Legal and Exempt Organization Tax Aspects of Impact Investing[1]

at

Nonprofit Governance Impact Investing: Key Issues for EOs

hosted by

Georgetown University Law Center, Independent Sector, and Council on Foundations

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April 26, 2017

I. Introduction

Any number of laws and regulations apply to 501(c)(3) organizations undertaking to engage in "impact investing."[2] Among these are common law and statutory duties of loyalty and care, "prudence", rules addressing jeopardy investments, relationships of such activities to the entity's charitable missions (or not), and potential impermissible private benefit. Private foundations have additional, more specific issues, including the payout requirement, excess business holdings, taxable expenditures, and self-dealing. Private foundations

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[2] We explain our use of the term "Impact investing" in section II below

also can avail themselves of, and are subject to the rules surrounding, the program related investment under section 4944 of the Internal Revenue Code."

We consider each of these, beginning with clarifying how we are using the term "impact investing" for purposes of this paper. We conclude with a summary chart that both identifies some of the key issues at a very high level and succinctly summarizes how variations of "impact investing" for 501(c)(3) enterprises intersect with those issues.

Ultimately, recent regulatory changes and announcements have made "impact investing" by 501(c)(3) organizations, including private foundations, more available from a legal perspective than ever before. There are still many practical and legal considerations, however, that should be explored given the wider door to responsibly pursuing the activity!

II. "Impact Investing" – What Does It Mean?

For our purposes, we are defining "impact investing" as activities of an organization that is tax exempt under IRC 501(c)(3)[3] that intend both financial and social and/or environmental returns, outcomes, or impact. Different investors may, however, calibrate the balance between social and financial returns differently. Because the degrees of such intentions are not explicit, we use the term to include social responsible investing, mission related investing, and program related investments. Two important distinctions among these categories will be the extent to which (1) financial return expectations are or are not reduced

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[3] Many investors who are not tax exempt are also venturing into the impact investment arena as they seek to align their investment activities with their values.

to induce greater social return or attract more conventional investors (e.g., concessionary) and (2) decisions relate to the entity's charitable mission.

Socially responsible investing or SRIg can have a both negative and positive approach. In both cases, the presumption is non-concessionary; that is, market rate returns remain the primary objective. Thus, from a private foundation perspective, these activities are undertaken with "endowment"[4] dollars or the 95% instead of the 5%. Also in both cases, the relationship to charitable mission need not be direct or even exist at all. Usually, SRIg applies when hiring fund managers in managed accounts to invest in the public markets and, to a more limited extent when investing in "pooled" funds such as venture capital, private equity, buy out, hedge funds, etc.

The negative approach imposes an "opt-out" screen on investment decisions such that the 501(c)(3) entity will not invest in companies or with funds that operate in certain sectors or geographic areas or that generate their revenues by selling certain goods or services. Some traditional industry examples include tobacco, firearms, military defense, pornography, or gambling. The divestiture movement of the 1980s is another example in which companies doing business in segregated South Africa were disfavored. Companies whose suppliers exploit child labor or whose products/games promote violence may be

[4] We use the term endowment to mean the investment portfolios maintained by foundation even if they do not technically constitute endowments, UPMIFA defines an endowment to mean "an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use."

additional screens. Recent examples of "negative" screens include unhealthy foods or coal, oil, gas and other carbon emitting byproducts.

The positive approach adopts an "opt-in" screen in which the 501(c)(3) entity preferences companies and/or funds that are deemed to operate in a socially responsible manner, which can encompass a wide range of characteristics. Examples include "environmentally" friendly companies or funds or companies or funds that prioritize strong environmental, social and governance practices ("ESG.") More narrowly targeted may be companies or funds that enable healthy eating or lifestyles, are women or minority owned or operated, advance bio-medical innovations and medical care alternatives, reduce or eliminate carbon emissions or generation of waste, target specific communities, etc. There are any number of funds that promote their socially responsible approach, including those that espouse various religious traditions. Certainly many "opt-in" approaches fall within any given subset of ESG, but they are more focused relative to ESG's breadth.

