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A guide to charitable investing

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Abstract

This article delineates guidelines to clarify the legal haze that seems to dissuade many tax-exempt organizations (TEOs) from engaging in programme-related investments (PRIs) in the USA. In specific, this article analyses the legal constraints on investments in private commercial ventures by private foundations and public charities. The article reaches the following main conclusions:

- TEOs may purchase debt or equity securities in a private commercial venture if its activities further the mission of the charity.
- PRIs may count towards the distribution requirement of a private foundation under certain conditions.
- PRIs are not subject to the limits in the excess business holdings rule, but must be consistent with diversification requirements.
- Investment income from a PRI will generally not be subject to unrelated business income tax.
- TEOs should not invest in ventures controlled or managed by officials closely related to the TEO.

Investment in PRIs through professionally managed pools can increase diversification and help avoid conflict rules, but the pools must be designed carefully to work for all parties.

Over the past decade, a number of prominent philanthropists have adopted a more business-like approach to grant making to non-profit groups. In venture philanthropy, for example, charities actively seek out grantees in a desired area, provide strategic and operational advice as well as grants, and establish specific metrics to measure the success of these grants.

However, most venture philanthropists have limited themselves to grants to tax-exempt organizations (TEOs). Public charities and private foundations have just begun to invest in commercial ventures—what can be called charitable investing. Under this model, the charity buys a debt or equity stake in a private commercial venture that is aligned with the charity's mission. For instance, a private foundation dedicated to promoting alternative energy might invest in a start-up company that is developing a promising new type of solar panel, or a public charity dedicated to helping low-income families start their own businesses might invest in a for-profit bank making micro-loans to these families.

In most charities, the investment portfolio is run separately from the grant-making function. Following an asset allocation policy, the charity typically invests in a diversified portfolio of stocks, bonds and alternative investments in order to grow its endowment. It then uses some or all of the investment returns to make grants to various TEOs consistent with its mission. The charity receives no financial return on its grants, even if they lead to a profitable result—for example, if a grant for medical research leads to the development of a new drug, which is ultimately sold to a pharmaceutical company.

Under the charitable investing model, by contrast, a charity buys stock or bonds in a privately held,

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commercial venture whose activities promote its charitable mission. If the commercial venture fails, the charity would be in no worse a financial position than if it made a grant to that venture. On the other hand, if the commercial venture produces a large financial return, the investment proceeds would go back to the charity to further its charitable goals. Thus, such mission-related investing offers the potential for periodic replenishment of a charity's coffers—supplying more funds to carry out its mission in the future.

In certain circumstances, charitable investing may be the most productive way for a charity to achieve its mission. In many fields, such as those based on new technologies, small privately held companies have been the leaders in innovation. For instance, the Gates Foundation recently bought stock in Liquidia Technologies, a private company developing innovative types of vaccines.[1] These companies can attract very talented people, who have the expertise and motivation to make breakthroughs in new products or services. While some of these people might also work for TEOs, others might gravitate toward commercial start-ups.

One field that is particularly ripe for charitable investing is drug discovery. Promising drug targets often languish in the 'valley of death'—the period after they have passed preliminary hurdles in test tubes or mice, but before they have been through large-scale human trials for safety and effectiveness.[2] It is often necessary to start these human trials in order to attract funding from venture investors or pharmaceutical companies, which have become increasingly risk-averse and want drugs further along on the development path. Yet the cost of starting these human trials is very high,[3] so small biotech companies usually need outside capital to help them get through the 'valley of death'.

Yet, despite these potential attractions of investments in private commercial ventures, they are not seriously considered by most private foundations and public charities. In some cases, they are simply not on the radar screen because the trustees or directors are not aware of this alternative. In other cases, the trustees or directors are concerned about the legal complexities of making commercial investments. As one foundation executive told me: 'Trustees do not usually get paid so they are quite risk averse. If they give a $1 million grant to Harvard, they will never be questioned regardless of the result. But if they buy $100,000 in stock of a commercial venture that fails, they might be asked questions.'

This article delineates guidelines to legitimize the practice of charitable investing by the two main types of TEOs—private foundations and public charities. Both are granted a federal tax exemption under the Internal Revenue Code (IRC); both are established, as trusts or non-profit corporations, under the laws of a State. Public charities receive financial support from a diverse array of donors,[4] and usually have a board representing a range of stakeholders. By contrast, private foundations are usually financed and controlled by a few individuals, often from the same family.

In specific, this article analyses the legal constraints on investments in private commercial ventures by TEOs according to the type of charitable institution. The IRC imposes special restrictions on investments by private foundations because they are perceived as having a relatively high potential for conflicts of interest. Investments by private foundations and public charities are both subject to more general tax rules against unrelated business income and private inurement. Finally, in making investments in private commercial ventures, the trustees of both private foundations and public charities must fulfil their fiduciary duties under the relevant State's laws.

1. 'Liquidia Technologies Receives Significant Equity Investment to Bolster Development of Next Generation Vaccines'. Liquidia Technologies. 4 March 2011. <http://www.liquidia.com/press/Liquidia_Gates_PR.pdf> accessed 23 December 2011.

