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Client Alert

Program Related Investments: Final Regulations

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Final Regulations Highlight the Broad Range of Available PRI Purposes, Recipients and Financial Structures

Final program related investment (PRI) regulations[1] released and effective on April 25, 2016 illustrate the broad range of programs and investment types that can qualify as PRIs for private foundations. PRIs are excepted from the private foundation excise taxes on investments that jeopardize the carrying out of a foundation's exempt purposes (i.e., investments that are too risky). The original ten examples in the regulations focus on domestic situations involving deteriorated urban areas and the poor, with investments structured either as loans or purchases of common stock.[2] The new and now final regulations add nine more examples that are more varied as to the qualifying exempt purposes, recipients, and financial structures available for use with PRIs. With some helpful changes, these new regulations are based in large part on proposed regulations issued in 2012.[3]

What Can a PRI Seek to Accomplish?

The primary purpose of a PRI is to accomplish one or more exempt purposes, including charitable, educational, scientific, and literary purposes.[4] 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, providing microloans to poor individuals in developing countries, 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).

The new examples illustrate just a fraction of the broad range of programs that can further a private foundation's exempt purposes through PRIs. For example, the Treasury Decision announcing the new, final regulations notes that scientific research carried on for the purpose of discovering a cure for a disease need not involve a disease predominantly affecting developing countries to accomplish an exempt purpose. This suggests that a PRI financing medical research involving a disease that predominantly affects developing countries, but with respect to which a lack of sufficient market incentives exist for research and development of new treatments, could also accomplish an exempt purpose.

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[1] Treas. Reg. section 53.4944-3(b), Examples 11-19, adopted effective April 25, 2016 by Treasury Decision 9762.

[2] See Treas. Reg. section 53.4944-3(b), Examples 1-10.

[3] For a detailed discussion on PRIs and the 2012 proposed regulations, see Lion and Mancino, "PRIs-New Proposed Regulations and the New Venture Capital," 24 Exempts 2 (Sept/Oct 2012), page 3.

[4] Treas. Reg. section 53.4944-3(a)

Key Principles

The new examples illustrate the following key principles:

(1) an activity conducted in a foreign country furthers an exempt purpose if the same activity would further an exempt purpose if conducted in the United States;

(2) the exempt purposes served by a PRI are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas;

(3) the recipients of PRIs need not be within a charitable class if they are the instruments for furthering a exempt purpose;

(4) a potentially high rate of return does not automatically prevent an investment from qualifying as a PRI;

(5) PRIs can be achieved through a variety of investments, including loans to individuals, tax-exempt organizations and for-profit organizations, and equity investments in for-profit organizations;

(6) a credit enhancement arrangement may qualify as a PRI; and

(7) a private foundation's acceptance of an equity position in conjunction with making a loan does not necessarily prevent the investment from qualifying as a PRI.

The IRS intends to post these principles on its website to serve as additional guidance to private foundations.

Who Can Receive PRIs?

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. IRS guidance suggests that L3Cs and benefit corporations, relatively new types of entities which have been adopted in some states, are eligible recipients of PRIs akin to "regular" LLCs and corporations. That is, their status has no import as distinct from a typical LLC or for-profit corporation.

The new examples confirm that private foundations can make PRIs 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. Moreover, that some private benefit is provided to one or more persons that are not members of a charitable class (often including the recipient of the PRI itself) is not impermissible, so long as such benefit is incidental to the PRI's primary purpose of accomplishing the private foundation's exempt purposes.

The new examples also clarify that PRIs involving below-market rate commercial microloans to poor individuals in developing countries, to enable them to start small businesses and become economically self-sufficient, provide relief to the poor and distressed (Example 15). The 2012 proposed regulations included a similar example involving loans to poor individuals in a developing country which had experienced a natural disaster, but the new regulations eliminate that extraneous reference - no natural disaster required.

How Can PRIs Be Structured?

The new regulations make clear that there are no limitations on the financial structures that can be used to make PRIs. 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") (Example 13), a loan guarantee (Example 19) and a loan guarantee deposit agreement (effectively, a fully funded guarantee) (Example 18).