Unlike SRIg, mission related investing or MRIg <u>may</u> be concessionary in that the entity may be willing to accept below market financial returns in exchange for "social returns", which introduces concerns about whether doing so can be consistent with fiduciary duties. The answer is "yes," assuming the presence of certain factors, which we discuss later. Unlike SRIg, MRIg usually relates directly to the entity's charitable mission – likely not just its broadly permissive mandate under 501(c)(3) but its more specifically stated programmatic areas. That focus is one of the reasons concessionary returns can be an allowable trade-off with regard to fiduciary duties. Private foundations that make MRIg may not count the investment against their distribution requirements and therefore are essentially drawing resources from their endowment or the 95% rather than the 5%. MRIg may apply with regard to hiring fund managers, investing in alternative assets (e.g., VC, private equity, etc.), or managing a portfolio of direct investments in companies.

Unlike SRIg and MRIg approaches, program related investments or PRIs "count" against the foundation's payout requirement. Consequently, many consider PRIS's as "coming" from the 5% rather than the endowment or the 95%. PRIs are by definition concessionary on the front end and must target charitable purposes. PRIs specifically prioritize significantly furthering the entity's specific exempt, charitable purposes such that "but for" the relationship to those purposes, the entity would not have undertaken the investment activity. Furthermore, no significant purpose of the engagement can be production of revenue to the foundation, appreciation of the foundation's investment, and no purpose can be to lobby or intervene in a political campaign. Although unique under the law to private foundations, the PRI criteria and structure can be adapted by other tax exempt entities by analogy.

III. Fiduciary Duties and Impact Investing[5]

Generally, state law controls fiduciary duties relating to the investment activities of 501(c)(3) enterprises. In some cases, it may be more specific trust

[5] For an excellent treatment of this topic, see Prof. Susan N. Gary's contribution to a panel at the 51st Annual Heckerling Institute on Estate Planning entitled "It's Hard to be Good: Fiduciary Duties and Impact Investing" delivered on January 12, 2017. Prof. Gary's paper is also the basis for many of the citations in this section.

law and in other cases the somewhat more general charitable corporation law. For instance, the duty of loyalty for a trust is to carry out the terms of the trust and to act in the sole interest of its beneficiaries.[6] In the corporate context, the duty is to the best interests of the corporation and its intended beneficiaries.[7] In both instances, however, the duty is to avoid conflicts of interest and prioritize the interests of the beneficiaries, perhaps even to the exclusion of social causes or concerns not related to the beneficiaries.

The state law duty of care demands that fiduciaries decide and act with prudence in how they manage/invest the assets of the enterprise.[8] The understanding of "prudence" has evolved to encompass considerations under modern portfolio theory and its recognition of risk analysis at the portfolio rather than transactional level and of the reasonableness of the portfolio being diversified across various asset categories and classes commensurate with the size and objectives of the endowment.[9]

Moreover, prudence as characterized by most states now recognizes the relevance – even importance – of considering the entity's charitable purposes when managing and investing its assets. More specifically, fiduciaries in most states may consider "an asset's special relationship or special value, if any, to the charitable purposes of the institution."[10]

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[6] See Restatement (Third) of Trusts §§ 76, 78 (2007).
[7] See Principles of the Law of Nonprofit Orgs., (Tentative Draft No. 4, 2013).
[8] See Restatement (Third) of Trusts § 77 (2007); Uniform Trust Code § 804 (2010); Uniform Prudent Management of Institutional Funds Act § 3 (2006) ("UPMIFA").
[9] See Uniform Prudent Investor Act § 3, cmt. UPMIFA adopted the UPIA prudent investor standard for 501(c)(3) entities in the corporate form. UPMIFA, Prefatory Note (2006)
[10] See UPMIFA § 3(a) and 3(e)(1)(H).

The IRS in September of 2015 provided important – perhaps even definitive -- guidance to private foundations, with persuasive application of the rationale to charities. In Notice 2015-62 and giving credit to changes in state law, the IRS acknowledged the fiduciary propriety of investments that further both charitable purposes and financial returns, even if concessionary.[11]

As such, MRIg, even with lower than market rate returns, can be undertaken consistent with fiduciary duties provided the investment activity (i.e. asset) is consistent with and in furtherance of the entity's specific charitable missions.