2. Eg David Bornstein, 'Helping New Drugs out of Research's Valley of Death' *New York Times* (2 May 2011) <http://opinionator.blogs.nytimes.com/2011/05/02/helping-new-drugs-out-of-academias-valley-of-death/> accessed 23 December 2011.

3. For instance, Robert Fee, 'The Cost of Clinical Trials', *Drug Discovery & Development* (Rockaway, NJ, 1 March 2007) <http://www.dddmag.com/the-cost-of-clinical-trials.aspx> accessed 23 December 2011

4. Internal Revenue Code 509(a)(1) and (a)(2).

As elaborated below, the article reaches the following conclusions:

1. A charity's purchase of debt or equity securities in a privately held, commercial venture is legally permissible as a programme-related investment (PRI) as long as the work of the venture furthers the mission of the charity.
2. Programme-related investments can count towards the distribution requirement of a private foundation if it monitors such investments in a similar manner to the expenditure monitoring of its grants.
3. Investment by one charity should generally not exceed 35% of the equity of an unaffiliated commercial venture, unless the investment is a PRI and constitutes a relatively small portion of the charity's total assets.
4. Investments by charities in private commercial ventures can usually avoid being taxed as unrelated business income if they further the mission of the charity.
5. A charity should eschew investments in a private commercial venture whose executives, directors or control shareholders are also officers, directors or substantial contributors of the charity.
6. Charitable investing through professionally managed pools can help address diversification and conflict issues, though such pools must be carefully designed to meet the needs of all participating parties.

Special restrictions for private foundations

The IRC imposes substantial penalties on investments by private foundations that 'jeopardize' the solvency or charitable goals of a private foundation. An investment will be considered 'jeopardizing' if it is not made with ordinary business care and prudence.[5] This determination is made at the time of the investment, and not with the benefit of hindsight. Although the determination is made on a case-by-case basis, taking into accounting all relevant facts and circumstances,[6] investments will not be considered 'jeopardizing' if foundations follow certain guidelines.

Treasury Regulations explicitly state that programme-related investments (PRIs) are not considered 'jeopardizing'

The Treasury regulations vaguely define 'jeopardizing' investments as unduly risky.[7] They also single out for special scrutiny certain types of investments such as margin trading and short selling.[8] However, this list of scrutinized investments was published over 30 years ago and has been superseded in part by more recent private letter rulings.[9]

Most importantly, the Treasury Regulations explicitly state that programme-related investments (PRIs) are not considered 'jeopardizing'.[10] Under the Treasury regulations, a PRI must meet all of the following criteria:[11]

1. The primary purpose of the investment must be to carry out the foundation's charitable purpose.
2. The purpose of the investment may not be the production of income or the appreciation of property.
3. The purpose of the investment may not be to influence legislation or support a political campaign.

Compliance with the third criterion is easily satisfied—no lobbying expenditures or political

5. Treasury Regulation 53.4944-1(a)(2)(i).
6. ibid.
7. Anne Stetson and Mark Kramer, *Risk, Return and Social Impact: Demystifying the Law of Mission Investing by U.S. Foundations* (Packard Foundation 2008) 17.
8. Treasury Regulation 53.4944-1(a)(2)(i).
9. Stetson and Kramer (n 7) 20–23.
10. Treasury Regulation 53.4944-3(a)(1).
11. ibid.

contributions—but not relevant to most instances of charitable investing. To comply with the first criterion, a foundation's investment in a private commercial venture must promote the charitable mission of the foundation. Depending on the foundation's mission, commercial ventures could include green technologies, land conservation, affordable housing, drug therapies or economic development in distressed communities.

The second criterion does not mean what it literally appears to say. Although an investment produces significant income or capital appreciation, it can still constitute a PRI. The key test for a PRI is whether the investment is on terms and conditions that would not be acceptable to a purely profit-seeking investor.[12] In other words, the lowers returns from a PRI would be justified if it served the foundation's charitable purpose.

As a practical matter, this second criterion implies that a foundation should generally charge a below-market interest rate on loans made to a private commercial venture that promotes the foundation's mission. A foundation could also buy a special class of preferred stock in such a commercial venture. Alternatively, if a foundation buys common stock in such a commercial venture, it should generally pay the same price as profit-seeking investors, but the foundation should negotiate terms different from those provided to such investors in ways that promote its charitable purpose. For instance, a foundation might agree not to receive cash dividends on stock sold by a biotech venture if the company agrees to grant a free license on potential patents to a specific university.

Once a purchase of debt or equity in a commercial venture is characterized as a PRI, this leads to other favourable results for the private foundation under federal tax law. As discussed below, these include qualifying for its annual distribution requirement and avoiding the 2% annual tax on investment income from PRIs. However, the private foundation still needs to abide by the prohibitions on transactions with disqualified persons and the limitations on excess holdings in any venture to the extent applicable.

Qualifying distributions

Non-operating private foundations must annually distribute at least 5% of their total endowment for charitable purposes, [13] averaged over a period of several years.[14] This is one of the critical distinctions between a private foundation and a public charity, because the latter is not required by the IRC to make annual charitable distributions. The 5% distribution requirement is usually satisfied by annual grants to tax-exempt charities by a private foundation.

