

# Emerging Forms of Philanthropy: Transforming the Field or Old Wine in New Bottles

---

Joshua J. Mintz<sup>1</sup>

## Introduction

Philanthropy is in flux. Some commentators argue that emerging forms will transform the field. Others assert the blurring of lines between philanthropy and commercial endeavors make existing rules governing charitable organizations archaic and a new paradigm required.

A growing cohort of newly minted wealthy entrepreneurs with the flexibility to use a myriad of forms to achieve impact are also disrupting traditional models of philanthropy, at least in the eyes of some commentators and philanthropists. Some newer philanthropists disdain building larger organizations because of perceived bureaucracy and costs and seek to use different vehicles and the business approaches that helped make them wealthy to achieve greater impact. The latest manifestation, but surely not the last, was the announcement by Mark Zuckerberg and Priscilla Chan that they would donate almost all of their Facebook stock in their lifetime, but use newly created limited liability company as the vehicle to achieve the most social and charitable impact.

For these and other reasons, existing independent and family foundations are under increasing pressure, some of it self-imposed, to demonstrate innovation and urgency, to take big risks, to achieve impact and to demonstrate their continued relevance. One commentator has suggested traditional foundations are dinosaurs, destined to die out over time as the emerging forms and the new philanthropists act as a metaphoric meteor leading to the extinction of the large foundation form.

But despite prognostications of impending doom for independent private foundations, there are numerous questions to be addressed before a new era is ordained:

- What exactly are these emerging forms and strategies?
- How are they different from the tools long available to foundations?
- Are these just the latest shiny baubles to capture the ephemeral attention of a sector where participants are eager to demonstrate they are up to date on the latest trends and where an assortment of actors sensing a market opportunity are pitching something new?
- Do these new forms or ways of operating really result in more beneficial impact?
- Are independent foundations, indeed, dinosaurs destined to be swept into the ashbin of history that will lead future generations puzzling over the bones of once robust organizations or, perhaps worse, a slow fade into irrelevance?
- What tools and strategies are available to existing foundations to achieve the greatest impact?

This paper suggests that independent foundations can and should continue to play a critical role in seeking to solve the vexatious problems confronting our country and the world. Effective and impactful grantmaking should remain a cornerstone of a holistic approach. Thoughtful leaders of foundations and their boards do need, however, to be aware of trends, new tools and emerging structures that, if used strategically, might increase their impact.

---

<sup>1</sup> The author would like to thank his colleagues, Lisa Montez, Emily Friedman, and Nancy Rinder for their contributions to this article. The opinions herein are solely that of the author and do not necessarily represent the views of the John D. and Catherine T. MacArthur Foundation. This was revised March 23, 2016.

This paper identifies the different structures available to a new philanthropist and the different ways foundations can use their resources and other structures and strategies to achieve greater impact. There is no single right choice. The best solution depends on the objectives to be achieved given the values, history, culture, resources and philosophy of the individuals or organizations involved. There is room in our philanthropic universe for a diverse set of approaches playing to the strengths and philosophies of founders and their successors.

**Part I** describes the choices facing a person or family who seeks to use their wealth for public good and highlights the pros and cons of various choices.

**Part II** describes the tools and resources available to a private foundation to extend its impact beyond grantmaking.

**Part III** describes different structural alternatives and entities a foundation may consider to further expand its impact.

*Exhibit 1* is a brief description of the principal legal issues to consider depending on the structure chosen.

### ***Part I: Alternative Forms/Structures of Philanthropy***

A new philanthropist, unburdened by existing structure, faces a number of choices to achieve impact. To determine the best approach, however, an emerging philanthropist might consider the following issues, among others: The desire for control; engagement of family in decisions; the need or desirability of a tax deduction; passion for particular causes; the desire for privacy or anonymity; the potential legacy; the importance of policy change; and flexibility in approach.