That is a different standard than applied to the SRIg subset of impact investing, which the Department of Labor clarified in October of 2015. Although directed to managers of pension funds, the DOL analysis arguably reinforces the validity of SRIg in analogous situations. The DOL guidance acknowledges consistency with fiduciary duties owed by pension fund managers in their decisions to make economically targeted investments that target both financial returns and "economic benefits" and to factor ESG into their analyses. The guidance recognizes that ESG factors can impact risk and return, not merely as "tie-breakers" or collateral/secondary considerations but as "proper components of the fiduciary's primary analysis of the economic merits of competing investment choices." Therefore, ESG factors can be appropriate – but not determinative -- fiduciary considerations when making investment decisions.[12]

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[11] See IRS Notice 2015–62, 2015–39 I.R.B. 411 (Sept. 28, 2015).
[12] See Department of Labor, Interpretive Bulletin 2015-01, published as § 2509.2015-01.

Importantly and distinguishing the DOL analysis from the IRS notice regarding MRIg, the DOL bulletin specifically disclaims conceding financial returns or accepting greater risk instead conditioning considerations on the investment being "economically equivalent, with respect to return and risk to beneficiaries in the appropriate time horizon, to investments without such collateral benefits."[13] Therefore, SRIg that does not otherwise qualify as MRIg may not prioritize social or even unrelated charitable purposes to the detriment of market rate financial returns or above market risks.

IV. PRIs and Private Foundation Specific Provisions Under Federal Law

In many ways, the PRI tool was decades ahead of its time in formalizing the ability of an entity to legally intermingle both investment returns and charitable purposes, which are notably narrower than but nonetheless a subset of "social" good.

PRIs are specific ways through which private foundations may pursue their charitable missions by engaging with nonprofit and for-profit entities and by building in both return of funds and possibilities of some growth on those funds although the balance must be carefully calibrated to charitable purpose. PRIs have implications for private foundation laws and regulations regarding the payout requirement, jeopardy investments, excess business holdings, and taxable expenditures. Even so, a public charity not constrained by these specific foundation requirements, might consider applying PRI standards and criteria as a subset of its mission related investing activities.

[13] Id.

PRIs must meet four characteristics if the foundation is to enjoy the benefits available under the law:[14]

- The primary purpose of the "investment" must be to significantly further one or more of the foundation's charitable purposes to the point that the "investment" would not have been undertaken "but for" the relationship between it and the foundation's charitable purposes;[15]
- No significant purpose of the "investment" can be production of income or appreciation of value (e.g., owner interests), although the fact that there is a significant return after the fact will not alone be conclusive evidence of such an intent or purpose;[16]
- No purpose can be lobbying or intervening in a political campaign(s); and
- The foundation must exercise expenditure responsibility if the PRI is to an entity other than a public charity.

Although the word "investment" is in the label, PRIs can be equity positions, loans, combinations of debt and equity or debt with convertibility features, or guarantees and other credit enhancements.

In April of 2016, Treasury issued final regulations that increase the number of examples from ten, originally issued in the 1970s, to 19. Those first ten examples focused domestic application and primarily on furthering economic development to remedy deteriorated urban neighborhoods. The new examples,

[14] See § 4944(c) and Treas. Reg. § 53.4944-3(a)(1).
[15] Id. See also Treas. Reg. § 53.4944-3(a)(2)(i).
[16] See § 4944(c) and Treas. Reg. § 53.4944-3(a)(1). See also Treas. Reg. § 53.4944-3.4944-3(a)(2)(iii).

most of which are drawn and aggregated from existing IRS guidance in letter rulings and otherwise, are nicely summarized by Ruth Madrigal as follows:

- scientific research in the public interest (example 11),
- combatting environmental deterioration (12, 13),
- relief of the poor and distressed (14, 15),
- promotion of the arts (17),
- education (16, 18, 19),
- investments in foreign businesses (12, 13, 15),
- U.S. organizations with foreign operations (11, 16); and
- a limited liability company (16).[17]

Going beyond program areas, the examples also elucidate the various forms that PRIs might take: equity (11, 12), loans (14-17), combinations of debt and equity (13), and credit enhancement (18, 19).[18]

The examples in the final regulations, including the original first ten, are attached as Appendix A.

