, please contact a member of the Tax-Exempt Organizations or Charitable Foundations practice.