

IRS Attacks Impact Investing With Flawed Logic: A Critical Review of the IRS Argument

Andrew M. Grumet, Jonathan S. Blum and Christina N. Cahill

On October 9th, the Internal Revenue Service released Private Letter Ruling 202041009 (the “Ruling”), which, in what many in the nonprofit community would have expected to be a relatively straight-forward exemption approval for a new 501(c)(3) nonprofit organization (the “Nonprofit”), resulted in not just a denial of the Nonprofit’s tax-exempt status, but, in some respects, a repudiation of impact investing as a whole, including program related investments (PRIs). While private letter rulings are only legally binding on the taxpayer that requested the ruling (in this case, the Nonprofit), these rulings are used by practitioners as a guide to IRS’s position on the application of the tax law. Thus, a negative IRS ruling is generally viewed as a warning to all others in similar circumstances.

All is not necessarily lost for the Nonprofit in the Ruling. The Nonprofit still has a variety of options to consider taking to continue its fight, which the authors of this article hope it will vigorously do. As the goal of this article is not to review all of the legal strategies one could take in the exemption process, we note that there are various options so readers know that this story may not be over.

Ruling Overview

The Ruling was prompted by the Nonprofit seeking a Determination Letter from IRS confirming that it qualifies for exemption as an organization described in Section 501(c)(3) of the Internal Revenue Code. According to the Ruling (which is heavily redacted to preserve the confidentiality of the actual applicant), the Nonprofit was formed:

Exclusively for charitable purposes, including, for such purposes, increasing the capital available to organizations that develop and/or operate (i) long term affordable housing for the economically and physically disadvantaged, (ii) community facilities such as schools and community health centers, (iii) businesses providing access to healthy foods, (iv) sustainable energy projects, (v) commercial real estate, and (vi) other projects that may increase social welfare.

The exempt purpose of the Nonprofit, more generally, is to “deploy capital into projects that promote a social good and that otherwise struggle to find financing in normal capital markets” in low income and underserved communities.

Capital for the Nonprofit’s work comes from impact investors, specifically in the form of equity investments in pooled

investment funds organized by the Nonprofit. The Ruling describes impact investors as “individuals and institutions who want to see that their funds accomplish positive social and environmental objectives and as a concomitant objective to earn financial returns and utilize capital to finance projects and organizations in line with the investors’ dual objectives”. While we recognize there are many different views on how to define an impact investor, this is the version used in the Ruling.

Unlike many determination requests from applicants in the exemption process, the Nonprofit had already begun conducting activities prior to making its request for an IRS determination. Thus, the Ruling provides actual examples of activities undertaken by the Nonprofit, namely two funds that were already organized. The first was a loan fund focusing on preventative healthcare and social service investments in an effort to reduce costly acute care interventions. The initial projects included the provision of housing and social services for the chronically homeless and for individuals exiting incarceration to reduce recidivism and the prison population. The second loan fund targeted small-scale energy efficiency and clean energy project finance. In this case, initial projects included efficiency upgrades in non-profit affordable housing units and at a non-profit senior living facility. Both projects focused on lowering operating and utility costs. The Ruling describes the funds’ projects as “not commercially financeable”. In fact, in characterizing all of the investments made to date by the Nonprofit, the Ruling states:

These kinds of activities are not well supported by traditional capital markets. The activities are too niche, too small scale, or too low-return to draw the attention and resources of banks, venture capital and private equity funds, and public stock and bond markets.

The Ruling also describes, in brief detail, the manner in which the Nonprofit selects projects for investment, which includes both somewhat traditional investment due diligence considering both risk and return, as well as social and environmental impact screens. In order for the Nonprofit to become sustainable it charges a “substantially below market” management fee for its services to the investment funds it manages. To the extent the Nonprofit earns any funds in excess of its costs, which it endeavors to keep low by sharing space and services with its parent organization 501(c)(3) nonprofit organization, such excess is either invested into one or more of the funds or contributed to its parent.

Some other facts describing the Nonprofit’s activities include that: (a) it will likely be required to register with the Securities and Exchange Commission (SEC) as an investment advisor at some point, (b) no guarantees are made to investors that they will receive a “fair market return”, (c) “as of a couple of years ago” the Nonprofit was already managing assets, (d) no charitable deductions are offered to investors in the Nonprofit’s funds, despite the Nonprofit’s management activities being conducted in furtherance of its charitable mission, and (e) the Nonprofit’s model is projected to be successful, with substantial excess revenue over expenses by its third year of operations.

Questionable Application of Legal Precedent

In reviewing the law governing qualification for exemption in the Ruling, IRS relies on a variety of Treasury Regulations articulating both the “organizational test” and the “operational test”. The former requires that an organization be organized in a manner that qualifies for exemption; in other words, the governing documents must meet the literal requirements for exemption. The latter test, being the more complex of the two, requires that the organization engage primarily in activities that accomplish one or more of the organization’s exempt purposes.