Benefits to private foundations of PRIs cut across several applicable laws and regulations. First, because of the priority and weighting of exempt, charitable purposes, payments under a PRI count towards the minimum 5% payout requirement under 4942, and PRIs are not included as assets in calculating that amount. Second, PRIs are specifically excluded as jeopardizing investments under 4944, in which foundation managers can be at risk of penalties if they fail

[17] See Madrigal, "Impact Investing: Recent Federal Tax and Other Guidance Regarding PRIs and Other Impact Investments," 51st Annual Heckerling Institute on Estate Planning (2017-01-12).
[18] Id.

to exercise ordinary business care and prudence at the time of making the investment. Third, foundation PRIs are exempted from 4943's "excess business holding" caps on the amount of a business enterprise a foundation and its disqualified persons may own in the aggregate. Fourth, PRIs, done correctly, are not considered taxable expenditures under 4945.

Self-dealing laws and regulations under 4941 and state-based conflicts of interest/duty of loyalty laws still apply. As such, foundation managers and their counsel should be wary of, and scrutinize closely, proposed PRI transactions that might involve a disqualified person as a co-investor or otherwise.

Perhaps one of the most interesting and challenging aspects of making PRIs is ensuring compliance with the first prong – significantly furthering the foundation's exempt, charitable purposes. After all, PRIs can operate at the intersection of charitability and profit-orientation, given that for-profit companies can be, and increasingly are, the vehicles for PRI activities.

V. Charitability and Private Benefit

As noted above, both MRIg and PRIs require a connection to the entity's charitable purpose in order for the benefits to accrue. For the former, benefits include the more inclusive and expansive definition of fiduciary "prudence", and for the latter and private foundations, benefits include exemption from or exception to certain restrictions. The connection to charitability is much more significant for a PRI than for MRIg, where the standard is to "further" the specific charitable purposes rather than "significantly" doing so.[19]

[19] See IRS Notice 2015–62, 2015–39 I.R.B. 411 (Sept. 28, 2015).

All of which gives rise to questions about "what is charitable," especially when dealing with entities that are not 501(c)(3) entities.

For instance, there is nothing inherently charitable about a grocery store. But a grocery store in a food desert in the urban core might qualify as furthering charitable purposes and support either MRIg or a PRI, especially if its primary offerings are healthy alternatives. A 501(c)(3) entity focused on curbing national obesity could be deemed to be engaging in MRIg by investing in Whole Foods or Sprouts, but such an investment would not likely constitute a PRI for a private foundation. But query whether an investment by a foundation to induce Whole Foods to open a store in a disadvantaged community and hire residents thereof could constitute a PRI.

There certainly is nothing inherently charitable about an angel level investment fund, but such a fund dedicated to providing angel capital to under-represented entrepreneurs and businesses that focus their hiring and/or sale into under-served communities might qualify as furthering charitable purposes and support either a PRI or being MRIg.[20] A 501(c)(3) entity focused on minority entrepreneurship might be deemed as engaging in MRIg by placing part of its endowment with a minority owned fund manager or private equity company, especially if it prioritizes investing in minority owned companies.

Researching cures, preventions, and/or treatments for malaria may or may not be charitable, depending in part on who is conducting the research and

[20] When a foundation should choose to make a PRI or MRI will often depend on whether a case can be made that there is a primary charitable purpose. Absent that conclusion, the appropriate tool must be the MRI.

whether impermissible private benefit attaches to its results and/or dissemination. But a for-profit company that agrees to conduct research when it is not otherwise in its economic interests to do so may support a PRI or MRIg. For a PRI, the research must fall under the scientific research regulations that make such research charitable. If it is in the company's economic interests, that might disqualify it as a PRI but it might still qualify as MRIg.

More and better examples of endeavors that "significantly further charitable" purposes are in the Appendix, which do not purport to exhaust the realm of where charitability and profit-orientations might intersect.[21]

One aspect of MRIg that is under-appreciated is that it is important that a 501(c)(3) investor understand the depth and intensity of its own commitment to its charitable purposes in an MRIg undertaking and that of other investors! From a legal standpoint, the commitment need not amount to devotion, but from a practical perspective, the understanding of self-motivation and others may indicate a lack of alignment that could be problematic later. Disputes might arise among investors and/or between any given investors and those who are managing/operating the enterprise, including about such things as allocation of financial and personnel resources to charitable outcomes, to minimizing or mitigating harms caused by the enterprise, to collecting and analyzing results related to those outcomes, or to sharing lessons learned.[22]

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[21] See Internal Revenue Bulletin: 2016-19, part III (2016-04-26).
[22] See Tyler, "Essential Policy and Practice Considerations for Facilitating Social Entrepreneurship: Commitment, Connections, Harm, and Accountability" (tentative title) in CAMBRIDGE HANDBOOK OF SOCIAL ENTREPRENEURSHIP LAW (Cambridge Univ. Press, forthcoming 2018).

