Investing In The Future: Mission-Related And Program-Related Investments For Private Foundations

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When it comes to private philanthropy, the return on an investment may not be only financial.

PRIVATE FOUNDATIONS LARGELY ARE KNOWN for giving away a certain amount of money each year in furtherance of their charitable missions. In 2009, private foundations collectively distributed $42.9 billion. *See "Foundation Yearbook: Facts and Figures on Private and Community Foundations* (Foundation Center 2010). However, mission-related and program-related investing can complement private foundation grantmaking in important ways. While charitable grants in general are never repaid, investments are expected to generate some level of financial return to the foundation, increasing the pool of funds available for future grants or investments. In years when investment portfolios are generating smaller returns, and foundations therefore have less to distribute, these investment opportunities can be very appealing. In addition, investments are a means of leveraging a higher percentage of a foundation's assets towards accomplishing its charitable goals.

Both mission-related investments ("MRIs") and program-related investments ("PRIs") are characterized by an intention to create positive social impact as well as some level of financial return. Despite this similarity, however, each type of investment has very different tax consequences for the investing private foundation, as described below.

DEFINITION OF A MISSION-RELATED INVESTMENT • An MRI, also commonly referred to as an "impact investment," is broadly defined as a financial investment that also furthers an organization's mission. Any investment in which the investor intends to generate both a social (including educational or environmental) return as well as a financial return, such that it is not exclusively about profit, could qualify. Despite current common usage, there is no legal definition of an MRI and no legal requirements to qualify for, or prohibitions resulting from, this status.

An MRI is not a charitable activity. MRIs are made from investment assets rather than program assets, sometimes referred to as "the other 95 percent" of a private foundation's assets that are not designated for making charitable qualifying distributions. Because an MRI is a commercial investment, it must be made prudently and satisfy the same investment standards under state and federal law as other investments. On the other hand, MRIs do *not* need to meet the charitable standards that a PRI must meet, described below.

MRIs can be distinguished from socially responsible investments, sometimes referred to as "SRIs," which typically refer to commercial investments that have passed certain positive or negative screens reflecting social criteria. Funds that exclude tobacco or oil companies from their investment portfolios, for instance, illustrate the use of a negative screen. An example of a positive screen would be a fund requirement that all portfolio companies have adopted a set of fair labor practices. MRIs also can be distinguished from investments made for purposes of engaging in shareholder advocacy to influence the future direction or policies of the company (e.g., proxy voting to achieve certain social objectives). In this article, the term MRI refers to an investment in a business enterprise where the business activity itself directly furthers a social mission.

DEFINITION OF A PROGRAM-RELATED INVESTMENT • PRIs are mission-driven investments that are closely akin to charitable grants. Unlike MRIs, an investment is required to meet a specific charitable standard to qualify as a PRI. However, a PRI does not need to be a prudent investment.

Private foundations rely on an explicit section in the Internal Revenue Code (the "Code") that defines a PRI and carves them out of the jeopardizing investment rules that prohibit certain types of risky investments. To qualify as a PRI, an investment must meet a three-part test, each of which is discussed in more detail below:

- The primary purpose of the investment must be to further one or more exempt purposes of the foundation.
- The production of income or the appreciation of property may not be a significant purpose of the investment.
- No electioneering and only very limited lobbying purposes may be served by the investment.

Primary Exempt Purpose Test

The first prong—primary exempt purpose—in large measure requires a determination specific to each foundation, its mission, and the proposed investment. There are two parts to the primary exempt purpose test. First, the investment must *significantly further* the accomplishment of the foundation's exempt activities. Second, the investment must be such that it would not have been made *but for* its relationship to the foundation's exempt activities. Treas. Reg. §53.4944-3(a)(2)(i).