The Ruling then proceeds to recite a series of Revenue Rulings from the late 1960s through the mid-1970s, as well as a number of court cases dating back to 1945. After analyzing the precedent, IRS ultimately determined that the Nonprofit fails to qualify for tax-exempt status because it fails to satisfy the operational test for exemption, more specifically, that a substantial portion of the Nonprofit’s activities consists of managing funds for a fee that provide a market or near-market return for investors. In other words, more than an insubstantial amount of the Nonprofit’s activities further non-exempt purposes. As IRS characterizes the Nonprofit’s activities, the funds are open to any interested investors who expect market or near-market returns while also capitalizing on activities with a public purpose. Ultimately, IRS believes the Nonprofit’s

“charitable objectives or results are incidental to [its] business purposes of maximizing returns for [its] investors.”

While some of the authority underlying the IRS conclusion is on point, a number of the citations referenced may best be described as misguided or, at worst, far from applicable to the Nonprofit’s activities. For example, IRS compares the Nonprofit to an organization denied exemption in Revenue Ruling 69-528, where the organization provided investment services for a fee to other nonprofits in a manner similar to what is considered an unrelated trade or business when operated by a nonprofit organization. In contrast, the Nonprofit charged below-market fees for investments not made in common stocks, but in specifically curated projects that not only advance the Nonprofit’s exempt purposes but that would not otherwise be funded without the Nonprofit’s actions. IRS seemingly ignores the fact that the Nonprofit’s purposes were advanced by its investment in those projects, which were charitable.

IRS similarly cites Revenue Ruling 72-369 for the proposition that offering services at cost is not enough to qualify an activity as charitable. However, the Nonprofit is not providing general managerial and consulting services at cost like the organization in Revenue Ruling 72-369, but is rather providing below-market rates for its investment services as part of a package meant to increase the desirability of investment in exempt purpose projects that would not be funded otherwise. Again, these are projects that were otherwise not commercially financeable.

In Revenue Ruling 74-587, a nonprofit invests in economically depressed areas with loans tailored to business needs based on a primary goal of advancing charitable goals, as opposed to amassing profit. While some individuals and businesses receiving financial assistance from the organization may not qualify for charitable assistance, they are “merely instruments” in effectuating the organization’s exempt purposes. IRS contrasts this organization with the Nonprofit, stating that because the Nonprofit screens potential investments for both financial feasibility/risk and social/environmental impact, as well as charging fees and benefitting investors, the Nonprofit is primarily concerned with the rate of return. On the other hand, the Nonprofit will only invest if the exempt purposes screen is met, so the assertion that the Nonprofit’s investments are “first and foremost concerned with the risk and return potential” seems an unfair characterization based simply on the order of operations of the Nonprofit’s vetting methodology; IRS said form counts more than substance. Additionally, the activities of the organization in Revenue Ruling 74-587 are not without private benefit (to the individuals/businesses). There is no indication the loans are interest-free and there clearly is no requirement that the recipients qualify for charitable assistance.

The cases cited by IRS in the Ruling highlight the impact of the commerciality doctrine on the exemption analysis, which is somewhat murky in practice but basically equates to the fact that substantial commercial activity, as defined based on all relevant facts and circumstances, must be in furtherance of a nonprofit's exempt purposes in order to be acceptable. Various court cases over time have enumerated different facts and circumstances to be weighed, but a few commonly cited examples include whether the activity competes with for-profit enterprises, as well as how the activity is priced, advertised and funded. IRS believes the Nonprofit's activities are like those typically operated by commercial ventures, with funding solely from management fees and resulting in a high financial reserve advising against a finding of exemption. However, a comparison to B.S.W. Group, Inc. v Commissioner, 70 T.C. 352 (1978), for example, is not directly on point as the Nonprofit is not offering consulting services for high fees, but instead charges below-market rates and eschews a carried interest typical of fund managers, all designed to not generate a profit for the Nonprofit. It is operating to provide investments that otherwise are not offered in the market because they could not attract capital, even if there is the potential for market or near market returns. The lack of competition is, in a way, the reason the Nonprofit created the funds in the first place and is the basis of its exempt purpose. Other cases are cited by IRS, including Airlie Foundation v. Commissioner (283 F. Supp 2d 58 (D.D.C., 2003) and Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991), in order to continue the competition argument, as well as to point to revenue from investment fees (as opposed to donations) and a projected high financial reserve as counseling against exemption. However, the Nonprofit invests any reserve back into its exempt projects or donates the funds to its parent 501(c)(3) organization. Additionally, based on the facts provided in the Ruling, it is a bit of a stretch to compare the Nonprofit's "promotional efforts," described as a publicly available brochure and offering documents accompanying the private funds that would be required by securities laws, with the wide-spread advertising and "commercial catch phrases" used to promote the restaurants and health food stores run by Living Faith, Inc.