Part of the key to concluding charitability is present is ensuring that the activity itself fits in or near the charitable definition (e.g., education, health care, reversing effects of discrimination, combating community deterioration, etc.), that it targets serving a charitable class, and that any private benefit is incidental to the charitable purpose to be served.

MRIg that is otherwise part of ordinary investment activity will likely involve private benefit, even if some concessions are made on financial returns. After all, MRIg in publicly traded companies or through venture capital or a private equity or other type of fund will probably have other investors wanting to maximize their financial returns. As long as the 501(c)(3) is entering the transactions on substantially the same market terms as others (and not unduly subsidizing others' investments), private benefit is less likely to be a concern.

With PRIs that involve other participants, the presumption is that the foundation is <u>not</u> transacting on substantially the same terms and conditions as the others; otherwise, the second prong of the standards may not be met. As such and as the IRS has noted, "some private benefit to one or more persons that are not members of a charitable class (often including the recipient of the PRI itself) that is incidental to the investment's primary purpose of accomplishing an exempt purpose."[23]

In some instances, the very purpose of the foundation's involvement with the PRI is to disadvantage the foundation's involvement while advantaging that of others through a tranched investing structure, which by definition will likely

[23] Id.

generate private benefit that should be incidental to achieving the foundation's charitable purposes.[24]

That being said, there can be risks that a tranche is mere window dressing for private benefit, and in cases involving for-profit entities, scrutiny must be applied to the potential private benefit. An already complex scenario can be exacerbated if the foundation fails to understand that the second prong – no significant purpose being owner value – is not necessarily satisfied by the mere willingness to accept a lower return or to cap the foundation's return in some way, thereby allowing the other investors to enjoy greater gains. Likewise, the foundation cannot necessarily agree to absorb losses at a disproportionate rate at the risk of unduly and inappropriately benefiting other investors.

VI. Conclusion

On the next page is a chart that attempts to summarize the preceding discussions at a very high level.

[24] Critics of the low profit limited liability (L3C) social business form because it permits tranched investing, seemingly fail to grasp that such activity can be legitimate in the PRI context. Moreover, they also seem to neglect that tranched investing is only one of legions of possible incarnations of the L3C. That being said, their criticisms in this regard are accurate about tranched investing being complicated and requiring experienced legal counsel to represent and protect the foundation's interests.

<table>
<tr><th colspan="5">Impact Investing In A Nutshell[25]</th></tr>
<tr><td colspan="2"></td><td>Socially Responsible Investing</td><td>Mission Related Investing</td><td>Program Related Investments</td></tr>
<tr><td colspan="2">Relationship to Charitability Required?</td><td>No (social)</td><td>Yes</td><td>Yes (significantly furthers)</td></tr>
<tr><td colspan="2">Prudent Investor Standard Applies?</td><td>Yes</td><td>As Modified By Assets relationship to Mission</td><td>No</td></tr>
<tr><td colspan="2">Unusual Private Benefit Concerns?</td><td>No</td><td>No</td><td>Yes</td></tr>
<tr><td colspan="2">Concessionary Financial Returns</td><td>No</td><td>Maybe</td><td>Yes</td></tr>
<tr><td colspan="2">Fund managers[26]</td><td>Yes</td><td>Yes</td><td>Maybe but unlikely</td></tr>
<tr><td colspan="2">Investment funds</td><td>Yes</td><td>Yes</td><td>Maybe but unlikely</td></tr>
<tr><td colspan="2">Portfolio of Companies</td><td>Not usually</td><td>Maybe</td><td>Yes</td></tr>
<tr><td rowspan="4">Private Foundation Specific Considerations</td><td>Jeopardy Investment Analysis</td><td>Yes</td><td>Yes, with considering relationship to mission</td><td>No</td></tr>
<tr><td>Excess Business Holdings Rules Apply</td><td>Yes</td><td>Yes</td><td>No</td></tr>
<tr><td>Counts Towards the Payout Requirement</td><td>No</td><td>No</td><td>Yes</td></tr>
<tr><td>Self-Dealing and Conflicts of Interest Concerns</td><td>Yes</td><td>Yes</td><td>Yes</td></tr>
</table>