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However, the regulations specifically include PRIs as qualifying distributions under this 5% requirement.[15] In other words, a PRI in a private commercial venture is considered in the same category as a grant to a non-profit organization under this 5% distribution requirement. If the PRI later produces income to the foundation, its distribution requirement would be increased by the amount of the initial investment in the year the income is received.[16] Since a PRI in a private commercial venture is treated like a grant by a foundation for distribution purposes, the foundation must exercise expenditure responsibility to ensure that the venture pursues the relevant charitable objectives.[17] Thus, a foundation should insist on a

12. Treasury Regulation 53.4944-3(a)(2)(iii).
13. Treasury Regulation 53.4942(a)-2(b)(ii).
14. Treasury Regulation 53.4942(a)-3(e).
15. Treasury Regulation 53.4942(a)-3(a)(2)(i).
16. Internal Revenue Code 4942(d)(1). Any gain above the amount of the initial PRI would increase the foundation's endowment.
17. Internal Revenue Code 4945(d)(4)(B) and 4945(h).

formal agreement with a commercial venture on how the PRI will be utilized—enforced through regular reports by the venture and periodic monitoring by the foundation.[18] If the venture subsequently stops pursuing these charitable objectives, the foundation should have the right to redeem its PRI.[19] If a foundation makes PRIs through a pooled vehicle, such as a limited partnership, the foundation must make sure that the partnership is committed to investing only in specified types of PRIs or, alternatively, that the partnership sets up a separate side vehicle for any non-PRI investments. Moreover, the foundation should monitor the actual activities of the partnership. If these deviate from its stated commitment to specified types of PRIs, the foundation should have the right to redeem its interest in the partnership.

Annual 2% tax on investment income

Every foundation must pay each year a 2% tax on its net investment income. This includes all dividends, interest and capital gains generated by its endowment.[20]

Capital gains from PRIs are excluded from the definition of the foundation's investment income for purposes of calculating the 2% annual tax

However, there is an important exception for capital gains resulting from a PRI by a private foundation, although the exception does not extend to interest or dividends paid by a PRI to a private foundation. Capital gains from PRIs are excluded from the definition of the foundation's investment income for purposes of calculating the 2% annual tax.[21]

Transactions with disqualified persons

Transactions between a private foundation and a 'disqualified person' are generally treated as self-dealing by the IRC, subject to a heavy excise tax.[22] The Treasury regulations strictly regulate such transactions; they are subject to an excise tax even if they are fairly priced and result in a material benefit to the foundation.[23] The regulations generally ban such transactions and specifically prohibit enumerated types of transactions—such as sales or leases of real estate, most kinds of lending and compensation payments for certain services.[24]

Transactions between a private foundation and a 'disqualified person' are generally treated as self-dealing by the IRC, subject to a heavy excise tax

The IRC broadly defines a 'disqualified person' to include the foundation's trustees, directors, officers and managers[25] plus family members of all such persons.[26] In addition, a 'disqualified person' includes any substantial contributor to a foundation[27] (making a contribution over $5000 if that constitutes more than 2% of the foundation's annual contributions[28]) as well as any owner of more than 20% of any entity that is a substantial contributor.[29] Furthermore, the

18. A foundation may ask for a seat on the advisory board of the venture, but should be reluctant to incur potential legal liability by having a foundation representative serve on the venture's actual board of directors.
19. As a practical matter, however, the venture may not have the cash left to effect such a redemption.
20. Treasury Regulation 53.4940-1(a).
21. Treasury Regulation 53.4940-1(f)(1).
22. Treasury Regulation 53.4941(a)-1(a)(1).
23. Treasury Regulation 53.4941(d)-1(a).
24. Treasury Regulation 53.4941(d)-2.
25. Treasury Regulation 53.4946-1(a)(1)(ii).
26. Treasury Regulation 53.4946-1(a)(1)(iv).
27. Treasury Regulation 53.4946-1(a)(1)(i).
28. Internal Revenue Code 507(d)(2)(A).
29. Treasury Regulation 53.4946-1(a)(1)(iii).

term encompasses any entity in which a group of disqualified persons together hold an ownership interest of more than 35%.[30]

On the other hand, the regulations contain limited exceptions to these self-dealing prohibitions. A disqualified person may, without charge, lease property[31] or provide services to a foundation.[32] A disqualified person may receive an 'incidental' benefit from a foundation—for example, a grant made by a private foundation to a public charity where one trustee serves on both boards.[33] The Treasury regulations also allow investment managers of a foundation to supply it with other necessary and reasonable services if the compensation received for such services is not excessive.[34]

To avoid excise taxes on transactions with disqualified persons, a private foundation should not invest in a commercial venture where any disqualified person has effective control. For instance, a foundation should not make a loan to a company owned more than 20% by one of its trustees,[35] or a company owned over 35% collectively by several of its substantial contributors.[36]

The situation is more complex when a private foundation seeks to invest through a pool in which a disqualified person has a substantial ownership position. The Internal Revenue Service (IRS) has allowed private foundations to acquire limited partnerships interests in hedge funds where a disqualified person controls the general partner, subject to several conditions designed to protect the foundation's interest.[37] Nevertheless, investment in a pool dominated by one or more disqualified persons raises serious questions under both the Internal Revenue Code (IRC) and state fiduciary duties (discussed below). Therefore, private foundations should proceed cautiously in such situations–by obtaining a private letter ruling from the IRS and seeking independent counsel on the relevant fiduciary laws.