Assuming that the desire for a tax deduction is part of the motivation, living donors can look at a wide range of tactics and forms:

- **Check book philanthropy**: An individual can simply write checks to organizations operating in areas of interest and be free from the bureaucracy associated with forming and operating an organization. He/she can have a philosophy and focus, but the decision to effectuate impact is largely outsourced to organizations where expertise and resources are already established.
- **Donor-advised fund**: An individual can set up a donor-advised fund at a community foundation or at a commercial fund such as Fidelity and Vanguard. The donor retains the right to suggest the eventual recipient of his/her largesse, but is largely free of the underlying bureaucracy. Again, in this approach, resources are shifted to a third party to effectuate impact. Legal control is also technically shifted to a third party although, in almost all cases, the advice from the donor is honored. Donor-advised funds have become increasingly popular sparking a backlash among some commentators and legislators because the money for which the tax deduction has been given can sit in an account forever without charitable impact. Suggested legislative fixes include a mandatory payout from such funds.
- **Partner with existing organization**: Identify an existing organization and partner with that organization rather than create a new organization. Warren Buffet's gifts and partnership with the Gates Foundation remains the prime example of this approach.
- **Form a charitable organization** (public charity, private foundation or private operating foundation): An individual can form a charitable organization and contribute money to the organization receiving

a tax deduction in the process. Depending on the structure chosen, the individual can retain control, engage with family members through a board or as employees, and exert greater control of giving. Depending on the desired size, the organization can effectively outsource resources or build the required expertise within the organization.

- Create a stand alone for profit entity or a network of different types of entities. Living donors can also form other structures or entities to work in concert with or augment the work of a charitable organization or forego the use of a charitable entity altogether. This can include 501(c)(4) social welfare organizations that are able to engage in political activity as long as it is not the primary purpose, for-profit entities such as limited liability companies, or newer hybrid entities such as benefit corporations. Jeff Skoll, Pierre Omidyar, and John and Laura Arnold have, to varying degrees, used one or more of these approaches. And, most recently, Mark Zuckerberg and Priscilla Chan sparked considerable discussion, debate and some controversy by announcing they would use a new limited liability company to achieve impact.<sup>2</sup>

The main differences among charitable organizations are described in the chart below.

<i>Type of organization:</i>	<b>Public Charity</b>	<b>Private Foundation</b>	<b>Private Operating Foundation</b>
Who funds it?	Must be publicly supported; Variety of tests: <ul style="list-style-type: none"> <li>• <u>At least 10%</u> publicly supported and facts and circumstances</li> <li>• 30% public support</li> </ul> See support test explanation and example public support chart	Funded by a single donor or small base of donors, typically family	Funded by a single donor or small base of donors
What types of operations/programs?	May conduct its own activities or may re-grant to other organizations	Grantmaking organization	Conducts its own charitable activities  "Significantly involved in its own projects in a continuing and sustainable fashion" <sup>3</sup>  Typically acquires and maintains assets used in its programs (such as buildings and artwork) (see asset test)

<sup>2</sup> In December 2015, Zuckerberg/Chan announced they would give almost all their Facebook stock to charity in their lifetimes and would use a limited liability company as the principal vehicle. It generated a storm of media attention, some thoughtful, some speculative, and some wrong.

<sup>3</sup> Bruce Hopkins, *The Legal Answer Book for Private Foundations*, page 254.

<i>Type of organization:</i>	<b>Public Charity</b>	<b>Private Foundation</b>	<b>Private Operating Foundation</b>
Tests it must meet	<p><b>SUPPORT TEST</b></p> <p>Public support, government grants and gifts, grants, contributions and membership fees from public charities count in full. Gifts, grants, contributions, and membership fees from all other sources (that are not government or public charities) are counted in full as public support so long as the amount from each source does not exceed two percent of the organization's total support. In those cases where the amount from other sources exceed the two percent figure over the five-year reporting period, gifts, grants, contributions and membership fees from other sources will be counted as public support up to, and no more than, two percent of the total support.</p>	<p><b>DISTRIBUTION TEST</b></p> <p>Generally must distribute five percent of the aggregate fair market value of investment assets each year through grants or charitable distributions ("minimum distribution requirement")</p>	<p><b>DISTRIBUTION TEST</b></p> <p><u>TEST 1:</u></p> <p>Must spend either the lesser of:</p> <ul style="list-style-type: none"> <li>• 85% of its income on direct charitable expenditures (not grants)</li> </ul> <p><i>OR</i></p> <ul style="list-style-type: none"> <li>• 85% of the five percent minimum distribution requirement applicable to private foundations</li> </ul> <p>PLUS</p> <p><u>TEST 2:</u></p> <p>Must meet one of these tests:</p> <ul style="list-style-type: none"> <li>• <i>Asset test --</i> At least 65% of the assets are directly devoted to the active conduct of charitable activities or to a functionally-related business (such as art collections, buildings), <i>OR</i></li> <li>• <i>Endowment test-</i> Expends at least 2/3 of its minimum investment return directly for the active conduct of its exempt activities <i>OR</i></li> <li>• <i>Support test-</i> Receives at least 85% of its support from the general public and at least 5% from unrelated exempt organizations.</li> </ul> <p>These tests are applied each year for a four-year period (current and past three years).</p>