[25] As with the disclaimer at the beginning, this chart offers a general summary of the presented topics for illustrative, educational purposes only. These areas are nuanced, and no high level summary – much less a chart – can adequately capture or present those nuances or details.
[26] It should be noted, however, that many fund managers of pooled funds may be unwilling to allow a single investor's preferences to dictate the investment strategy

APPENDIX A
PRI Examples from Treas. Reg. § 53.4944–3(b)
81 Fed. Reg. 24014 (TD 9762)

Example 1. X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose for making the loan is to encourage the economic development of such minority groups. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.

Example 2. Assume the facts as stated in Example (1), except that after the date of execution of the loan Y extends the due date of the loan. The extension is granted in order to permit X to achieve greater financial stability before it is required to repay the loan. Since the change in the terms of the loan is made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property, the loan shall continue to qualify as a program-related investment.

Example 3. X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling to provide funds to X at reasonable interest rates unless it increases the amount of its equity capital. Consequently, Y, a private foundation, purchases shares of X's common stock. Y's primary purpose in purchasing the stock is to encourage the economic development of such minority group, and no significant purpose involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the purchase of the common stock is a program-related investment, even though Y may realize a profit if X is successful and the common stock appreciates in value.

Example 4. X is a business enterprise which is not owned by low-income persons or minority group members, but the continued operation of X is important to the economic well-being of a deteriorated urban area because X employs a substantial number of low-income persons from such area. Conventional sources of funds are unwilling or unable to provide funds to X at reasonable interest rates. Y, a private foundation, makes a loan to X at an interest rate below the market rate for commercial loans of comparable risk. The loan is made pursuant to a program run by Y to assist low-income persons by providing increased economic opportunities and to prevent community deterioration. No significant purpose of the loan involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 5. X is a business enterprise which is financially secure and the stock of which is listed and traded on a national exchange. Y, a private foundation, makes a loan to X at an interest rate below the market rate in order to induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. The loan is made pursuant to a program run by Y to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, even though X is large and established, the investment is program-related.

Example 6. X is a business enterprise which is owned by a nonprofit community development corporation. When fully operational, X will market agricultural products, thereby providing a marketing outlet for low-income farmers in a depressed rural area. Y, a private foundation, makes a loan to X bearing interest at a rate less than the rate charged by financial institutions which have agreed to lend funds to X if Y makes the loan. The loan is made pursuant to a program run by Y to encourage economic redevelopment of depressed areas, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 7. X, a private foundation, invests $100,000 in the common stock of corporation M. The dividends received from such investment are later applied by X in furtherance of its exempt purposes. Although there is a relationship between the return on the investment and the accomplishment of X's exempt activities, there is no relationship between the investment per se and such accomplishment. Therefore, the investment cannot be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) and cannot qualify as program-related.

Example 8. S, a private foundation, makes an investment in T, a business corporation, which qualifies as a program-related investment under section 4944(c) at the time that it is made. All of T's voting stock is owned by S. T experiences financial and management problems which, in the judgment of the foundation, require changes in management, in financial structure or in the form of the investment. The following three methods of resolving the problems appear feasible to S, but each of the three methods would result in reduction of the exempt purposes for which the program-related investment was initially made:

> (a) Sale of stock or assets. The foundation sells its stock to an unrelated person. Payment is made in part at the time of sale; the balance is payable over an extended term of years with interest on the amount outstanding. The foundation receives a purchase-money mortgage.
>
> (b) Lease. The corporation leases its assets for a term of years to an unrelated person, with an option in the lessee to buy the assets. If the option is exercised, the terms of payment are to be similar to those described in (a) of this example.
>
> (c)Management contract. The corporation enters into a management contract which gives broad operating authority to one or more unrelated persons for a term of years. The foundation and the unrelated persons are obligated to contribute toward working capital requirements. The unrelated persons will be compensated by a fixed fee or a share of profits, and they will receive an option to buy the stock held by S or the assets of the corporation. If the option is exercised, the terms of payment are to be similar to those described in (a) of this example.