"Significantly Further" Sub-Test

To meet the "significantly further" test, the foundation must determine that the PRI is consistent with one or more purposes described in section

501(c)(3). If the foundation has purposes that are narrower than those generally described in section 501(c)(3), then the foundation must also determine that the PRI is consistent with the specific charitable purposes of the foundation. For example, if a foundation's stated purpose is to improve the quality of life for the people of Essex County, New Jersey, then a PRI to promote economic development taking place in a foreign country is unlikely to be consistent with that foundation's exempt purposes, even though the PRI is consistent with section 501(c)(3) and likely would be permitted for another private foundation. A foundation must review its own organizational documents (e.g., Articles of Incorporation), along with any other restrictions that may have been placed on the charity's assets, to determine whether a PRI is consistent with that foundation's mission.

Perhaps the most often cited charitable purpose under section 501(c)(3) is the "relief of the poor and distressed or of the underprivileged." Treas. Reg. §1.501(c)(3)-1(d)(2). However, a "charitable" purpose as the term is used in section 501(c)(3) is broader. It also includes the advancement of religion; the advancement of education or science; the lessening of the burdens of government (e.g., providing a service that the government otherwise is required to provide), as well as promoting social welfare by organizations designed to lessen neighborhood tensions, eliminate prejudice and discrimination, and defend human and civil rights secured by law; or the combating of community deterioration and juvenile delinquency. Treas. Reg. §1.501(c)(3)-1(d)(2). *See also* Rev. Proc. 96-32. The IRS and the courts also have recognized a legitimate charitable purpose in the promotion of health and protection of the environment. *See Restatement (Second) of Trusts*, §§368, 372 (1959); *Redlands Surgical Services v. Commissioner*, 113 T.C. 47, 73 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001); Rev. Rul. 75-197, Rev. Rul. 69-545 (health); Rev. Rul. 76–204 and Rev. Rul. 72–560 (environment).

"But For" Sub-Test

To satisfy the but for sub-test, the foundation must be able to conclude that it would not have made the investment but for its contribution to the accomplishment of the exempt purposes of the foundation.

Noncharitable Recipients

A foundation can make a PRI in noncharitable, non-exempt organizations, provided the *purposes* of the investment are charitable. The IRS has recognized that for-profit entities may serve as "the instruments by which the charitable purposes are sought to be accomplished." Rev. Rul. 74-587. The Treasury Regulations also contain 10 examples of investments involving noncharitable recipients, nine of which qualify as PRIs. *See* Treas. Reg. §53.4944-3(b), Examples 1 through 10. In one private letter ruling, the IRS concluded that even though an investing foundation operated "much like a venture capital organization," the foundation's equity investment in a for-profit company still met the primary purpose test, because the foundation intended to encourage the creation of new jobs and economic development in underdeveloped and disadvantaged areas through its investment. PLR 199943044.

No Significant Investment Purpose Test

The single test here is whether *no significant purpose* of the investment is the production of income or the appreciation of property. This prong is often the most difficult to prove, since some investments inevitably will generate a return. How does one demonstrate that the return was not a significant purpose of the investment? This is easier to do in the case of a below-market loan, where the foundation clearly could have made more money investing the funds elsewhere at a market rate. Equity investments, on the other hand, involve a greater and less predictable opportunity for return on the investment.

The Treasury Regulations state that the IRS will consider whether investors solely concerned with profit would be likely to make the investment on the same terms. Treas. Reg. §53.4944-3(a)(2)(iii). However, this factor alone is not determinative. It is also relevant, for instance, whether the foundation's investment policy, which sets forth the foundation's parameters for its purely commercial investments, would permit an investment involving the risk-adjusted return of the proposed PRI. Whereas some investments may offer the possibility of a high return, the risks and uncertainty involved may make it very unlikely that this is ever going to happen. It is also important to recognize that an investment that produces *significant* income or capital appreciation is not by itself conclusive evidence that income or appreciation was a significant purpose of the investment, *id.*, and therefore does not preclude the investment from being a valid PRI. The assessment is made at the time of the investment, not in hindsight.

