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Investing for Impact: Opportunities for Entrepreneurial Philanthropy

People engage in philanthropy for various reasons: to shape their communities, to advance societal well-being, and to avail themselves of tax benefits. Federal tax law provides incentives to encourage individual giving to tax-exempt organizations such as museums, environmental organizations, universities, and hospitals. Donors can make tax-efficient gifts during their lifetime (in their own name or using a tax-exempt vehicle such as a donor-advised fund or private foundation) and as part of their estate planning. However, individual giving is only one approach to advance charitable causes. This update describes two ways in which **private foundations can use investment capital for social impact.**

Private foundations are organizations which are recognized as exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code. Every 501(c)(3) organization is classified as either a public charity or a private foundation. The classification is generally based upon the mission of the organization (if it is a school, church, or hospital) or the nature and diversity of the organization's financial support. Private foundations receive support from relatively few sources—often an individual, a family, or a company. The most familiar type of private foundation fulfills its charitable purpose by making grants to public charities.* Specifically, the Internal Revenue Code requires a private foundation to make annual "qualifying distributions" in an amount equal to or greater than 5% of its net investment assets. Qualifying distributions generally include grants to public charities and direct expenditures for charitable purposes, including administrative expenses associated with the conduct of the foundation's charitable activities. Private foundations are subject to various restrictions regarding their operations, including an excise tax on investment income, restrictions on self-dealing transactions with insiders, a prohibition on holding too large an interest in a business enterprise, and a prohibition on certain "jeopardizing" investments which show a lack of reasonable care and prudence in providing for the long- and short-term financial needs of the foundation.

Program-Related Investments

Program-related investments ("PRIs") are **charitable investments** which private foundations can use to fulfill their 5% spending requirement, instead of, or in addition to, traditional grant making. PRIs are an exception to the excess business holding and jeopardizing investment rules mentioned above through which a private foundation makes investments in for-profit companies or tax-exempt entities under the following conditions:

- The primary purpose of the investment must be to accomplish one or more of the foundation's exempt purposes. Such purposes could include, for example, helping the environment, encouraging medical research, supporting economically disadvantaged communities, or providing job training.
- Production of income or appreciation of property must not be a significant purpose of the investment. In determining whether a significant pupose of the PRI is the production of income or appreciation of property, relevant factors include whether investors engaged in the investment solely for profit would be likely to make the investment on the same terms and whether the investment is the sort of investment that a private foundation would generally pursue for financial gain. Stated differently, a PRI uses the tools of investors, but the goal is charitable rather than return-driven (although limited returns as a way to measure impact are commonly negotiated).
- Influencing legislation or taking part in political campaigns on behalf of candidates must not be a purpose of the investment.

*Another type of private foundation—the private operating foundation—fulfills its charitable purpose by meeting certain expenditure tests which demonstrate that it operates less as a grant maker and more as an operating charity. The details of such foundations are beyond the scope of this update, although both mission-related investments and program-related investments may be made by private operating foundations (in the case of program-related investments, if the foundation exercises "significant involvement" with respect to the investment).

PRIs can take a range of forms, including investments in debt, equity, private equity interests, and guarantees/letters of credit. Examples of PRIs include:

- Providing low-interest loans in communities which do not have ready access to credit.
- Encouraging vaccines to be made available at low cost in developing countries by guaranteeing vaccine purchases.
- Purchasing equity in an educational software company and requiring the software to be provided to low-income schools for free or substantially below cost.

Through PRIs, private foundations can engage with companies as investors while requiring companies to work toward measurable charitable outcomes.

Mission-Related Investments

Mission-related investments ("MRIs") are **financial investments** which further the mission of a given organization by generating both a social, as well as a financial, return. MRIs are not considered direct charitable activities. They are subject to federal and state prudent investment standards and federal excess business holding rules and do not count toward a foundation's 5% payout. Sometimes called "double bottom line" investments, MRIs allow a private foundation to combine its obligation to prudently invest foundation assets with a desire to promote certain social goods, including with respect to environmental, social, and governance ("ESG") issues. MRIs are best understood as a continuum of numerous forms of interventions by institutional investors and asset managers designed to achieve social impact. MRIs align fiduciary duties to ensure a prudent financial return with the desire to utilize foundation funds in ways (i) that do not undermine charitable purposes and programs and/or (ii) that further or enhance institutional goals. MRIs take numerous forms, including, but not limited to:

- Screening certain investments because of their involvement in activities deemed to be negative, such as heavy polluters, arms companies or animal testers.
- Divestment from a particular company or industry.
- Considering ESG factors (such as environmental impact, fair labor practices, and executive pay) when deciding which investments to make.
- Investing in companies which focus on societal improvement (such as cleantech companies or affordable housing development projects).

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Founders and entrepreneurs who strive for impact and innovation in their businesses may wish to consider these goals in their philanthropy as well. Integration of PRIs and MRIs into the work of private foundations involves cooperation among foundation leaders and their financial and legal advisors.

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Patterson Belknap has a multi-disciplinary team of lawyers who are focused on the legal needs of founders and entrepreneurs. A description of the full range of our services and attorney contacts can be found here. Please visit the Founder Focus Resource Center for more content on broad range of topics of interest to founders and their professional advisors.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact the following attorney or call your regular Patterson contact.

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