<i>Type of organization:</i>	<b>Public Charity</b>	<b>Private Foundation</b>	<b>Private Operating Foundation</b>
Issues	<p><b>Advantages</b>            “Excess benefit” IRS rules applicable to public charities are considered less onerous than private foundation rules            Able to lobby to insubstantial part</p> <p><b>Disadvantages</b></p> <ul style="list-style-type: none"> <li>• Generally subject to more public scrutiny and public disclosure requirements</li> <li>• Fundraising is subject to a myriad of state fundraising regulations</li> <li>• Need to monitor public support and meet applicable tests</li> </ul>	<p><b>Advantages</b>            Donor may retain control; may be fewer fundraising concerns; less public scrutiny</p> <p><b>Disadvantages</b></p> <ul style="list-style-type: none"> <li>• Subject to strict IRS “self-dealing” rules regarding relationships with “disqualified persons” including donors</li> <li>• Excess business holding rules</li> <li>• Minimum distribution requirement (see below)</li> <li>• Excise tax</li> <li>• Cannot lobby except in self-defense</li> </ul>	<p><b>Advantages</b></p> <ul style="list-style-type: none"> <li>• Higher donor deductibility rate—see below</li> <li>• No strict distribution requirement if largely funding own programs</li> </ul> <p><b>Disadvantages</b></p> <ul style="list-style-type: none"> <li>• Subject to stricter IRS (self-dealing rules)</li> </ul>
How much may donors deduct?	Up to 50% of adjusted gross income	Up to 30% of adjusted gross income	Up to 50% of adjusted gross income
Examples	American Red Cross, Habitat for Humanity	MacArthur, Ford, Gates	Art museum; historic restoration project; library; research institute; disaster relief

## ***Part II: Resources and Tools to Achieve Impact for Existing Private Foundations***

Historically, many grantmaking foundations sought to achieve impact primarily through strategic grantmaking, usually for specific projects and, for some, program-related investments. There are of course other tools and resources available to a foundation to increase its impact. Some of those tools are described below:

- Make more and larger **general operating support grants** to anchor organizations to further larger goals.
- Help create **new institutions** in fields in which the foundation works through grants or impact investments (program-related investments or mission-related investments).
- Use **prizes and competitions that focus on individuals** to ferret out ideas and find creative people and institutions that might otherwise escape their radar.
- Use **contracts** more extensively to retain experts and other consultants to advance work through papers, reports and research. This gives the organization more control and direction over the work compared to a grant.
- Use the power of the foundation **brand and strategic communications** to help build a field and assist grantees.
- **Convene** parties sharing similar interests from a wide range of sectors, not-for-profit and for-profit, more regularly to help devise strategies to attack common problems or take advantage of opportunities.
- **Expand the types of assistance** provided to grantees to enhance their effectiveness. At MacArthur, for example, we implemented a **legal pro bono program** that provides legal assistance to grantees through a partnership with PILnet. Consideration can also be given to expanding the types of resources available, including communications, accounting or business-modeling expertise.
- Have foundation representatives serve on the **boards of grantees** more frequently to assist the grantee when the expertise of staff would be particularly helpful (this would have to be balanced against the inherent conflict of interests and the additional time burden on staff).
- Partner or assist other donors to leverage resources. At MacArthur, we have a separate initiative known as MacArthur Advisory Services to **provide free expert advice to other donors**.
- Be intentional about the **specific policies** or positions that drive a foundation's work and aggressively pursue those policies through a variety of means (advocacy, support of research, papers, conferences). A number of charitable organizations have successfully worked towards implementation of an overarching philosophical framework. Examples include the Scaife Foundation, the Bradley Foundation and similar organizations in supporting the American Enterprise Institute, the Cato Institute, and similar "conservative" think-tanks and thought leaders).
- **Engage directly** in implementing the work. This could range from identifying the strategy and funding grantees to helping to carry it out operationally (and could include things like funding and organizing conferences, writing and presenting papers, assisting in the ideas for research, helping to oversee the research, and other direct work).