No Political Purpose Test

No purpose of the PRI may be to attempt to influence legislation, or to participate or intervene in campaigns of candidates for public office. Treas. Reg. §53.4944-3(a)(1)(iii). There is an exception: the PRI recipient may appear before or communicate with a legislative body on a legislative matter of direct interest to the recipient, if the expense of doing so is deductible by the recipient under section 162. Treas. Reg. §§53.4944-3(a)(2)(iv) and 53.4945-2(a)(4) (which thus allow a business organization to use PRI funds for direct lobbying in certain narrow circumstances). However, the foundation must not earmark any PRI funds for use in such communications or appearances.

The most common method of assuring compliance with the third prong of the PRI test is to obtain a statement from the recipient of the PRI funds pledging compliance with this restriction on use of PRI funds for political purposes. Typically, one would find this statement in the loan agreement, in the case of a loan, or in the guarantee agreement, in the case of a guarantee. In an equity investment, the foundation often enters into a side letter agreement containing the restrictions that it needs to qualify the investment as a PRI, if the terms will not be included in the other transaction documents.

Changes In PRI Terms

The Code and the accompanying Treasury Regulations also address the possibility that after a PRI has been made, the foundation and the recipient may find that changes in the terms of the investment are needed. If the changes, like the original investment, are made primarily to further the investment's exempt purposes and not significantly to improve the prospects for income or capital appreciation from the PRI, there is no problem. Treas. Reg. §53.4944-3(a)(3)(i). Changes made "for the prudent protection of the foundation's investment" also will not ordinarily cause the investment to lose PRI status. *Id.* Other changes however may affect qualification as a PRI. In that case, reliance on a legal opinion based on circumstances before the change would no longer protect the foundation or its directors.

A "critical change in circumstances," such as when the PRI turns out to be serving illegal purposes or private purposes of the foundation or its managers, will cause the investment to cease to be program-related. *Id.* A foundation will not be penalized, however, if it terminates the PRI within 30 days after it or its managers have actual knowledge of the critical change in circumstances. *Id.*

FEDERAL TAX CONSEQUENCES OF MAKING AN MRI OR A PRI • In general, PRIs are treated similarly to grants for purposes of the federal tax rules governing private foundations, while MRIs do not receive the same treatment. Below is a summary of how certain Code provisions apply to both types of investments.

Excise Tax On Net Investment Income

Section 4940 imposes an excise tax on the net investment income of private foundations. The amount of that tax is currently two percent, but in certain circumstances the tax may be reduced to one percent. This annual tax on a private foundation's net investment income applies to income generated by both MRIs and PRIs. Therefore, where the terms of a loan provide for the payment of interest, the two percent tax will apply to PRI or MRI income just as it does to a foundation's other investment income. In addition, the Pension Protection Act of 2006 has clarified that capital gains on an equity investment, whether structured as an MRI or a PRI, are also taxable under section 4940. *See* Pension Protection Act §1221, codified at §4940(c).

Mandatory Distributions

Section 4942 requires a private foundation to distribute each year, for charitable purposes, an amount equivalent to five percent of the fair market value of the foundation's noncharitable assets. PRIs count toward meeting a foundation's annual distribution requirement. In addition, PRIs are excluded from the foundation's assets on which the five percent distribution is calculated. Therefore, a foundation with an asset base of $5 million in 2010, that has a distributable amount for that year of $250,000 (5%), and that makes a $250,000 equity PRI on January 1, 2011 (i) will have satisfied its qualifying distribution requirement that must be made before the end of 2011 and (ii) will not include the $250,000 PRI in its investment assets for purposes of calculating the 2011 distributable amount. The foundation's required distributions to be made before the end of 2012 therefore will be less than if the foundation had made an MRI of $250,000 in 2011 (by 5% of $250,000, or $12,500).

