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IRS issues new guidance on charitable investments by foundations

TAXING MATTERS
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Can a foundation advance its charitable objectives by making investments tied to its mission?

The law has long permitted so-called "program-related investments" and has become much more liberal in recent years.

New guidance from the IRS issued last fall provides for even greater flexibility.

There are two types of tax-exempt charitable organizations: public charities and private foundations. In general, public charities are operating entities that perform charitable activities such as Foodlink or the Open Door Mission. Private foundations, on the other hand, are typically not engaged in direct charitable activities but rather make grants to public charities that carry on charitable work directly.

Private foundations are subject to a variety of IRS rules designed to ensure that their funds are actively used for charitable purposes and not placed in jeopardy due to conflict transactions or risky investments.

In the absence of special exceptions these restrictions would make it difficult for private foundations to make investments designed to further their charitable purposes.

However, the tax code establishes a concept of "program-related investments," which are investments that have a primarily charitable purpose. If an investment qualifies as a program-related investment it counts as a distribution by the foundation and is exempt from rules that prohibit certain investments that are deemed too risky.

For example, imagine that a foundation wished to loan a hospital a million dollars to help fund a new wing. If the million dollar loan did not count as a distribution, the foundation would need to further deplete its endowment to fund its 5 percent minimum required distributions for the year. However, the program-related investment rules allow this distribution to count towards the foundation's distribution requirements.

In addition, punitive penalty taxes are imposed on "jeopardizing investments," investments that are deemed too risky for a foundation. Program-related investments are exempt from these rules as well.

Based on the above, the foundation in our example would not have to analyze whether the hospital is a good credit risk in deciding whether to make the loan. This makes sense because the foundation would be permitted to simply grant the funds to the hospital in the first place, which is what would effectively happen if the hospital defaults on the loan.

A loan to a charitable organization is the simplest and most common form of program-related investment. However, the IRS permits foundations to be much more creative with their charitable investing.

The IRS has provided examples of a variety of types of charitable investments which are treated as program-related investments. For example, a foundation may make a loan to a for-profit business owned by members of disadvantaged minority groups or purchase shares in such a business. They can also make loans to financially secure businesses to establish new facilities in deteriorated urban areas.

In 2012, the IRS issued proposed regulations with new examples that extend the realm of allowed activities even further. They allow for a foundation to treat investments in for-profit businesses that advance the foundation's mission as program-related investments. The regulations contain examples of program-related investments in a company developing vaccines for diseases affecting the poor and a company developing new recycling strategies.

The interest in program-related investments by large philanthropies has greatly increased in recent years. For example, in 2015 the Bill and Melinda Gates Foundation made a $52 million investment in a German pharmaceutical firm that is engaged in the research and development of medicines that utilize RNA to treat cancer and certain infectious diseases.

In order to be a program-related investment, an investment may not have a significant purpose of producing income or capital appreciation.

In its latest guidance, the IRS addressed investments that are designed both to do good and also make money. For example, this would apply in the hospital example above if the investment was both designed to make a profit and to help the hospital.

Because these investments are designed to be profitable, they can't qualify as program-related investments. However, the new guidance states that in making investments foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes. Foundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity so long as the foundation managers exercise the requisite ordinary business care and prudence under the facts and circumstances. If these standards are met, mission-related investments are not treated as jeopardizing investments.

Mission-related investing is a new frontier in philanthropy. There are substantial philanthropic dollars in Upstate New York that can be used to fund enterprises that aid disadvantaged persons or regions or advance health, environmental and similar objectives.

The IRS's latest guidance provides further flexibility to foundations in making investments that both further the public good and provide returns for their endowment.

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