- **Incubate and “spin out”** areas of work within the foundation to achieve the necessary scale so that the new entity can achieve greater impact than possible if the work stayed within the foundation. MacArthur recently did this with its digital media and learning work in helping to create and then fund a new charitable organization, Collective Shift, to carry on certain of the work and hopefully bring it to scale.
- Use **impact investments**, program-related or mission-related investments more extensively to invest in or partner with social entrepreneurs.
- Consider establishing a **presence or partnership** with other organizations that bring different perspectives and expertise including entities outside the foundation’s comfort zone. This can include community foundations, emerging leaders, and organizations taking a different path in which the combination will be more impactful than working alone.
- Establish partnerships **with innovative centers** at universities to **exchange ideas and create exposure to different types of people**. This could include having a rotating **scholar in residence** at the foundation and fellowships at innovative centers.
- **Network** more extensively and deliberately with innovators and big thinkers outside of the foundation world.
- Create a **pool of money** that can be quickly invested, venture capital style, in new innovative companies that would further a program strategy (Knight Foundation, among others, has established such a venture pool).
- Locate **networks of staff** in various geographic locales where the foundation works. This would not necessarily mean physically setting up an office, but rather take advantage of technology to allow “telecommuting” (there would be cultural and regulatory issues would have to be addressed that could make this more cumbersome than it appears).
- Engage more aggressively in **permitted advocacy** to further strategies. This could include one or more of the following steps:
  - Support more aggressively organizations that are permitted to lobby through *general operating support grants*.
  - *Submit amicus briefs* in cases involving matters of interest to the foundation.
  - More and deeper *engagement* in online, social media or traditional media debates.
  - Establish a *physical presence in Washington*.
  - Coordinate with the efforts of membership groups such as the *Council on Foundations’* efforts on the legislative advocacy side.
  - Do more aggressive outreach to *representatives in Congress* to educate them about impact and the foundation’s concerns.

### ***Part III: New Forms and Structures for Existing Foundations***

Some living donors have created networks of entities to achieve maximum impact that includes charitable organizations and for-profit entities. Skoll, Omidyar and the Arnolds have used this approach, but there are many others.

Living donors have more flexibility in creating for-profit entities, but there are options for foundations without living donors to create or invest in alternative vehicles and structures to enhance impact. In considering options, an organization should weigh the complexity, trade-offs, legal issues and costs involved with the impact to be achieved.

#### **A. Key Questions to Consider**

Key questions to consider in thinking about creation of a new entity and its legal status (charitable or for-profit) include the following:

- What is the purpose of the new entity and why can't the objective be achieved through an existing structure? (For example, if a foundation wanted to have more policy influence through lobbying, a new entity would be necessary.)
- Is there a business or programmatic opportunity available that is best achieved through an alternate form because of tax, fundraising or liability reasons?
- Does the opportunity to obtain scale require outside investors or contributors and is the vehicle a more attractive option for third party investors and contributors?
  - If so, what type of entity (charitable or for-profit) would be more likely to attract the necessary capital? Does an investor want a charitable donation or the possibility of a return on investment? If the latter, a viable business plan reflecting the opportunity to earn a return on the capital contributed would be required.
- What is the business plan of the entity and what are the impediments to success?
- What incentives, if any, are necessary to attract talented individuals to the new entity (e.g., innovative compensation structures or stock incentives)?
- Is it important for the foundation to have effective control of the entity?
- What is the time frame to create the new entity and is there urgency to the creation of the entity from a business opportunity standpoint?
- Would the entity involve an international presence and, if so, what are the impediments or opportunities from a local law standpoint?
- If a new vehicle is warranted, what form (limited liability corporation, partnership or corporation)?
  - What is the long-term viability of the new entity (is there interest in going public or selling to a third party like a venture capital model) and how might the entity be wound up?