Because PRIs count toward meeting a foundation's mandatory payout requirement, repayment of a PRI in a future period may increase its distribution requirement in that future year. A foundation's annual distribution requirement is increased by the amount a foundation receives as repayment of principal or a return on capital from a PRI previously used to meet its prior qualifying distribution requirement in the tax year following the year in which the repayment is received. This recapture applies only to the return of principal or capital, not to capital gains, dividends, or interest received beyond the initial investment. A foundation also may avoid increasing its annual distribution if it has excess qualifying distributions in the past five years that can be carried forward. Taking the same foundation above with $5 million in assets: if it instead made a PRI loan of $2 million in year one to be repaid in year 10, the $2 million loan is treated as a qualifying distribution in year one, which then can be carried forward five years before it expires. (The foundation is only required to pay out $250,000 each year.) Therefore, repayment in year 10 after this carry-forward period is over will create an additional $2 million payout requirement.

A foundation therefore will need to plan for appropriate accounting and reporting to the IRS of PRIs as qualifying distributions, both when investments are made and also when they are repaid. MRIs, on the other hand, do *not* count toward meeting a foundation's annual distribution requirement and are *not* excluded from the foundation's assets on which its five percent distribution requirement is calculated.

Excess Business Holdings

Under section 4943, a private foundation and its disqualified persons together may own no more than 20 percent (and in some cases 35 percent) of the voting or ownership interest in a business enterprise. §4943. (Some exceptions apply.) This restriction on business holdings applies to MRIs and therefore limits a private foundation and its disqualified persons together from owning more than a certain percentage of the voting shares of a business corporation or of the profits interest in a partnership or limited liability company. PRIs, on the other hand, are not included in the calculation of excess business holdings; therefore, an ownership interest acquired through an equity PRI is not limited by the excess business holding rules.

Jeopardizing Investments

Section 4944 imposes an excise tax on private foundation investments that are deemed to "jeopardize the carrying out of any of its exempt purposes." §4944(a)(1). Both a private foundation and its directors and officers can potentially be subject to excise taxes for making imprudent investments. MRIs are subject to these jeopardizing investment rules. PRIs, on the other hand, exist specifically as an exception to the jeopardizing investment rules and therefore are not subject to penalty under section 4944.

Expenditure Responsibility

Section 4945 imposes penalties on private foundations that make "taxable expenditures" and on any foundation manager who, knowingly and without reasonable cause, participates in the making of a taxable expenditure. If the taxable expenditure is not reversed, additional penalties are imposed. The rules regarding taxable expenditures apply to PRIs, including the expenditure responsibility requirements described below. MRIs, on the other hand, are not subject to these requirements.

When a foundation makes a grant or PRI in a noncharitable entity, such as a for-profit corporation, the foundation must exercise expenditure responsibility or it will have made a taxable expenditure. The private foundation "is responsible to exert all reasonable efforts and to establish adequate procedures (1) to see that the grant is spent solely for the purpose for which it is made, (2) to obtain full and complete reports from the grantee on how the funds are spent, and (3) to make full and detailed reports [to the IRS]." §4945(h). This oversight requirement consists of a "pre-grant inquiry," a written agreement containing specific terms, receipt of certain reports from the recipient, and grant/PRI reporting to the IRS on Form 990-PF.

The Treasury Regulations enumerate requirements for the contents of a written investment agreement and for the frequency and types of reporting for PRIs that are distinct from the expenditure responsibility requirements which apply to grants made to noncharitable entities. (Treas. Reg. §53. 4945-5(b)(3) provides for the terms that must be in grant agreements, while Treasury Reg. §53.4945-5(b)(4) provides the requirements for PRIs.) The foundation must receive a written commitment signed by an appropriate officer, director, or trustee of the recipient organization that specifies the purpose of the investment and includes an agreement by the recipient to do all of the following:

- To use all the funds received from the private foundation only for the purposes of the investment and to repay any portion not used for such purposes, provided that, with respect to equity investments, such repayment shall be made only to the extent permitted by applicable law concerning distributions to holders of equity interests;
- At least once a year during the existence of the program-related investment, to submit full and complete financial reports of the type ordinarily required by commercial investors under similar circumstances and a statement that it has complied with the terms of the investment;
- To maintain books and records adequate to provide information ordinarily required by commercial investors under similar circumstances and to make such books and records available to the private foundation at reasonable times; and

- Not to use any of the funds for other purposes prohibited under section 4945 (e.g., legislative lobbying or candidate electioneering activity).