Excess business holdings

A private foundation is generally subject to a heavy excise tax if it, together with any of its disqualified persons, owns over 20% of a corporation's voting stock or similar interests in other forms of business enterprises.[38] This limit is raised from 20% to 35% if control of the business is effectively held by an individual or entity other than a disqualified person.[39] Nevertheless, regardless of the level of ownership interest in the business entity by one or more of its disqualified persons, a foundation may own up to 2% of the entity's voting stock and up to 2% of the total value of all its classes of shares.[40]

> *The excess business holdings rule does not apply to the PRIs of a foundation. For the purpose of this rule, a business enterprise does not include an enterprise functionally related to a foundation's basic objectives*

There are exceptions to these IRC limits on a foundation's excess business holdings. For example, these limits do not apply to businesses that earn at least 95% of their gross income from passive sources.[41] Passive sources include dividends, interest, royalties, rents and certain types of capital gains.

Thus, a foundation's ownership interest in an investment pool will generally not be subject to either

30. Treasury Regulation 53.4946-1(a)(1)(vi).
31. Treasury Regulation 53.4941(d)-2(b)(2).
32. Treasury Regulation 53.4941(d)-2(d)(3).
33. Eg, Revenue Ruling 75-42, 1975.
34. Treasury Regulation 53.4941(d)-3(c).
35. Internal Revenue Code 4946(a)(1)(C).
36. Internal Revenue Code 4946(a)(1)(E).
37. Letter Ruling 2003 18069, clarified by Paul Weiss, 'Investment Guidelines for Private Foundation Managers' *Estate Planning Magazine* 30(11) (New York, NY, 2003). <http://www.paulweiss.com/files/Publication/9543fe4c-19dc-4875-bd14-1c9c04d36056/Presentation/PublicationAttachment/1c1e8f99-7911-4b71-9ed6-23a738d79193/11-03pvtfdnmgr.pdf>, page 3 of pdf. accessed 23 December 2011.
38. Internal Revenue Code 4943(c)(2)(A).
39. Internal Revenue Code 4943(c)(2)(B).
40. Internal Revenue Code 4943(c)(2)(C).
41. Internal Revenue Code 4943(d)(3)(B).

the 20% or the 35% limits in the excess building holding rule. Under this rule, for example, the IRS had held that a foundation's ownership interest in the general partner of a hedge fund would be viewed as an investment in the underlying hedge fund.[42] As a result, all the income from this ownership interest in the general partner—as well as any interest in the hedge fund itself—would be deemed passive income and therefore not constitute an excess business holding.

Most importantly for charitable investing, the excess business holdings rule does not apply to the PRIs of a foundation. For the purpose of this rule, a business enterprise does not include an enterprise functionally related to a foundation's basic objectives, such as a foundations investment in a commercial venture that promotes its charitable mission.[43] On the other hand, the excess business holding rule is not the only constraint on the level of a foundation's ownership interest in a business entity or its investment in entities controlled by disqualified persons. These situations are also subject to diversification obligations under the laws of the State in which the foundation is incorporated.

Other tax constraints

Beside the special rules for private foundations, the IRC taxes the unrelated business income of all TEOs including public charities as well as private foundations. But this tax does not usually apply to PRIs. In addition, public charities must be operated for the public benefit and not for private inurement. These requirements are similar, though not as strict, as the prohibitions on transactions between disqualified persons and private foundations.

Unrelated business taxable income

A private foundation or public charity is subject to corporate income tax, typically at the 35% rate, on unrelated business taxable income (UBTI). UBTI refers to activities of a TEO that are unrelated to its charitable mission, such as a macaroni company owned by a liberal arts university. But an investment by a TEO in a commercial venture that constitutes a PRI does not produce UBTI, because such an investment furthers the charitable purpose of the organization.

> *An investment by a TEO in a commercial venture that constitutes a PRI does not produce unrelated business taxable income*

While UBTI does not generally include dividends, interest or capital gains, or rents or royalties, it does encompass most forms of debt-financed income. For example, if a foundation is a limited partner in a hedge fund, which earns income through leveraged investments, the foundation's share of such income will usually be subject to corporate income tax.[44] However, a foundation can avoid producing UBTI if it invests in a commercial venture through an offshore taxable corporation, rather than as a partnership (or limited liability company taxed as a partnership).[45]

No private inurement

Section 501(c)(3) of the IRC allows a charity to be exempt from federal income taxes if, among other requirements, 'no part of the net earnings of which inures to the benefit of any private shareholder or individual.' Inurement involves the transfer of income, property or services by a charity to a private

42. Letter Ruling 2003 18069, clarified by Paul Weiss, 'Investment Guidelines for Private Foundation Managers' *Estate Planning Magazine* 30(11) (New York, NY, 2003) 10. <http://www.paulweiss.com/files/Publication/9543fe4c-19dc-4875-bd14-1c9c04d36056/Presentation/PublicationAttachment/1c1e8f99-7911-4b71-9ed6-23a738d79193/11-03pvtfdnmgr.pdf> accessed 23 December 2011.