Specific circumstances may warrant obtaining opinions of legal counsel or private letter rulings from the IRS before actively engaging in the activity. This would protect the foundation and its officers from potential liability if the IRS viewed the activities as problematic.

## B. Options

- **Incubate** various strategies or programs and then **spin** all or a portion out as a separate entity, initially funded by the organization but requiring a viable business model that does not depend on foundation funding indefinitely. The spin-off could be a charitable organization, a for-profit entity, or a “hybrid organization” (described more below).
- Consider creating a **donor-advised fund**(s) at the foundation. The foundation would want to be sensitive to competing with its local community foundation, but there could be opportunities for a partnership or a joint venture with the community foundation.
- Form a **single member limited liability company** (with the foundation as sole member) to carry out specific programmatic activity. This provides more focus for the activity and protects the foundation from liability and, potentially, reputational harm. The foundation could make grants to this entity to carry out activity that, if the foundation did itself, would increase the administrative expenses of the foundation.
- Create and share ownership in a **new entity** with other like-minded foundations. This could be a **functionally-related business** in the form of a not-for-profit or a for-profit business with ownership split to avoid excess business holdings.
- Create a **501(c)(4) affiliate** that could lobby on specific matters of interest to the foundation (this option, in particular, would warrant advice of counsel).

### (1) Considerations on Choice of Entities

#### (a). Type of vehicle.

The choice of a particular legal structure depends on its objective, the limitations imposed by applicable law and other factors, such as the need to attract other investors or contributors. Possible structures include the following:

- Private foundation;
- Public charity;
- Private operating foundation;
- Not-for-profit joint venture;
- Functionally-related business;
- For-profit entity or joint venture (LLC, corporation or partnership); and
- Hybrid entities: Single for-profit legal entities that serve both a business and a social or charitable mission (depending on the state, referenced as a benefit corporation, social purpose corporation, public benefit corporation, flexible purpose corporation, L3C).

**(b). Forms of “investment”.**

Investments can include one or more of the following:

- Grant from the foundation or a charitable donation from third party individuals or businesses;
- Program-related investment by a foundation (debt, equity, guarantee);
- Mission-related investment (debt, equity, guarantee); and
- Conventional investment in the form of debt, equity, warrants, guarantees.

**(c). Legal/business issues.**

The primary legal and business issues for a foundation to address in considering the type of vehicle and choice of investment are the following:

- Excess business holding rules/lack of control.<sup>4</sup>
- Unrelated business income tax (UBIT).
- Avoiding private benefit to other participants.
- Securities law and regulations.
- Fiduciary obligations.
- Prudent investment standards (Uniform Management of Institutional Funds Act and Jeopardizing Investment Rules under section 4944 of Internal Revenue Code).
- Potential liability arising from control or business operations.
- Reputational concerns.

**(2) Use of Certain Types of Entities**

**(a). Create a public charity subsidiary.**

(i) Public charities do not need to comply with the excess business holding restrictions. However, public charities must consider UBIT, demonstrate broad-based public support, and ensure that their activities are primarily charitable and that only an “insubstantial” part of their activities is non-charitable. A public charity can lobby to an insubstantial part of its activities.

(ii) To be classified as a public charity rather than a private foundation, the entity must demonstrate broad-based financial support for its operations by passing one of three public support tests. Each of these public support tests will require funding sources beyond foundations as essential for public charity status.

**(b). Joint venture options.**

(i) The foundation may join other **exempt organizations** to engage in a for-profit business enterprise, preferably one that is functionally-related or a program-related investment, but these are not mandatory. However, private foundations must comply with the excess business holdings rules and all of the exempt organizations must be aware of UBIT.