Each of the three methods involves a change in the form or terms of a program-related investment for the prudent protection of the foundation's investment. Thus, under § 53.4944-3(a)(3)(i), none of the three transactions (nor any debt instruments or other obligations held by S as a result of engaging in one of these transactions) would cause the investment to cease to qualify as program-related.

Example 9. X is a socially and economically disadvantaged individual. Y, a private foundation, makes an interest-free loan to X for the primary purpose of enabling X to attend college. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 10. Y, a private foundation, makes a high-risk investment in low-income housing, the indebtedness with respect to which is insured by the Federal Housing Administration. Y's primary purpose in making the investment is to finance the purchase, rehabilitation, and construction of housing for low-income persons. The investment has no significant purpose involving the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the investment is program-related.

[Examples added in 2016:]

Example 11. X is a business enterprise that researches and develops new drugs. X’s research demonstrates that a vaccine can be developed within ten years to prevent a disease that predominantly affects poor individuals in developing countries. However, neither X nor other commercial enterprises like X will devote their resources to develop the vaccine because the potential return on investment is significantly less than required by X or other commercial enterprises to undertake a project to develop new drugs. Y, a private foundation, enters into an investment agreement with X in order to induce X to develop the vaccine. Pursuant to the investment agreement, Y purchases shares of the common stock of S, a subsidiary corporation that X establishes to research and develop the vaccine. The agreement requires S to distribute the vaccine to poor individuals in developing countries at a price that is affordable to the affected population, although, the agreement does not preclude S from selling the vaccine to other individuals at a market rate. The agreement also requires S to publish the research results, disclosing substantially all information about the results that would be useful to the interested public. S agrees that the publication of its research results will be made as promptly after the completion of the research as is reasonably possible without jeopardizing S’s right to secure patents necessary to protect its ownership or control of the results of the research. The expected rate of return on Y’s investment in S is less than the expected market rate of return for an investment of similar risk. Y’s primary purpose in making the investment is to fund scientific research in the public interest. No significant purpose of the investment involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y’s exempt activities and would not have been made but for such relationship between the investment and Y’s exempt activities. Accordingly, Y’s purchase of the common stock of S is a program-related investment.

Example 12. Q, a developing country, produces a substantial amount of recyclable solid waste materials that are currently disposed of in landfills and by incineration, contributing significantly to environmental deterioration in Q. X is a new business enterprise located in Q. X’s only activity will be collecting recyclable solid waste materials in Q and delivering those materials to recycling centers that are inaccessible to a majority of the population. If successful, the recycling collection business would prevent pollution in Q caused by the usual disposition of solid waste materials. X has obtained funding from only a few commercial investors who are concerned about the environmental impact of solid waste disposal. Although X made substantial efforts to procure additional funding, X has not been able to obtain sufficient funding because the expected rate of return is significantly less than the acceptable rate of return on an investment of this type. Because X has been unable to attract additional investors on the same terms as the initial investors, Y, a private foundation, enters into an investment agreement with X to purchase shares of X’s common stock on the same terms as X’s initial investors. Although there is a high risk associated with the investment in X, there is also the potential for a high rate of return if X is successful in the recycling business in Q. Y’s primary purpose in making the investment is to combat environmental deterioration. No significant purpose of the investment involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, Y's purchase of the X common stock is a program-related investment.

Example 13. Assume the facts as stated in Example 12, except that X offers Y shares of X's common stock in order to induce Y to make a below-market rate loan to X. X previously made the same offer to a number of commercial investors. These investors were unwilling to provide loans to X on such terms because the expected return on the combined package of stock and debt was below the expected market return for such a package based on the level of risk involved, and they were also unwilling to provide loans on other terms X considers economically feasible. Y accepts the stock and makes the loan on the same terms that X offered to the commercial investors. Y's primary purpose in making the investment is to combat environmental deterioration. No significant purpose of the investment involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the loan accompanied by the acceptance of common stock is a program-related investment.