43. 'Business Enterprise—Excess Business Holdings of Private Foundations'. The IRS. Last updated 6 September 2011 <http://www.irs.gov/charities/foundations/article/0,,id=137801,00.html> accessed 23 December 2011.

44. IRS Publication 598, 'Income from Debt-Financed Property' <http://www.irs.gov/publications/p598/ch04.html> accessed 23 December 2011.

45. Letter Rulings. 200315028, 200315032, and 200315035; Colin (n 33). These offshore corporations, called blockers, are specially designed for foundations and other entities exempt from US income tax.

shareholder or individual when the TEO pays excessive compensation or receives inadequate benefits depending on the circumstances.[46] A private shareholder or individual is defined as those persons having a personal and private interest in a charity—often called 'insiders' of the charity.[47]

Section 501(c)(3) of the IRC allows a charity to be exempt from federal income taxes if, among other requirements, 'no part of the net earnings of which inures to the benefit of any private shareholder or individual'

The IRC establishes heavy penalties for violations of this prohibition on private inurement. It imposes large excise taxes on 'excess benefit' transactions between a public charity and a 'disqualified person' of such organization.[48] A 'disqualified person' is defined by the IRC as a person in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period before the alleged excess benefit transaction occurred.[49] Family members[50] and entities controlled by the disqualified person[51] are also considered disqualified persons.

An 'excess benefit' transaction is one in which the tax-exempt organization provide benefits, directly or indirectly, to or for the use of the disqualified person and the value of the benefits provided exceed the value of the consideration received in return by the organization.[52] While an excess benefit transaction may be grounds for loss of a public charity's tax exemption, this is too draconian a remedy in most situations. More likely such a transaction will result in the imposition of excise taxes on the disqualified person (and perhaps on the public charity's officials who knowingly participated in such a transaction).[53] This is why such excise taxes for public charities are typically called 'intermediate sanctions'.

The most common type of private inurement case involves allegedly excessive compensation paid to insiders—disqualified persons—of a public charity. But compensation paid to insiders is not excessive if it is reasonable under the Treasury Regulations—which look at whether that amount of compensation would ordinarily be paid by like enterprises under like circumstances.[54] There is a rebuttable presumption of reasonableness if the public charity follows all of the following three procedures:[55]

- the transaction is approved by an authorized body of the public charity composed of individuals with no conflict of interest in the transaction;
- prior to approving the transaction, the authorized body obtained and relied on appropriate data on comparability; and
- the authorizing body adequately documented the bases for its determination of reasonableness at the time such determination was made.

In addition, the prohibition against private inurement applies to a broad range of transactions between insiders and a public charity, subject to the rebuttable presumption of reasonableness. For example, such transactions would include:[56]

- the charity's sale of an asset to an insider;
- the charity's rental of property from an insider;
- the charity's purchase of stock from an insider or an insider's company; and

46. Treasury Regulation 1.501(c)(3)-1(c)(2).
47. Treasury Regulation 1.501(a)-1(c).
48. Internal Revenue Code 4958(a).
49. Internal Revenue Code 4958(f)(1)(A).
50. Internal Revenue Code 4958(f)(1)(B).
51. Internal Revenue Code 4958(f)(1)(C).
52. Internal Revenue Code 4958(c)(1)(A).
53. Internal Revenue Code 4958(a).
54. Treasury Regulation 53.4958-4(b)(1)(ii).
55. 'Rebuttable Presumption—Intermediate Sanctions'. The IRS. <http://www.irs.gov/charities/charitable/article/0,,id=173697,00.html> accessed 23 December 2011.
56. Karl Emerson, *The Private Inurement Prohibition, Excess Compensation, Intermediate Sanctions, And the IRS's Rebuttable Presumption—A Basic Primer for 501(c)(3) Public Charities* (2009) 2 <http://www2.guidestar.org/ViewCmsFile.aspx?ContentID=2933> accessed 23 December 2011.

- the charity's lending of money to an insider or an insider's company.

The latter two examples could occur if a public charity made a PRI in a commercial venture where an insider of that organization was an officer, director or substantial shareholder of the venture. Therefore, before making a PRI in any of those situations, a public charity should follow the above procedures for obtaining the rebuttable presumption of reasonableness. Nevertheless, if a PRI is made in these types of situations by a private foundation, rather than a public charity, such a PRI might result in an excise tax on the disqualified person involved in the transaction. As discussed above, the prohibitions on transactions between disqualified persons and private foundations generally apply even if the transactions are fairly priced and beneficial to the foundation. To obtain exceptions from these prohibitions in appropriate circumstances, a foundation should seek a private letter ruling from the IRS.

No private benefit

A public charity must not only avoid private inurement but also must primarily serve the public interest rather than any private interest. While the prohibitions against private inurement and private benefit are overlapping to some degree, they are distinct in three key respects.

