

IRS LETTER RULINGS

Letter Ruling Alert

by Kristen Gurdin

Caplin & Drysdale, Chartered

PRI Possibilities in the Age of Venture Philanthropy: Foundation's Investment in Environmental Venture-Capital Fund Qualifies as a Program-Related Investment

In PLR 200136026 (June 11, 2001), the Service ruled that a private foundation's investment in a for-profit venture-capital fund qualified as a program-related investment (PRI), and was not a taxable expenditure under section 4945. The private foundation proposed to invest in a fund operated with the dual financial and environmental objectives, directed by investment eligibility guidelines based on a set of internationally endorsed environmental principles. The Service's recognition of a PRI where a foundation made its contribution to further environmental objectives on the same financial terms as private investors and governments suggests the potential of PRIs as a tool for promoting a large range of charitable purposes in accordance with modern philanthropic practices. (For PLR 200136026, see p. 91.)

Factual Background

The private foundation requested a ruling on the tax treatment of its investment in a venture capital fund ("the fund"). The fund is described as a financial intermediary created to "coordinate the funding efforts of socially conscious investors" by investing directly in environmentally focused business ventures in a specific region. These ventures will, among other efforts, support the sustainable use of natural resources, foster the presence of biodiversity, and promote biodiversity in regional organic agriculture. The fund will base its investment strategy on guidelines fashioned in accordance with the internationally recognized environmental principles.

In addition to its environmental mandate, the fund is also formed and operated to yield a set rate of financial return for its investors. This return rate, however, is said to be substantially lower than the return of other international venture capital funds of comparable risk. The foundation represents that the fund's financial return would not be sufficient compensation, given degree of speculation and risk associated with its investments, absent the achievement of environmental objectives.

A board of directors comprised of representatives of other charitable organizations, private investors, and a foreign government controls the fund. The private foundation does not have a representative on the board of directors. An investment advisor, a separate entity formed by another charity and a sustainable development investment company, monitors all financial and environmental aspects of the fund's invest-

ments. It also recommends to the fund's investment committee potential investments that have already been approved by a group of internationally renowned environmental and investment experts, as well as representatives of governments and nonprofits from the countries targeted for investment.

Although the foundation has no governance control over the fund or its advisory entity, the foundation's investment will be protected by a special agreement with the fund, which preempts any conflicting provisions of the fund's standard shareholder and subscription agreements. This agreement generally provides that no substantial variations to the foundation's investments may be made without the private foundation's approval, funds not dedicated to environmental purposes shall be returned to the foundation, and the private foundation will be furnished with all reports relating to the nature and progress of the investments.

The foundation requested that the IRS rule that its investment qualified as a PRI under section 4944(c) and did not constitute a taxable expenditure under section 4945.

IRS Legal Analysis and Conclusions

First, the Service ruled that the private foundation's equity contribution to the high-risk fund would not subject the foundation to section 4944 taxes for jeopardizing its accomplishment of its exempt purposes, because the investment qualified as a "program-related investment" in accordance with section 4944(c).

Essentially, in order to qualify as program-related under section 4944(c), an investment must meet three requirements. It must: (i) have the primary purpose of accomplishing a charitable, educational, or other exempt purpose as described in section 170(c)(2)(B); (ii) have no significant income-producing purpose; and (iii) have no lobbying or political purposes.

According to Treas. reg. section 53.4944-3(a)(2)(i), an investment is made primarily for an exempt purpose where it furthers the foundation's exempt purposes significantly and would not have been made but for the relationship between the investment and the accomplishment of exempt purposes. The regulations provide examples of such investments, including a loan to a small business owned by a minority group in a deteriorated urban area where other funding sources are unwilling to provide funds at reasonable interest rates unless the business increases its amount of equity capital.¹ Similarly, another example describes a loan to a business listed and traded on a national exchange in order to persuade the business to establish a plant in a deteriorated urban area, which,

absent such an inducement, the business would be unwilling to do because of the high risk involved.²

The Service concluded that the foundation's investment in the fund fulfills the requirements of a PRI. First, the Service found that investment in an overseas fund financing environmental projects directly furthers the foundation's environmental conservation and protection objectives, which are recognized as charitable purposes within the meaning of section 501(c)(3). The Service focused on the foundation's representation that it would not invest in the fund, but for the investment's direct furtherance of its exempt purposes, thus resembling the examples of PRIs in the regulations. The Service also recognized the prominent role of environmentally interested organizations (other charities, foreign non-profits, and foreign governments) in the fund's formation and governance as an indication that investment in the fund is motivated primarily by environmental objectives. Second, the Service determined that the foundation's investment in the fund is not significantly motivated by profit, because the fund's projected rate of return is insufficient by itself to compensate for risk of its investments. Finally, the Service found that the private foundation satisfies the last requirement for PRIs because the fund will not use the foundation's investments for any political or legislative activities.

