

# Program-Related Investments: Will New Regulations Result in Greater and Better Use?

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*Beautifully level / [Alex Gilbert](#)*

[Final regulations concerning program-related investments](#) (PRIs) were published and made effective on April 25, 2016, providing private foundations with additional varied examples of how they can use PRIs to further their charitable missions. While PRIs are vastly underutilized, many commentators believe recent changes in how the law is administered will encourage more use of PRIs and change the competitive playing field for philanthropic dollars.

## What are Program-Related Investments?

PRIs are investments made by private foundations in which:

1. The primary purpose is to accomplish one or more of the foundation's 501(c)(3) exempt purposes (other than testing for public safety),
2. Production of income or appreciation of property is not a significant purpose, and
3. Influencing legislation or engaging in political campaign intervention is not a purpose.

## Why are PRIs interesting?

PRIs represent an alternative to grantmaking as a way private foundations can further their missions and still meet their distribution requirements. Instead of making a grant, a private foundation can make a loan, provide a loan guarantee, or even purchase stock in a for-profit corporation.

Because PRIs are made primarily to accomplish the private foundation's exempt purposes, they are not considered *jeopardizing investments* subject to significant penalty taxes under Section 4944 of the Internal Revenue Code. The purpose limitations, however, do not preclude a foundation from profiting from a financially successful PRI. For example, a foundation could make a purchase of equity in a social enterprise and make a substantial profit by selling such equity a few years later. However, to qualify as a PRI, the purpose for the foundation's initial investment in the social enterprise is primarily to advance its exempt purposes and not significantly to make a profit.

Unlike the case with grants, PRIs may result in a return of the foundation's investment and possibly some profit. This provides the opportunity for the foundation to recycle its funds over and over, though subject to the significant potential for the investment not to be repaid. With a grant, the foundation distributes its funds without any expectation or requirement of repayment.

## **PRIs instead of Grants**

PRIs are generally *qualifying distributions* under Section 4942 of the Internal Revenue Code, except when made to a private non-operating foundation or an organization controlled by the contributing foundation or one of its disqualified persons (e.g., substantial contributors, directors, officers, trustees). So, they can be made instead of grants to meet a foundation's minimum distribution requirement (generally, five percent of its investment assets minus administrative overhead). A PRI to an operating foundation may be a qualifying distribution only if the grantor foundation maintains some "significant involvement" in the active programs in support of which such grants are made.

## **PRIs to For-Profit Social Enterprises**

Private foundations must exercise *expenditure responsibility*, a set of due diligence procedures codified in the Treasury Regulations, when making PRIs (or grants) to for-profit social enterprises. Expenditure responsibility involves making reasonable efforts and establishing adequate procedures:

1. To see that the grant is spent solely for the purpose for which made (in connection with this requirement the foundation must conduct a pre-grant inquiry concerning potential grantees and make all its grants subject to a certain type of written grant agreement with the grantee),
2. To obtain full and complete reports from the grantee on how the funds are spent, and
3. To make full and detailed reports with respect to such expenditures to the IRS.

## **Final Regulations: New Examples of PRIs**

Prior to promulgation of the new regulations with additional examples of PRIs, Section 53.4944 of the Treasury Regulations included only nine examples of investments that qualify as PRIs and one example of an investment that does not qualify as a PRI. These ten examples focused on

domestic situations principally involving economically disadvantaged individuals and deteriorated urban areas. The recently promulgated regulations added nine new examples that cover a broader range of investments that qualify as PRIs.

- In Example 11, the private foundation purchases shares of a subsidiary corporation of a drug company that has been established to research and develop a vaccine that will predominantly help poor individuals in developing countries. The vaccine will be sold to such individuals at a price that is affordable to them even though it may be sold to others at a market rate. While the investment agreement between the parties allows the corporation to patent its findings, it also requires the corporation to publish the research results.
- In Example 12, the private foundation purchases stock of a foreign corporation that collects recyclable solid waste materials in the foreign country and delivers them to recycling centers inaccessible to the majority of the population, an activity consistent with the foundation's goal of combating environmental deterioration. There is a high risk associated with the investment, which has not generated sufficient appeal to commercial investors. But there's also the potential for a high rate of return if the foreign corporation is successful.
- In Example 13, the private foundation accepts stock from the same foreign corporation in Example 12 as an inducement to make a below-market rate loan to the corporation on the same terms offered to, and rejected by, commercial investors.
- In Example 14, the private foundation makes a below-market rate loan to a business enterprise in a rural area damaged by natural disaster that lacked access to conventional funding sources. The primary purpose of such a loan is to provide relief to the poor and distressed.
- In Example 15, the private foundation makes below-market rate loans to poor individuals in a foreign country to enable them to start small

businesses. Again, the primary purpose of such loans is to provide relief to the poor and distressed.

- In Example 16, the private foundation makes a below-market rate loan to a limited liability company (LLC) to be used to provide training to poor farmers in a developing country in efficient water management, crop cultivation, pest management, and farm management.
- In Example 17, the private foundation makes a below-market rate loan to a 501(c)(4) social welfare organization to fund the purchase of an exhibition space for weekly community art exhibits and thereby further its primary purpose of promoting the arts.
- In Exhibit 18, the private foundation provides a deposit to a commercial bank that serves to secure a loan made by the bank to a 501(c)(3) childcare organization for purposes of funding construction of a new childcare facility.
- In Example 19, the private foundation enters into a guarantee agreement with a commercial bank to repay a loan the bank made to the same 501(c)(3) organization in Example 18. Separately, it enters into a reimbursement agreement with the organization requiring the organization to reimburse the foundation for any amounts the foundation paid to the bank under the guarantee agreement.

According to the IRS, the examples illustrate the following principles:

1. 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.
2. The exempt purposes served by a PRI may include any of the purposes described in section 170(c)(2)(B) [generally, the same exempt purposes described in section 501(c)(3) other than testing for public safety] are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas.

3. The recipients of PRIs need not be within a charitable class if they are the instruments for furthering an exempt purpose.
4. A potentially high rate of return does not automatically prevent an investment from qualifying as program-related.
5. 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.
6. A credit enhancement arrangement may qualify as a PRI.
7. 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.

Notably, the proposed examples did not specifically reference benefit corporations or low-profit limited liability companies (L3Cs) as recipients of PRIs. Although the IRS received comments requesting such references, the Service's explanation of their exclusions evinces that, for the purpose of PRIs, benefit corporations are no different from other (for-profit) corporations and L3Cs are no different from other limited liability companies.

PRIs allow for the possibility of philanthropic distributions to be made and recoupled continuously over and over until an investment fails. They represent a valuable tool for foundations to consider in effectively and efficiently using their assets to further their missions. And they offer an attractive alternative to grantmaking for funding social enterprises.

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*The Nonprofit Quarterly has previously covered [the successful use of PRIs by the Kresge Foundation](#) and [criticized proposed changes in the law to make L3Cs preferred recipients of PRIs](#).*