(ii) The foundation may also join with a **public charity in venturing with for-profit entities** to create a new enterprise. In addition to the excess business holdings and UBIT issues raised by this

---

<sup>4</sup> For the rules on excess business holdings, UBIT, and private benefit, see Exhibit 1.

structure, exempt entities also must ensure that the exempt organization assets are used primarily for exempt purposes, that the enterprise operates for public rather than private interests, and that no more than an insubstantial part of the enterprise's activities benefits or is in furtherance of non-exempt purposes. These issues can be addressed by ensuring that the public charity retains control over the entity's operations and the activities are managed by the exempt entity. The foundation cannot serve this function because of the excess business holdings restrictions (unless a PRI is used or the business is a functionally-related business).

**(c). A separate functionally-related business.**

(i) The foundation may independently own and operate or invest in an enterprise<sup>5</sup> that is a functionally-related business. The excess business holdings rules do not apply to a functionally-related business. In addition, passive income from a functionally-related business is not taxable as unrelated business income but is subject to the two percent private foundation excise tax.

(ii) Categories of functionally-related businesses include enterprises that:

- (a) Are substantially related to achieving the foundation's exempt purposes;
- (b) Are operated substantially by volunteers;
- (c) Are carried on primarily for the convenience of the foundation's employees;
- (d) Sell donated merchandise (it is not clear how the IRS will treat the sale of donated intangible rights); or
- (e) Are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that are related to the foundation's exempt purposes.<sup>6</sup>

(iii) Examples of functionally-related businesses include the following:

- (a) Operating a center for regional economic development and educational and cultural activities;
- (b) Leasing of industrial buildings to promote development in an economically distressed county;
- (c) Selling products in connection with conducting educational programs;
- (d) Selling computer software by an entity formed to broadly disseminate new scientific technology for the benefit of the public;
- (e) Licensing of curricula by an educational institution to other colleges and universities; and
- (f) Market development and investment programs by a public charity promoting investment in foreign countries.

---

<sup>5</sup> The functionally-related business entity may be a sole proprietorship, a pass-through entity, or a corporation without violating the excess business holding rules.

<sup>6</sup> An example of a functionally-related business that falls into category (e) above would be a private scientific foundation with wholly-owned business subsidiaries that serve to translate the foundation's scientific achievements into human progress by demonstrating the feasibility of new scientific discoveries or aiding in the technical development of geographic areas by bringing to the public innovative products and processes that might not otherwise reach them. Similarly, a publishing business owned by a scientific foundation could be a functionally-related business even though it sold taxable, commercial advertising for the journal.

**(d). For-profit or hybrid entities.<sup>7</sup>**

- (i) Hybrid entities are formed principally to allow directors (and, therefore, the company) to pursue both financial and social gain without fear of potential liability for breach of fiduciary duties.
- (ii) The foundation could invest in a hybrid entity subject to the excess business rules. The foundation would also be subject to unrelated business income tax.
- (iii) A hybrid vehicle may be more attractive to certain socially conscious investors who are interested in a “double bottom line”.

---

<sup>7</sup> Hybrid entities are legal entities that may be established under applicable state law and that, depending on the state law and form, are authorized to pursue both social and financial objectives. They can be benefit corporations (already authorized in about 20 states with more to come), flexible purpose corporations (in California), and/or L3C entities. There is a growing body of articles and resources concerning hybrid entities. Exhibit 2 contains a partial listing of available resources and articles on this topic.

## Exhibit 1

### Key Legal and Tax Issues for a Foundation to Consider in Making Investments: Brief Review

**a. Excess business holding rules.** The excess business holdings rules limit ownership and control by private foundations and their disqualified persons to no more than 20% of for-profit enterprises. This ceiling is increased to 35% if others besides the foundation or its disqualified persons effectively control the enterprise. These rules do not limit the non-voting interests that a private foundation may hold in a corporation. Income from investments in corporations, such as dividends, interest, or capital gains, will usually be deemed passive and, therefore, not taxable as unrelated business taxable income. Slightly different rules apply to partnerships and entities treated as partnerships for tax purposes.