The Service also ruled that the foundation's investment was not a taxable expenditure under section 4945, which imposes a tax on expenditures private foundations make in support of organizations that are not public charities, unless the foundation exercises expenditure responsibility. Section 4945(h) defines expenditure responsibility as exerting all reasonable efforts, establishing adequate procedures, and obtaining reports to assure that all funds are spent on the purpose for which they were contributed. With respect to PRIs, this entails a written commitment specifying the purpose of the investment and limiting funds to that use, requiring annual reports, and prohibiting use for lobbying and political activity.³ The Service concluded that the foundation's special agreement with the fund meets these requirements because it obligates the fund to furnish the foundation with all expenditure reports and return any monies not used for environmental purposes.

Commentary

Although the Service's conclusions in this ruling are not particularly surprising, given the careful structuring of the fund, the ruling serves to illustrate both the scope of issues that PRIs can address, as well as the open-ended set of transactions in which a foundation's investment may qualify as program-related. Although PRIs have been an available vehicle for private foundations since 1969, foundations have traditionally limited their use of PRIs to addressing the sort of community and economic development issues described in the Treasury regulations' examples of PRIs. See Treas. reg. section 53.4944-3(b). However, this is likely to change. The current trend of venture philanthropy, which can be loosely defined as an entrepreneurial approach to charity, has increased interest in furthering charitable purposes through financial investments in which foundations retain an economic interest.

Accordingly, this ruling, which employs a PRI in support of socially and environmentally conscious venture investing, exemplifies a new generation of PRIs addressing a broad range of issues, other than traditional economic and community development initiatives. Although PRIs have certainly had this potential since 1969, the ruling provides a useful reminder of the broad opportunities that PRIs offer.

This ruling also indicates that the IRS might acknowledge a wider scope of foundation investments as program-related than is suggested by the Treasury regulations examples. Although the regulations provide no explicit rule, the examples provided in Treas. reg. section 53.4944-3(b) identify charitable objectives that would not be accomplished without the investing foundation's participation. For instance, Examples 1 and 3 describe a foundation's financing of a minority business in a depressed community that could not feasibly secure funding otherwise. Similarly, Example 4 describes a foundation's below-market loan to a business that could not otherwise afford to operate in a depressed area, and Example 5 describes a foundation's low-interest loan to a corporation that would not otherwise locate in a depressed community.

Unlike these examples, the facts of this ruling do not indicate that the foundation's investment in the fund is necessary to the achievement of the fund's identified environmental objectives. Rather, private investors, foreign governments, as well as other charities have invested in the fund at the same rate of return as the foundation, indicating that the fund will benefit the environment whether or not the foundation invests. The participation of other charities and foreign governments is key, indicating the significant nonprofit motivations behind the initiative. Nevertheless, the Service's positive treatment of this PRI leaves open the question of whether a foundation's investment can qualify as a PRI where commercial entities are willing to invest on the same terms, so long as it is clear that these investments primarily further an exempt purpose.

This possibility is also relevant in terms of the section 4944(c) requirement that PRIs have no "significant" profit purpose. Treas. reg. section 53.4944-3(a)(2)(iii) provides that in determining whether a significant profit purpose is present, it is relevant "whether investors engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation." The Service seems satisfied that this requirement is met by the fact that the financial return for the fund's investments is substantially less than the yield from other venture funds with comparable risk. However, it is clear from the ruling that private investors have been willing to invest on the same terms as the foundation, and that this fact has not disqualified the foundation's investment from being classified as program-related. This potential ability for foundations to use PRIs to invest alongside private investors in carefully structured investment vehicles is significant, given the growing trends of venture philanthropy and socially conscious investing.

Endnotes

¹Treas. reg. section 53.4944-3(b), Example 3.

²Treas. reg. section 53.4944-3(b), Example 5.

³ Treas. reg. section 53.4945-5(b)(4).