Although a grant recipient must account for the funds separately, the recipient of a PRI investment need not hold the funds in a separate account or otherwise account for the funds separately, unless the private foundation asks it to do so.

Self-Dealing

A private foundation is subject to the prohibitions on self-dealing described in section 4941. Self-dealing prohibitions apply to all private foundation transactions, including both MRIs and PRIs.

The self-dealing prohibition imposes severe sanctions on a variety of transactions between a private foundation and a "disqualified person." A disqualified person includes any person (including any individual, entity, trust, or estate) that is related to a foundation as a substantial contributor or foundation manager, persons owning a certain amount of a substantial contributor, certain family members of any of the above, persons that are owned to a certain extent by disqualified persons, and (for 4941 purposes only) relevant government officials. Prohibited transactions include the sale, exchange, or leasing of property; loans or other extensions of credit; or the furnishing of goods, services, or facilities, all subject to certain limited exceptions.

In addition to the specific self-dealing transactions enumerated in the Code, a private foundation also may not engage in any transaction that involves "the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation." §4941(d)(1)(E).

A common self-dealing concern for both PRIs and MRIs is when the foundation and disqualified persons co-invest in a company or investment fund or otherwise mutually participate in an investment opportunity. Consequences to both the foundation and the disqualified persons can be severe. The key issue under section 4941 is often whether the co-investment constitutes the use of private foundation assets for the benefit of disqualified persons. The IRS has issued a number of rulings on co-investment, identifying various ways in which a foundation's investment could impermissibly benefit its disqualified persons (e.g., by resulting in lower fees, smaller minimum investment amounts, or greater access to investments). *See, e.g.*, PLR 9726006. If a disqualified person will in any way be involved in a foundation investment, for instance as a co-investor in a target company or investment fund, or as an officer, director, or employee of any foundation investment recipient, the foundation should be mindful of potential self-dealing and, if necessary, engage legal counsel to assess the risks involved.

Unrelated Business Income Tax

Both MRIs and PRIs are subject to the federal tax rules regarding unrelated business income tax ("UBIT"). PRIs generally avoid UBIT by being "substantially related" to a foundation's exempt purposes, as a result of meeting the first prong of the PRI test described above. In some situations, MRIs also might be considered to be substantially related. However, the commercial nature of an investment that is not a PRI, where the charitable purpose does not need to be primary and return on investment can be a significant purpose, makes this more unlikely.

To avoid UBIT, an MRI may therefore need to meet a statutory exception. For instance, dividends paid on shares of preferred stock or profit allocated to a holder of a limited partnership interest may meet the exception for passive investment income and therefore not be taxed. However, the rules governing debt-financed income and the use of acquisition indebtedness then come into play—MRI income generated through assets that are acquired with debt do not qualify for a statutory exception to UBIT. The debt-financed income rules, and the consequence of UBIT as a result of acquisition indebtedness, can be complicated to determine.

With an MRI, acquisition indebtedness always must be considered. Because a PRI, on the other hand, typically would be considered "substantially related" to the charity's exempt purpose, the charity does not need to rely on a specific statutory exception to avoid UBIT. Therefore, debt financing does not create the possibility of taxation, and the foundation need not avoid debt financing or determine the proper debt-to-equity ratio for UBIT purposes.

Public Disclosure

The IRS Form 990-PF requires that a private foundation identify its PRIs made in the filing year. See Form 990-PF, Part IX-B. PRIs in non-charities requiring expenditure responsibility also must be reported correctly in the Form 990-PF. Proper reporting is critical; a court decision involving a PRI made by one foundation strictly upheld the IRS requirement for complete PRI reporting on Form 990-PF and held that the IRS was entitled to collect section 4945 excise taxes on a PRI that the foundation did not adequately report. *See Charles Stewart Mott Foundation v. United States*, 938 F.2d 58 (6th Cir. 1991).