The excess business holding rules and UBIT rules do not apply in the following types of structures:

- Functionally-related businesses,
- Program-related investments, and
- Businesses that have at least 95% of their revenue from purely passive sources.

**b. Functionally-related business (discussed [infra](#))**

**c. Program-related investments (PRIs).** Program-related investments are excluded from the definition of “business enterprise.” Consequently, the excess business holdings limitations do not apply to PRIs. The foundation could, therefore, control an entity if its investment is in the form of a PRI.

The unrelated business taxable income laws do apply to a PRI, but most income from PRIs, at least in corporations, will be passive and not taxable because it will be interest, dividends and capital gains.

The private foundation two percent excise tax also applies but in an unusual way. Capital gains from PRIs are not subject to the two percent excise tax because the Internal Revenue Code (“Code”) exempts PRIs from the definition of property “used for the production of income.” However, the foundation must pay the two percent excise tax on income derived from PRIs as if regular investment income.

A foundation may make PRIs to either non-profit or for-profit entities subject to the applicable regulations. The expenditure responsibility rules apply to PRIs made to entities that are not public charities.

PRIs must have as their primary purpose to further the Foundation’s exempt purposes. The IRS also evaluates whether the PRI produces a charitable effect that would not have occurred otherwise and if the PRI’s effect is commensurate with the investment.

Finally, no significant purpose of the PRI may be production of income or appreciation of property.

PRIs generally occur as either loans or equity investments. If a loan, the IRS considers whether the interest rate is substantially below market or, if at market, whether the loan risk is higher than what a conventional lender might take. If through equity, the IRS considers (a) whether the venture is new and in an untested market; (b) whether the venture is for an activity operating at a lower level of capitalization than a conventionally structured investment; and (c) whether the investment involves less-favorable collateral or prepayment terms than conventional investments in the same project.

**d. Entity generating purely passive income.** The excess business holdings rules allow a foundation to own more than a 35% interest in an entity if at least 95% of the entity's gross income is passive. This is a look-through test that considers the underlying investments and portfolio companies. Examples of passive income include rental income from a lease of real estate, royalties, licensing fees, capital gains, interest, and dividends. Therefore, the foundation could own and operate an enterprise that generates at least 95% of its income from royalties from licensing patent or other intellectual property rights.

The Code usually exempts passive income from the unrelated business income tax. For purposes of unrelated business income taxation but not necessarily for evaluating the excess business holdings rules, the Code also does not tax income derived from certain scientific research endeavors.

There are two notable exceptions to the general rule regarding application of the unrelated business taxable income rules to passive income. First, debt-financed acquisition of property will usually be treated as "taxable" rather than "passive" income. Second, payment of annuities, interest, rent, and/or royalties – but not dividends -- from a "controlled entity" to the Foundation may be taxable as unrelated business taxable income when deductible by the controlled entity. The test for control looks to substance over form.

**e. Unrelated business income tax ("UBIT").** Foundations are generally taxed on their investment income at two percent (subject to reduction to one percent if certain distribution thresholds are met). Certain types of activity, however, will give rise to unrelated business income that is taxed at corporate rates (typically 35%). This applies to income from activities that are not substantially related to the foundation's underlying purpose and from revenue from active businesses. Passive income is NOT taxed as unrelated income. As noted above, this includes rents, royalties, capital gains, dividends and interest.

**f. Private inurement and private benefit.**

*Private inurement* refers to the prohibition in the Code against any part of the net earnings of a §501(c)(3) organization from inuring to the benefit of any private shareholder or individual. The private inurement doctrine forbids the income or assets of a tax-exempt organization from flowing away from the organization to a person who has a significant relationship with the organization and is considered an "insider".

Forms of prohibited private inurement include unreasonable compensation, unreasonable rental arrangements, unreasonable borrowing arrangements, unreasonable sales arrangements and some involvement by tax-exempt organizations in joint ventures or partnerships.