As long as neither the production of income nor the appreciation of property is a significant purpose of the investment, it appears that PRIs 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.

In addition, the Treasury Decision suggests that any of these structures, which could involve the private foundation taking on certain risks, may be used to catalyze the entry of private investment capital, so long as the PRI is made for a qualifying purpose.

Note that equity investments in partnerships, including LLCs treated as partnerships, raise a host of attribution issues - whereby the partners are deemed to be conducting their allocable portion of the partnership's activities - which potentially could jeopardize a private foundation's tax-exempt status. The IRS is considering issuing a revenue ruling to provide additional guidance regarding PRIs involving such investments.

Are PRIs Limited to Below-Market Returns?

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

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. The IRS confirmed this view in its "key principles" and by amending Example 11 of the 2012 proposed regulations to clarify that a PRI agreement may require that the drug be distributed to low-income individuals in developing countries at an affordable price, but may also permit drug sales to other individuals at a market rate, potentially resulting in a high rate of return on the PRI.

Also, while the examples generally refer to the interest rate or rate of return on a PRI as being less than the expected market rate for an investment of comparable risk, the Treasury Decision notes that there is no requirement that the rate of return of a PRI must fall below an absolute percentage threshold (e.g., the prime rate) to demonstrate no significant purpose involving the production of income or the appreciation of property.

As a result, private foundations need not hesitate to make otherwise qualifying PRIs 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 foundation's operations.

By adding PRIs to its toolbox, a private foundation can further its exempt purposes by serving as a business incubator. As opposed to supporting programs reliant on continuing grants, a PRI can spark a self-sustaining business whose ongoing success will itself further the private foundation's exempt purposes.

Is a Private Foundation Required to Cash Out of a Successful PRI? Does a PRI Require an Exit Strategy?

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

For PRIs 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 the 2012 proposed 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 (Example 13). However, a number of the other examples of equity investments did not require an express intention to exit. The newly final regulations delete the exit/liquidation reference in Example 13, indicating that a defined, advance agreement for an exit is not a prerequisite to qualification as a PRI.

The Treasury Decision notes, however, that the establishment, at the outset of the PRI, of an exit condition that is tied to the private foundation's exempt purposes in making the PRI can be an important indication that a foundation's primary purpose in undertaking the PRI is in fact accomplishment of the exempt purposes.

Thus, private foundations may wish to consider various exit strategies and negotiate appropriate provisions when structuring a PRI by including, for example, a "put," "call," forced liquidation, demand or piggy-back registration right, or similar provisions tied to the foundation's exempt purposes.

Typically, and almost by rule, the private foundation offering to make a PRI has a significant amount of leverage, and negotiating an appropriate means to exit could be one way to put that leverage to good use.

Is a Private Letter Ruling or Legal Opinion Required Prior to Making a PRI?

No. A private letter ruling (PLR) is not necessary for an investment to qualify as a PRI. Some private foundations request rulings for contemplated PRIs for absolute reassurance of a favorable determination by the IRS prior to the actual investment. This is often motivated by the desire to avoid the costly excise taxes on jeopardizing investments if the investment is later determined to not be a qualifying PRI, but the process can often take years before a response is issued (if one is issued at all). However, a PLR can take years to secure, and may come only long after the need for the PRI has come and gone.

Other foundations seek a reasoned legal opinion indicating that a particular investment is more likely than not to qualify, or should qualify, as a PRI. A formal tax opinion is often considered a prerequisite for board approval of a PRI and indicates counsel's level of comfort that the proposed investment qualifies as a PRI. 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 PRI.

Conclusion

The new examples in the now final Treasury Regulations are quite substantive and help to answer many of the more frequently asked questions about PRIs. Moreover, the issuance of these new examples, and private letter rulings based on the new examples, should continue to illustrate the potential of and interest in the use of PRIs by private foundations.

If you have any questions about this alert or PRIs generally, please contact Ofer Lion at *olion@seyfarth.com*, Douglas Mancino at *dmancino@seyfarth.com*, or your Seyfarth attorney.

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