Ultimately, the facts and circumstances of the Nonprofit's activities do not fit neatly with the precedents cited by IRS, which means there seems to be a significant basis for challenging the legal foundation for the position taken by IRS to deny the Nonprofit's exemption.

Tensions with Established Impact Investing Practices

In addition to applying flawed logic to the facts as presented, the Ruling seems to indicate a discomfort with the very types

of activities that drive impact investing, including program-related investments (PRIs) made by private foundations. The Ruling provides a definition of impact investing that highlights dual objectives of positive social and/or environmental good and financial returns, such that the investment is not exclusively about generating profit. Nonprofits have long engaged in impact investing, sometimes termed "mission related investments (MRIs)" and IRS has declined to penalize nonprofit organizations for investments made with a charitable mission in mind that may offer lower returns than standard investment alternatives.

The tax law explicitly blesses PRIs, on the other hand, with private foundations authorized to treat amounts expended in connection with PRIs as part of their required 5% minimum distribution requirements and without being considered imprudent from an investment perspective. The Treasury Regulations define PRIs as investments characterized by a primary purpose to advance exempt purposes, without a significant purpose of production of income or appreciation of property. The actual production of significant income or appreciation, however, is not, in and of itself, considered evidence of a significant purpose involving the production of income. In fact, an investment is considered to be made primarily to accomplish exempt purposes if it significantly furthers the accomplishment of the nonprofit organization's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the exempt activities. A relevant consideration is whether investors solely focused on profit would make the investment on the same terms.

The Ruling stands in stark tension with PRIs and the larger impact investing environment, as the PRI criteria seem to directly echo the facts in the Ruling. The Nonprofit created "not commercially financeable" funds in furtherance of its exempt purposes, as typical capital markets were not an option due to the "niche," "small-scale," and "low-return" nature of the investments. In short, the investments further the Nonprofit's purposes and would not have been made but for the Nonprofit's efforts. While the Nonprofit was able to provide market or near-market returns to its investors, in the PRI context, the mere creation of profit is not enough to villainize the investment itself. IRS makes much of the Nonprofit's cost-saving efforts, which again, are not enough to make profit the primary motive. Similarly, evaluating potential investments for both risk and social impact does not automatically mean a PRI is not in furtherance of exempt purposes, nor should the assumption be made about the Nonprofit's activities simply because the possibility of a return is considered. While the investors in the Nonprofit's funds may have entertained any number of reasons for investing in the Nonprofit's projects,

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the Nonprofit offers no promises or expectations to investors about market returns and focuses instead on furthering its exempt purposes in innovative ways.

Additionally, there is no requirement that a PRI, or for that matter, charitable activities, only benefit a recipient that would otherwise qualify for charitable assistance, though IRS cites this as a reason against exemption. Lastly, as noted, PRIs are not considered to have a primary profit motive simply because they happen to be a good investment with market or near-market returns. Characterizing the Nonprofit's activities as "trying to secure the highest returns possible for your clients" misses the greater context in which the Nonprofit is operating, namely in a space where projects in furtherance of exempt social and environmental purposes would not otherwise get done.

IRS is also uneasy about the fact that investors, including the general public as opposed to simply exempt organizations, can (and are) benefitting from the Nonprofit's investments. However, in the PRI context, the private enterprises that receive support are most certainly benefitted, but so are exempt purposes furthered. On the other hand, PRI returns are required to be recycled by the investing private foundation for charitable purposes. Perhaps the decision in the Ruling would have come out differently had the Nonprofit's management activities been funded through donations as opposed to below-market fees, but the arguments made by IRS strain against the backdrop of established PRI regulations.

The Ruling may result in the curbing of creative fundraising of third-party dollars by nonprofit organizations striving to provide much-needed capital for exempt-purpose facilities and services when facing a dearth of traditional funding options. One of many dangers with this approach is a reduced ability for nonprofits to court or work with outside funding that is not a charitable donation, grant or loan, which, in turn, will reduce the probability that many difficult-to-fund projects with immense social good will ever be started. While IRS may have legitimate arguments in favor of such restrictions, the reasoning provided in the Ruling is not altogether convincing.

Strategic Nonprofit Solutions Team



Andrew M. Grumet
Shareholder | Practice Chair
agrumet@polsinelli.com



Virginia C. Gross
Shareholder
vgross@polsinelli.com



Christina N. Cahill
Associate
ccahill@polsinelli.com



Douglas K. Anning
Shareholder
danning@polsinelli.com



Thomas J. Schenkelberg
Shareholder
tschenkelberg@polsinelli.com



Nicole P. Ribeiro
Director of Strategic
Philanthropy
nribeiro@polsinelli.com



Jonathan S. Blum
Shareholder
jblum@polsinelli.com



Lisa M. Schultes
Senior Partner
lschultes@polsinelli.com



Erica R. Seaborne
Manager of Strategic
Philanthropy
eseaborne@polsinelli.com

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