*Private benefit* is similar in concept to private inurement and prohibits a private foundation from permitting an outsider from benefiting from a transaction in a manner that is more than incidental to the primary charitable purpose of the transaction. Violation of the private inurement doctrine has serious consequences in that it can lead to the revocation of the tax-exemption of an organization. The private inurement rules tolerate less benefit to insiders as incidental to a charitable purpose than would be permissible under the private benefit test for transactions with outsiders.

The prohibition against private inurement does not extend to the payment of reasonable compensation or the provision of reasonable benefits to staff.

## Exhibit 2

### **BIBLIOGRAPHY ON HYBRID ISSUES**

J. Battilana, M. Lee, J. Walker & C. Dorsey, *In Search of the Hybrid Ideal*, Stanford Social Innovation Review, Summer 2012, at 51, [http://www.ssireview.org/articles/entry/in\\_search\\_of\\_the\\_hybrid\\_ideal](http://www.ssireview.org/articles/entry/in_search_of_the_hybrid_ideal) (last visited March 2015)

C.G. Bishop, *Fifty State Series: L3C and B Corporation Legislation Table* (Suffolk University Law School Legal Studies Research Paper Series, Research Paper 10-11, April 1, 2014) at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1561783](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1561783) (last visited March 2015)

V. Bjorklund and R. Keatinge, *New Social Hybrid Legal Forms, What Matters to State Regulators*, June 2012, available at <http://gosw.org/files/leadership/New%20Social%20Hybrid%20Legal%20Forms.pdf> (last visited March 2015)

K. Cooney, J. Koushyar, M. Lee & H. Murray, *Socially Responsible Business, Benefit Corporation and L3C Adoption: A Survey*, Stanford Social Innovation Review, Dec. 5, 2014, [http://www.ssireview.org/blog/entry/benefit\\_corporation\\_and\\_l3c\\_adoption\\_a\\_survey](http://www.ssireview.org/blog/entry/benefit_corporation_and_l3c_adoption_a_survey) (last visited March 2015)

I. Mittermaier & J. Neugart, *Operating in Two Worlds: Tandem Structures in Social Enterprise*, The Practical Tax Lawyer, Fall 2011, [http://www.adlercolvin.com/pdf/social\\_enterprise/Operating\\_in\\_Two\\_Worlds\\_Tandem\\_Structures\\_in\\_Social\\_Enterprise\\_\(403192\).pdf](http://www.adlercolvin.com/pdf/social_enterprise/Operating_in_Two_Worlds_Tandem_Structures_in_Social_Enterprise_(403192).pdf) (last visited March 2015)

K.R. Lofft, P.B. Maniar & T.R. Rosenberg, *Are Hybrids Really More Efficient? A 'Drive-By' Analysis of Alternative Company Structures*, Bus. Law Today, Sept. 2012, [http://www.ebglaw.com/content/uploads/2014/06/53119\\_Lofft-Maniar-Rosenberg-ABA-Business-Law-Today-Hybrid-Structures.pdf](http://www.ebglaw.com/content/uploads/2014/06/53119_Lofft-Maniar-Rosenberg-ABA-Business-Law-Today-Hybrid-Structures.pdf) (last visited March 2015)

R.A. Wexler & D.A. Levitt, *Using New Hybrid Legal Forms: Three Case Studies, Four Important Questions, and a Bunch of Analysis*, TaxAnalysts Special Report, Exempt Org. Tax Rev. Vol. 69 No. 1, January 2012, available at: <http://www.adlercolvin.com/pdf/hybrid.pdf> (last visited March 2015)

John Tyler, *Analyzing Effects and Implications of Regulating Charitable Hybrid Forms as Charitable Trusts: Round Peg and a Square Hole*. [http://www.nyjlb.org/wp-content/uploads/nyb\\_9-2\\_535-586\\_Tyler.pdf](http://www.nyjlb.org/wp-content/uploads/nyb_9-2_535-586_Tyler.pdf)

[http://www.ssireview.org/blog/entry/benefit\\_corporation\\_and\\_l3c\\_adoption\\_a\\_survey](http://www.ssireview.org/blog/entry/benefit_corporation_and_l3c_adoption_a_survey)