

Client Alert

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Program-Related Investments and Private Foundations — New Guidance Reflects the Modern World

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New proposed regulations illustrate the broad range of programs and investment types that can qualify as program-related investments for private foundations. Program-related investments are excepted from the private foundation excise taxes applicable to investments that jeopardize the carrying out of a private foundation's exempt purposes (i.e., investments that are too risky). The examples in the current regulations focus on domestic situations involving deteriorated urban areas and the poor, with investments structured either as loans or purchases of common stock. While the proposed regulations do not modify the existing regulations, their more modern examples help to answer the following frequently asked questions about program-related investments.

What Can a Program-Related Investment Seek to Accomplish?

The primary purpose of a program-related investment is to accomplish one or more exempt purposes, including charitable, educational, scientific and literary purposes. The newly-added examples involve domestic and international programs for combating environmental deterioration, promoting the arts, providing relief to the poor, educating poor farmers in a developing county, supporting commercial employers in disaster areas, constructing a child care facility in a low-income neighborhood, and furthering "orphan drug" research and development (e.g., finding a vaccine to prevent a disease that predominantly affects the poor in developing countries).

These new examples illustrate just a fraction of the broad range of programs that can accomplish a private foundation's exempt purposes through program-related investments.

Who Can Receive Program-Related Investments?

In the new examples, the investment recipients are 501(c)(3) organizations, 501(c)(4) social welfare organizations, foreign and domestic business enterprises and foreign and domestic individuals. These examples confirm that private foundations can make program-related investments with legal entities or individuals that are not themselves tax-exempt organizations or members of a charitable class. Instead, such recipients serve as the instruments through which the private foundation furthers its exempt purposes.

How Can Program-Related Investments Be Structured?

The proposed regulations make clear that there are no limitations on the financial structures that can be used to make program-related investments. The investment types in the new examples include the familiar loans and common stock purchases, but add a loan accompanied by stock issued as an inducement for making the loan (one form of an "equity kicker"), a loan guarantee and a loan guarantee

deposit agreement (effectively, a fully funded guarantee). As long as no significant purpose of the investment is the production of income or the appreciation of property, it appears that program-related investments can be structured as straight debt, convertible debt, debt with an “equity kicker,” common or preferred equity interests, warrants, loan participations, funded or unfunded loan guarantees, royalty interests or otherwise.

Are Program-Related Investments Limited to Below-Market Returns?

No. Although the production of income or appreciation of property cannot be a significant purpose of a program-related investment, the new examples make clear that the potential for a high rate of return on an investment does not preclude its qualification as a program-related investment.

For example, a long-shot equity investment in an orphan drug research company could incidentally lead to significant income or capital appreciation, from the drug itself or a profitable offshoot from the research and development conducted. This alone is not conclusive evidence that a significant purpose of the investment is the production of income or the appreciation of property. A royalty interest in diabetes research could lead to a blockbuster return, but the IRS nonetheless approved of such a program-related investment in a 2011 private letter ruling.

Private foundations need not hesitate to make otherwise qualifying program-related investments in a long-shot or a potentially highly successful business. Providing grants to support worthwhile endeavors by public charities or, in some cases, private companies or individuals, is an important aspect of a private foundation’s operations. By adding program-related investments to its toolbox, a foundation can further its exempt purposes by serving as a business incubator. As opposed to supporting programs reliant on continuing grants, a program-related investment can spark a self-sustaining business whose ongoing success will itself further the foundation’s exempt purposes.

Is a Private Foundation Required to Cash Out of a Successful Program-Related Investment? Does a Program-Related Investment Require an Exit Strategy?

The exit strategy for loans is clear. Private foundations hope to be repaid in full at maturity.

For program-related investments involving indefinite terms, such as equity investments, there does not appear to be any requirement to monetize the investment if, for example, the recipient becomes profitable. In one of the new examples, a private foundation planned to liquidate its stock in a recycling collection business once it became profitable or it was established that the business would never become profitable. However, a number of the other new examples of equity investments do not require an express intention to exit, so a defined, advance agreement for an exit does not appear to be a prerequisite to qualification as a program-related investment.

In any case, private foundations may wish to consider various exit strategies and negotiate appropriate provisions when structuring a program-related investment by including, for example, a “put,” “call,” forced liquidation, demand or piggy-back registration right, or similar provisions. Typically, and almost by rule, the private foundation offering to make a program-related investment has a significant amount of leverage, and negotiating an appropriate means to exit could be one way to put that leverage to good use.

Can the New Examples Be Relied On Despite Being in Proposed Regulations?

Yes. The proposed regulations specifically provide that taxpayers may rely on the new examples before they are finalized. Private foundations and their managers, who can also be subject to excise taxes on jeopardizing investments, may not be the only ones relying on the new examples.

The new examples may ease a tax attorney's ability to issue a reasoned legal opinion that a particular investment is more likely than not to qualify, or should qualify, as a program-related investment. A formal tax opinion is often a prerequisite for board approval of a program-related investment and indicates counsel's level of comfort that the proposed investment qualifies as a program-related investment. The tax opinion is particularly important because reasonable reliance on a legal opinion can shield a foundation manager from otherwise applicable excise taxes if the investment is later found to be a jeopardizing investment and not a program-related investment.

Conclusion

The proposed regulations are the result of years of work by the Exempt Organizations Committee of the ABA Section of Taxation, which proposed additional examples on program-related investments akin to those recently issued. While the proposed regulations do not modify the general rules applicable to all program-related investments, the new examples are quite substantive and help to answer many of the more frequently asked questions about program-related investments. The issuance of these new examples may broaden both the interest in and the flexibility of program-related investments by private foundations.

If you have any questions about this alert or program-related investments generally, please contact any of the Hunton & Williams lawyers listed below.

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