MRIs are reported along with all of the foundation's other investments; no special reporting of MRIs is required. A foundation nevertheless may wish to highlight on its financial statements and Form 990-PF reporting its employment of investments in support of its mission.

PRUDENT INVESTMENT CONSIDERATIONS • A PRI permits a foundation to make investments that significantly further its charitable purpose without satisfying a prudent investor standard as would be necessary for a permissible business investment. An MRI, on the other hand, is treated on a par with other foundation investments and not as a charitable activity. Therefore, an MRI must meet the same applicable prudent investment standards under state and federal law as a pure commercial investment.

Each state has its own law defining director fiduciary duties and how this fiduciary standard applies specifically to investment decisions. Different prudent investor standards applicable to MRIs are described below.

Federal Tax Law

Section 4944 prohibits a private foundation from investing any amount, whether income or principal, "in such a manner as to jeopardize the carrying out of any of its exempt purposes." §4944(a)(1). An investment is considered to jeopardize the carrying out of exempt purposes of the private foundation if the foundation directors have failed to exercise ordinary business care and prudence prevailing at the time of making the investment in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In exercising that standard, foundation directors should consider the expected return, the risks of rising and falling price levels, and the need for diversification. Under section 4944, no investment is *per se* improper. Rather, the determination whether a jeopardy investment exists is made "on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole." Treas. Reg. §53.4944-1(a)(2)(i).

The determination whether an investment is a jeopardy investment is made as of the time that the foundation makes the investment "and not on the basis of hindsight." If an investment does not jeopardize the carrying out of a foundation's exempt purposes at the time it is made, the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of such investment, the foundation subsequently suffers a loss.

A reason often cited in IRS private letter rulings for a fiduciary failing to meet the investment standard under section 4944 is a lack of diversification. Many of these rulings involve a significant amount of the foundation's investments in one company. For instance, the IRS determined that private foundation managers failed to meet the requisite standard of care when the percentage of the private foundation's assets invested in one company exceeded 50 percent. PLR 8631004. See also General Counsel Memo 39537 (violation of section 4944 when approximately 75 percent of private foundation assets were invested in a publicly traded stock that was not of blue chip quality.)

In other rulings, the IRS has indicated what level of diversification it did find acceptable when a foundation included nontraditional investments as part of its portfolio. For instance, the IRS found no jeopardizing investment when no more than 30 percent of the foundation's total assets would be in "alternative investments" and no more than two percent of the portfolio would be in any one fund. PLR 9723045. (The IRS noted that the foundation relied on the advice of two outside investment consultants, all of the funds were limited liability vehicles, and the foundation would incur no debt to make the proposed investments.)

No bright line exists for what level of diversification is considered prudent. The analysis will be fact-specific in each case, and diversification is only one of many factors in each investment decision. However, it does appear from IRS rulings that allocating a small percentage of a portfolio to higher-risk investments is unlikely alone to result in a violation of the jeopardizing investment rules.

State Corporate Or Trust Law

The corporate law in each state may set forth a specific standard for directors making investments on behalf of a nonprofit corporation. For instance, charities in California are governed by the "prudent person" investment rule: in investing, reinvesting, purchasing or acquiring, exchanging, selling, and managing the corporation's investments, directors must "avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income as well as the probable safety of the corporation's capital." California Corporations Code §5240. This standard does not apply, however, to "assets which are directly related to the corporation's public or charitable programs." California Corporations Code §5240(a).

For foundations formed as trusts rather than corporations, trust law instead of corporate law would provide the applicable prudent investor standard.

UPMIFA

Almost all of the states have adopted some version of the Uniform Prudent Management of Institutional Funds Act, which includes a fiduciary standard for the management and investment of institutional funds. This investment standard applies to all institutions, not just private foundations or charities with an endowment.