Example 14. X is a business enterprise located in V, a rural area in State Z. X employs a large number of poor individuals in V. A natural disaster occurs in V, causing significant damage to the area. The business operations of X are harmed because of damage to X's equipment and buildings. X has insufficient funds to continue its business operations and conventional sources of funds are unwilling or unable to provide loans to X on terms it considers economically feasible. In order to enable X to continue its business operations, Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose in making the loan is to provide relief to the poor and distressed. No significant purpose of the loan involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 15. Y, a private foundation, makes loans bearing interest below the market rate for commercial loans of comparable risk to poor individuals who live in W, a developing country, to enable them to start small businesses such as a roadside fruit stand. Conventional sources of funds were unwilling or unable to provide such loans on terms they consider economically feasible. Y's primary purpose in making the loans is to provide relief to the poor and distressed. No significant purpose of the loans involves the production of income or the appreciation of property. The loans significantly further the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loans and Y's exempt activities. Accordingly, the loans to the poor individuals who live in W are program-related investments.

Example 16. X is a limited liability company treated as a partnership for federal income tax purposes. X purchases coffee from poor farmers residing in a developing country, either directly or through farmer-owned cooperatives. To fund the provision of efficient water management, crop cultivation, pest management, and farm management training to the poor farmers by X, Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. The loan agreement requires X to use the proceeds from the loan to provide the training to the poor farmers. X would not provide such training to the poor farmers absent the loan. Y's primary purpose in making the loan is to educate poor farmers about advanced agricultural methods. No significant purpose of the loan involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 17. X is a social welfare organization that is recognized as an organization described in section 501(c)(4). X was formed to develop and encourage interest in painting, sculpture, and other art forms by, among other things, conducting weekly community art exhibits. X needs to purchase a large exhibition space to accommodate the demand for exhibition space within the community. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X at an interest rate below the market rate for commercial loans of comparable risk to fund the purchase of the new space. Y's primary purpose in making the loan is to promote the arts. No significant purpose of the loan involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 18. X is a non-profit corporation that provides child care services in a low-income neighborhood, enabling many residents of the neighborhood to be gainfully employed. X meets the requirements of section 501(k) and is recognized as an organization described in section 501(c)(3). X's current child care facility has reached capacity and has a long waiting list. X has determined that the demand for its services warrants the construction of a new child care facility in the same neighborhood. X is unable to obtain a loan from conventional sources of funds including B, a commercial bank because of X's credit record. Pursuant to a deposit agreement, Y, a private foundation, deposits $h in B, and B lends an identical amount to X to construct the new child care facility. The deposit agreement requires Y to keep $h on deposit with B during the term of X's loan and provides that if X defaults on the loan, B may deduct the amount of the default from the deposit. To facilitate B's access to the funds in the event of default, the agreement requires that the funds be invested in instruments that allow B to access them readily. The deposit agreement also provides that Y will earn interest at a rate of t% on the deposit. The t% rate is substantially less than Y could otherwise earn on this sum of money, if Y invested it elsewhere. The loan agreement between B and X requires X to use the proceeds from the loan to construct the new child care facility. Y's primary purpose in making the deposit is to further its educational purposes by enabling X to provide child care services within the meaning of section 501(k). No significant purpose of the deposit involves the production of income or the appreciation of property. The deposit significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the deposit and Y's exempt activities. Accordingly, the deposit is a program-related investment.

Example 19. Assume the same facts as stated in Example 18, except that instead of making a deposit of $h into B, Y enters into a guarantee agreement with B. The guarantee agreement provides that if X defaults on the loan, Y will repay the balance due on the loan to B. B was unwilling to make the loan to X in the absence of Y's guarantee. X must use the proceeds from the loan to construct the new child care facility. At the same time, X and Y enter into a reimbursement agreement whereby X agrees to reimburse Y for any and all amounts paid to B under the guarantee agreement. The signed guarantee and reimbursement agreements together constitute a "guarantee and reimbursement arrangement." Y's primary purpose in entering into the guarantee and reimbursement arrangement is to further Y's educational purposes. No significant purpose of the guarantee and reimbursement arrangement involves the production of income or the appreciation of property. The guarantee and reimbursement arrangement significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the guarantee and reimbursement arrangement and Y's exempt activities. Accordingly, the guarantee and reimbursement arrangement is a program-related investment.