> *A public charity must not only avoid private inurement but also must primarily serve the public interest rather than any private interest*

First, the rule against private inurement applies to those who are insiders of the charity, whereas the rule against private benefit applies to a much more extensive set of individuals and entities. According to the IRS Audit Guide:

> Private benefit encompasses those who are not only inside the organization but also 'outside' the organization. Thus, all inurement is private benefit, but not all private benefit is inurement.[57]

Second, the prohibition against private inurement is aimed at what is received by insiders—whether they are receiving any part of the charity's earnings. By contrast, the private benefit doctrine focuses on the identity of the main class of beneficiaries from the charity's activities. The IRS asks:

> Does the class represent the community at large, or is there private benefit to certain individuals or entities?[58]

Third, although any private appropriation of a public charity's income runs afoul of the private inurement rule, the analysis of the private benefits is more refined. The IRS will consider the extent to which a charity's activities confer private benefits on private individuals or entities relative to the public benefits generated by these activities. If the private benefits are relatively insubstantial, they will not endanger the charity's tax exemption.[59]

Thus, the rule against private benefit implies a broad evaluation of any PRIs made by a public charity within the context of its overall activities. Even if the PRIs confer some benefits on 'outsiders' involved with a commercial venturethat would be permissible as long as those benefits were insubstantial relative to the other activities of the charity. On the other hand, if most of the assets of the charity were used to make PRIs in a relatively small set of commercial ventures, this might run afoul of the private benefit rule even if

57. IRS Audit Guide (4.76.3.11.1). Point 1 <http://www.irs.gov/irm/part4/irm_04-076-003.html#d0e1401> accessed 23 December 2011. Also, Treasury Regulation 1.501(c)(3)-1(d)(1)(ii).

58. IRS Audit Guide (4.76.3.11.1). Point 2 <http://www.irs.gov/irm/part4/irm_04-076-003.html#d0e1401> accessed 23 December 2011.

59. IRS Audit Guide (4.76.3.11.1). Point 3 <http://www.irs.gov/irm/part4/irm_04-076-003.html#d0e1401> accessed 23 December 2011.

no insider of the public charity were involved with any of these ventures.

State fiduciary duties

In addition to regulatory constraints under the federal tax code, the directors or trustees of all charitable institutions—public charities and private foundations—must fulfil their fiduciary duties under the relevant State's laws. Most TEOs are chartered as non-profit corporations under the laws of their home State; a smaller number of charities are organized as trusts in their home State.

The directors or trustees of all charitable institutions—public charities and private foundations—must fulfil their fiduciary duties under the relevant State's laws

The fiduciary duties of directors and trustees of charities can be divided into two main categories—duty of care and duty of loyalty. Under the duty of care, the officials of a TEO must act prudently, with a particular emphasis on preserving its endowment. Like the federal tax standard for avoiding jeopardy investments, the duty of care provides TEO officials with considerable discretion in making PRIs consistent with its stated objectives.

Under the duty of loyalty, by contrast, the conduct of a TEO's officials will be closely scrutinized if they personally have financial stakes in transactions involving that same organization. Such transactions may present material conflicts of interest or issues involving the usurpation of corporate opportunities, as explained below. However, the applicable legal standard for such transactions depends on whether the TEO is organized under State law as a non-profit corporation or as a trust.

Duty of care

Almost every State has adopted the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which sets the legal standards for the management of charitable endowments. Under UPMIFA, the charity's officials must invest that endowment prudently—exercising the care an 'ordinarily prudent person in a like position would exercise under similar circumstances'.[60] UPMIFA delineates the following eight general factors to be considered by fiduciaries in the circumstances of managing the endowment of each charitable institution:[61]

- General economic conditions.
- Possible impact of inflation or deflation.
- Expected tax consequence.
- Role played by individual investments within the overall investment portfolio.
- Expected total return from both income and appreciation.
- Other resources of the institution.
- Needs of the institution to make distributions and to preserve capital.
- Any special relationship or value of any asset to the charitable purposes of an institution.

Under UPMIFA, the charity's officials must invest that endowment prudently—exercising the care an 'ordinarily prudent person in a like position would exercise under similar circumstances'

This last factor is part of UPMIFA's focus on the specific objectives of each charity. Under the statute, the fiduciaries must give precedence to the donor's intent as expressed in any gift instrument and the charity's purposes as stated in any governing document.[62] For this reason, UPMIFA carves out PRIs

60. UPMIFA, 3(b).
61. UPMIFA, 3(e)(1).
62. UPMIFA, 3(a).

from the normal risk/return analysis of a charity's potential investments. The drafters of the statute recognized that PRIs can be properly selected on different grounds than normal investments—eg, with below-market returns in order to carry out the charity's mission.[63]

UPMIFA generally supports an investment management approach aimed at maintaining a permanent endowment over the long term, while producing adequate funds for charitable distributions on an annual basis.[64] The drafters of UPMIFA discussed, but did not adopt, an annual payout restriction to protect against overspending by a charitable institution. Instead, the drafters included an optional provision, which states may choose to adopt, with a presumption of imprudence if a charity spends in one year more than 7% of its endowment's average value over the last three years.[65]

To preserve a permanent endowment for a charitable institution, it is critical that PRIs qualify under the 5% distribution requirement for private foundations. Otherwise it would be very difficult for the foundation to meet this requirement and make additional PRIs, while preserving the long-term value of the endowment. In addition, if any State adopted the 7% spending restriction, it should create an exception for those years when a private foundation receives a significant return on one of its PRIs. In such years, as mentioned previously, the distribution requirement of a foundation under federal tax law will be increased by up to the amount paid initially for the PRI.