Under UPMIFA, the standard for prudent investment is as follows: "each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." UPMIFA §3(b).

UPMIFA applies the "modern portfolio investment theory" in its fiduciary standard for the management and investment of institutional funds by nonprofit corporations. Therefore, decisions about an individual asset are to be made in the context of the portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the organization. As a general matter, no type of investment is *per se* deemed imprudent under UPMIFA. Except under special circumstances, an organization must diversify its investments.

UPMIFA enumerates certain specific factors that, if relevant, a charity must consider in making an investment decision. In addition to considerations like the expected total return and the organization's need to preserve capital, these factors also include "an asset's special relationship or special value, if any, to the charitable purposes of the institution." According to the Uniform Law Commission, which drafted UPMIFA, the Act "does not preclude a charity from acquiring and holding assets that have both investment purposes and purposes related to the organization's charitable purposes." *See UPMIFA Program Related Assets Article* at www.upmifa.org.

Investment Policy

A foundation must also consider whether a proposed MRI complies with its own investment policy, which may set additional restrictions for an investment beyond the fiduciary considerations discussed above. For instance, an investment must fit within any pre-existing asset classes and permitted allocations that the organization already has established. On the other hand, if the proposed investment is particularly underrepresented in the portfolio, or might hedge against declines in other parts of the portfolio, an MRI could contribute to diversification even if not part of an existing asset allocation plan.

Donor Restrictions

A foundation must make investment decisions consistent with donor intent. If, at the time of a donation, a donor expressly permitted or required the consideration of mission-related criteria in investing the donated funds, then an MRI properly based on these criteria should not be barred by prudent investor standards. When considering future gifts, the donor and the charity should consider whether restrictions on the gift would help or hinder the recipient foundation from pursuing certain uses for the funds. A donor restriction may free the board of directors from concerns regarding liability for not meeting state prudent investment standards that would otherwise apply. However, donors may not relieve a private foundation from complying with section 4944. Section 4944 does not apply to assets that are donated to the foundation by gift or bequest, as opposed to investments that the foundation itself purchases. Treas. Reg. §53.4944-1(a)(2)(ii).

CONCLUSION · MRIs and PRIs are two distinct tools that can be used by a private foundation to further its mission. While PRIs must primarily serve a charitable purpose and in many respects are treated similarly to grants for tax purposes, an MRI is fundamentally a financial investment rather than a grant and must meet applicable prudent investor standards like more conventional investments. The private foundation rules applicable under federal tax law will not only affect a foundation's compliance and reporting obligations, but often as a result will play a significant role in shaping the terms of an investment. Therefore, a private foundation and its tax advisors should consider these implications carefully before making an investment decision.

MRI vs. PRI: Private Foundation Considerations

Issue	**PRI**	**MRI**	**Comments**
Investment income tax (§4940)	Yes	Yes	1-2% tax on net investment income. Applicable to interest, dividends, and capital gains.
Self-dealing (§4941)	Yes	Yes	Certain uses of a foundation's assets that benefit its insiders are prohibited.
Payout requirement (§4942)	---	---	---
Count towards payout?	Yes	No	Consider 5-year carry-forward for PRIs and possible recapture upon repayment.
Part of asset base on which minimum payout is calculated?	No	Yes	---
Excess business holdings (§4943)	No	Yes	Limits foundation to holding 20% (or possibly 35%) of controlling interest, if MRI.
Jeopardizing investments (§4944)	No	Yes	MRIs must meet prudent investment standard.
Expenditure responsibility (§4945)	Yes	No	Foundation must exercise expenditure responsibility for noncharitable PRI recipients.
Unrelated business income tax (UBIT)	No	Yes	MRIs more likely to be "an unrelated trade or business" under section 513. Use of acquisition indebtedness may preclude UBIT exception.
Public disclosure	Yes	No	PRIs have specific disclosure requirements on Form 990-PF. No specific disclosure requirements for MRIs.
State prudent investor standards	No	Yes	PRIs are generally exempt from state law standards, while MRIs are not.