Impact Investing and Private Foundations

Laws Under Which Private Foundations Operate

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Who Is Impacted by these Rules?

- Private Foundations ("PFs"): Many PFs want to invest their funds through impact investing
  - PFs have an estimated $732 Billion of investment assets
  - From 2000 – 2010, around 400 foundations invested $3.4 Billion in so-called program-related investments ("PRIs"), a specific type of impact investment that enjoys special tax treatment for PFs.
  - Gates Foundation has set aside $1.5 Billion to fund PRIs
  - MacArthur Foundation has set aside $.5 Billion to fund PRIs
  - Numerous other high profile foundations are actively using PRIs, including the Heron Foundation, Rockefeller Foundation, Wal-Mart Foundation, Ford Foundation, and Packard Foundation, to name a few
- For-Profits: For-Profits that seek capital may turn to PFs as a source of funds
  - L3Cs were originally created to attract PRIs
  - Benefit corporations and B corporations often seek PRIs
- Public Charities: Charities also seek capital through PRIs and/or use the PRI guidance to engage in impacting investing

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Section 4942 Minimum Distribution Requirement

- Section 4942 imposes an annual “minimum distribution” requirement on PFs
  - A PF must make annual “qualifying distributions” equal to approximately 5% of the FMV of the PF’s assets
  - Qualifying distributions must be made by end of the following tax year (2016 obligation is due by the end of the 2017 tax year)
  - Qualifying distributions include grants for exempt purposes and related administrative expenses
  - Qualifying distributions also include PRIs
  - Failure to satisfy Section 4942 results in imposition of 30% excise tax on the “undistributed income”

Section 4943 Excess Business Holdings

- Section 4943 imposes limitations on the maximum amount of a business interest a PF may own
  – PFs and “disqualified persons” may not own more than a 20% interest in a for-profit business
  – 2% de minimis exception
  – 5 year rule for gifts
  – PRIs are not subject to the limitations under Section 4953
  – Failure to satisfy Section 4943 results in imposition of 10% excise tax on the excess business holdings

Section 4944 Jeopardizing Investments

- Section 4944 imposes a “prudent investor” standard on PFs
    - Must exercise ordinary business care and prudence in providing for the long and short term financial needs of the foundation to carry out its exempt purposes.
  - Effectively prohibits overly risky investments
  - No per se prohibitions, but certain investments scrutinized:
    - Trading in securities on margin, commodity futures, investments in working interests in oil and gas wells, the purchase of “puts,” “calls,” and “straddles,” the purchase of warrants, and selling short
  - Encourages diversification and sound investments
  - Requires consideration of risk and reward
  - PRIs are not subject to Section 4944 standard
  - Failure to satisfy Section 4944 results in imposition of 10% excise tax on the amount of the investment

Section 4945 Taxable Expenditure Rules

- In general, Section 4945 restricts a PF's grants to non-public charities:
  - Applies to grants to other PFs, non-501(c)(3)s and for-profits
  - Such grants are basically prohibited unless the PF exercises "expenditure responsibility" (additional due diligence)
    - Pre-grant inquiry, written grant agreement, grantee reporting, disclosure on Form 990-PF
- PRIs are typically investments in a non-public charity and thus subject to the expenditure responsibility rules
- Failure to satisfy Section 4945 results in imposition of 20% excise tax on the amount of the grant

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UPMIFA

- Uniform Prudent Management of Institutional Funds Act ("UPMIFA")
  - UPMIFA is a uniform act that provides rules and guidance regarding the investment of "endowment funds"
    - Endowment funds are funds that under the terms of a gift instrument are not wholly expendable by a foundation on a current basis
    - Endowment funds do not include any board restricted or board designated funds
  - UPMIFA imposes prudent investor standard
    - Managers may take into account any special relationship between a proposed investment and the organization's charitable purposes
    - UPMIFA generally does not apply to PRIs

Duty of Care

- A board member shall discharge his or her duties as a director in good faith, with the care of an ordinarily prudent person and in a manner the director reasonably believes to be in the best interests of the corporation
- Directors should pay attention to fiscal matters, conscientiously decide matters that come before them, and serve as a check or veto on management

Duty of Loyalty

- A board member shall act and make decisions in the interest of the corporation rather than in own personal interest or interest of others (including other entities to whom the director also owes duties)
- Protect the confidentiality of corporate information
- Recusal from discussions with respect to matters as to which a director has a personal interest

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Duty of Obedience

- Duty to fulfill the organization’s mission and purposes
- Duty to follow the law and the organizational documents