Similarly, there is significant relationship between the diversification requirement of UPMIFA and the holdings limit for private foundations under federal tax law. Under UPMIFA, an endowment must diversify its investments unless, because of special circumstances, the charitable institution's purposes would be better served by more concentrated investments.[66] UPMIFA also allows such diversification to be achieved by delegating the investment function to an external managers or allocating assets to an investment pool such as a mutual fund.[67]

Diversification should be examined from two perspectives—the size of the foundation's holding relative to the aggregate securities issued by a commercial venture and the size of the foundation's holding in this venture relative to the total value of the foundation's portfolio. Thus, although a private foundation may buy up to 20% or even 35% of a commercial venture under the excess business holdings rule, such an investment may or may not meet its diversification obligation pursuant to State law. Under UPMIFA, the permissibility of such a large investment in one company would depend on several factors, including the amount of this one investment relative to the overall size of the endowment, the importance of this investment to the institution's charitable mission, and the degree of diversification in the rest of its portfolio. On the other hand, if a private foundation owned 20% or 35% of a limited partnership holding a portfolio of many PRIs, that investment would clearly be consistent with UPMIFA's diversification mandate.

Duty of loyalty

UPMIFA does not establish a duty of loyalty; rather, it expressly incorporates by reference the duty of loyalty under other state laws.[68] In essence, the duty of loyalty requires every trustee, director and officer of a charitable institution to act in the charity's best interests, and not to obtain personal financial benefits from the relationship (other than normal salaries and expenses). The duty of loyalty under State law is broader, though less strict, than the IRC's specific rules for private foundations against transactions with disqualified persons, and closer to the IRC's general rules against private inurement for insiders at public charities. The remedies for violations of the duty of

63. UPMIFA comments, 10–11 <http://www.law.upenn.edu/bll/archives/ulc/umoifa/2006final_act.pdf> accessed 23 December 2011.
64. UPMIFA comments, 3 <http://www.law.upenn.edu/bll/archives/ulc/umoifa/2006final_act.pdf> accessed 23 December 2011.
65. UPMIFA, 4(d).
66. UPMIFA, 3(e)(4).
67. UPMIFA, 5(a).
68. UPMIFA, 3(b).

loyalty under State law are quite different—either monetary damages or voiding transactions, as compared to the imposition of excise taxes under federal tax laws.

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The duty of loyalty for charities organized as corporations is set forth in the Model Not-for-Profit Corporation Act, which is gradually being adopted in most States. The Model Act follows the approach to loyalty issues of directors and officers used in statutes applicable to for-profit corporation—which is quite flexible. Under the Model Act, no contract or transaction between a non-profit corporation and any of its directors or officers will be voidable solely because of their own financial interest in the contract or transaction if EITHER of two conditions are met:[69]

- there is full disclosure of the material facts about the contract or transaction, which is approved by a majority of the disinterested directors; or
- the contract or transaction is otherwise deemed fair to the corporation.

Suppose a charity organized as a non-profit corporation makes a PRI in a commercial venture whose controlling shareholder is also a director of the charity. Under the Model Act, such an investment would be permissible if it were approved after full disclosure to the disinterested directors of the corporation or if the investment were fair to the corporation. Yet if this charity were also a private foundation under federal tax laws, this investment would be subject to an excise tax as a transaction between the foundation and a disqualified person. Moreover, under the federal tax rule against private inurement for public charities, the presumption of validity would be triggered only if the disinterested directors approved the investment as reasonable based on sufficient data about comparable investments.[70] These criteria are similar, though not the same, as the conditions for director approval of interested transactions under the Model Act.

By contrast, if the charity were organized as a trust, it would be subject to a relatively strict standard of loyalty under State law. Most states have adopted the Uniform Trust Code (UTC), which is patterned after the historically strict rules applicable to management of trusts. Any transaction involving trust property that is affected by a conflict between the fiduciary duty of the trustee and the personal interests of the trustee (including his or her family) is voidable, unless expressly authorized by the terms of the trust, its beneficiaries or a court.[71] Accordingly, if a charity organized as a trust makes a PRI in a commercial venture where a trustee has a significant financial interest, that investment would be voidable regardless of any assessment of fairness.

The UTC also allows the voiding of a transaction when the trustee takes a business opportunity arguably in conflict with his or her duty of loyalty to the trustee. This is called the corporate opportunity doctrine; among other things, it prohibits the trustee from personally acquiring an investment that the trust would have been reasonably expected to acquire.[72] Again this is a much stricter test than the standard for non-profit corporations. Under the Model Act, a director may pursue a corporate opportunity if he or she brings it to the attention of the disinterested directors who decide against the corporation pursuing that opportunity.[73]

Conclusions

In sum, a TEO may legally invest in private commercial ventures to further its charitable mission if it

69. Model Not-for-Profit Corporation Act 8.60(a).
70. See text at n 55 above.
71. Universal Trust Code 802(b).
72. Universal Trust Code 802(e).
73. Model Not-for-Profit Act 8.70(a).

complies with certain conditions. The exact nature of these conditions depends on three main factors:

- whether the TEO is a private foundation or public charity under federal tax law;
- whether the TEO is organized as a trust or non-profit corporation under state law; and
- whether the investment is made directly by the TEO or through an investment pool.

A TEO may legally invest in private commercial ventures to further its charitable mission if it complies with certain conditions

The strictest legal regime applies to a TEO that is a private foundation under federal law and a trust under state law. But even such a foundation-trust is allowed to make PRIs, despite their relatively high risk, as long as they further its charitable mission. Under federal tax law, foundations are allowed to own up to 35% of an unaffiliated commercial venture, or an even higher percentage of a PRI. Nevertheless, a higher ownership percentage might raise concerns about the trust's diversification obligations under state law, unless the PRI is small relative to the foundation's overall assets. Because PRIs are treated like grants for many purposes, they can help meet both the 5% distribution requirement for non-operating private foundations and the state law mandate to preserve the long-term value of trust endowments. Indeed, PRIs have the potential to significantly increase the size of their endowments. If a PRI generated a large financial return, the initial amount of the PRI must be distributed again, but any capital gains would go to augment the endowment. All of these positive attributes of PRIs extend to other organizational formats for TEOs. Although the rules on PRIs do not technically apply to public charities, it seems advisable for public charities to follow these rules to the maximum degree feasible. That would assure that any investments in commercial ventures by public charities would be consistent with their mission and treated as grants for expenditure monitoring and other purposes.

In any event, the rules against transactions involving self-dealing are considerably stricter for foundations and trusts than other types of TEOs. The IRC imposes heavy excise taxes on disqualified persons of a foundation that makes a PRI in a commercial venture if those same persons are senior executives or substantial owners of the venture. Similarly, such a PRI would be voidable under state law if the trustee was on both sides of the transaction, regardless of the fairness of the transaction.

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By contrast, the self-dealing rules for public charities and non-profit corporations allow for a more flexible approach to PRIs. These rules look to whether a particular transaction results in actual damage to the public charity or inappropriate benefit to the interested party. Thus, PRIs between insiders and public charities will not usually constitute private inurement if they are deemed reasonable by a majority of disinterested directors—based on comparable data—and properly documented at the time the PRI is made. Legal concerns about self dealing can be substantially assuaged if a TEO acquires PRIs through an investment pool, instead of directly buying securities of a commercial venture. In the typical investment pool—a limited partnership—the general partner is a private equity expert in the relevant substantive area, and is not a disqualified person or insider of the TEO. Of course, there can be conflicts of interest in the way a general partner manages the pool and chooses PRIs. But these will be governed by the normal fiduciary duties of general partners, as elaborated or modified in the partnership agreement and offering documents for the specific investment pool. In particular, by acquiring PRIs through investment pools, a foundation or public charity may avoid many of the difficult issues surrounding compensation that could arise if it employed private equity experts on its own staff. These experts usually expect to receive an annual fee equal to 2% of assets under management, plus a carried interest in 20% of any realized profits. Although such a compensation arrangement might seem rich for most TEO executives, it is the standard pay scale for general partners of private equity pools.

Acquiring PRIs through investment pools, rather than directly, has other legal advantages to TEOs. For instance, investment pools of PRIs can sidestep the diversification concerns when a TEO buys a large position in a commercial venture to further its charitable mission. Similarly, by acquiring PRIs through a limited partnership, rather than directly, TEOs can shift certain legal obligations to the general partner. Most importantly, the general partner would perform the due diligence on whether each PRI would not only offer good investment prospects but also would further the charitable objectives of the TEOs participating as limited partners. The TEOs could focus on selecting talented and trustworthy general partners, as well as restricting the scope of the partnership to PRIs in the relevant substantive areas.

If the TEO carefully selects a qualified firm and restricts the partnership's scope, the delegation of the PRI function to a general partner is legally permissible. Nevertheless, there are several potential drawbacks to TEOs investing through limited partnership. First, debt-financed income from limited partnerships is taxed as unrelated business income. This unfortunate result can be avoided if the partnership holds only PRIs or otherwise engages in sensible tax planning. Second, acquiring PRIs through a limited partnership would mean that a TEO loses much of its discretion in picking and choosing among specific PRIs. While some TEOs may be glad to give that discretion to the general partner, other TEOs might want to participate more in each of the investment decisions of the pool—at least as to charitable fit. Third, in a related matter, acquiring PRIs through a pool raises legal and practical questions about how the private foundation or public charity can fulfil its expenditure responsibility to ensure that all pool investments are in fact PRIs consistent with the missions of these TEOs. This responsibility can be effectively met by establishing an advisory committee to the general partner of the pool—comprised of representatives from the investing TEOs and relevant domain experts. The general partner would seek the committee's input before making PRIs and would periodically report on their progress to the committee. Finally, and most fundamentally, every investment pool by its very nature involves multiple parties with different objectives and their own legal constraints. Although some pools for PRIs may limit their investors to TEOs, there can be significant differences in approach among various types of charities. Other pools for PRIs may allow a broader range of investors. For example, pools for PRIs in community development for low-income families may include banks seeking to fulfil their obligations under the Community Reinvestment Act and public pension funds engaged in social investing as well as private foundations and public charities. Given this multiplicity of interests, TEOs must be prepared to spend considerable time in negotiating the legal structure and financial issues involved in establishing and operating these pools for PRIs.

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