

Program Related Investments

THE JFN EDITION OF THE GUIDE BY
MISSION INVESTORS EXCHANGE

Funded by the Max M. & Marjorie S. Fisher Foundation



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Foreword to the JFN edition

Over the next 25 years, an estimated \$35 trillion in wealth will transfer to the next generation of families in the U.S. alone. At the same time, however, we confront increasingly urgent and complex challenges: mass migration, education and achievement gaps, climate change, hunger, poverty, and lack of access to basic needs.

Including those who live inside the issues we hope to face together, philanthropic foundations play a vital role in catalyzing new solutions to these problems. By funding innovative research, the development of new solutions, and the measurement and evaluation of their impacts, philanthropies can take risks where government and commercial capital will not.

To bridge the sizeable resource gaps, foundations must harness all of their resources – financial, human, and intellectual – more effectively. Private foundations are finding ways to maximize the impact of their grant dollars by making program-related investments (“PRIs”). PRIs are powerful, versatile tools that allow foundations to achieve their philanthropic goals alongside traditional grant-making. By deploying PRIs, foundations can leverage their financial resources and balance sheets more effectively than through grant-making alone.

PRIs are often used to stimulate innovation driven by the private-sector, to encourage market-driven efficiencies, and to attract external capital to priority initiatives. PRIs prove particularly valuable when grants alone are not enough to bring a solution to scale, or when a time-limited infusion of capital is needed to jumpstart, grow, or sustain a social enterprise. Unlike grants, PRIs return capital which can be redeployed to amplify impact.

The Max M. & Marjorie S. Fisher Foundation’s core mission is to strengthen and empower children and families in need. Our impact-investing strategy includes leading alongside others by investing in individual deals, participating in collaborative investments with seasoned impact investors, and accelerating the field by investing in opportunities that create on-ramps for new impact investors.

Given the significance of the number 18 in the Jewish tradition (the number 18 in Hebrew is *chai* which denotes life), in 2012 the Fisher Foundation dedicated itself to deploying 1.8% of assets in impact investing. In late 2015, our board doubled the target to 3.6% (twice *chai*) of existing assets, bringing our total commitment to nearly \$10 million.

If you have already started your journey in impact investing, we hope this guide will fortify your efforts.

If you have not already started your impact investing practice, we ask you to consider committing a minimum of 1.8% of your asset base as a first step. It is far easier to act your way into a new way of thinking than to think your way into a new way of acting. Join us.

We are excited about the prospects of Program Related Investing and the broader field of Impact Investing. In that spirit, we hope this guide will encourage foundations reaching toward *tikkun olam* in the true spirit of *tzedakah* to make full and fruitful use of PRIs.

Douglas Bitonti Stewart
Executive Director
Max M. & Marjorie S. Fisher Foundation

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Funded by the Max M. & Marjorie S. Fisher Foundation

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Although Mission Investors Exchange has provided permission for the JFN edition, the supplements made are wholly written and reviewed by JFN, which takes full responsibility for the content presented herein.

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Introduction

In our day, the Hebrew phrase “*tikkun olam*” (repairing the world) has come to connote social action and the pursuit of social justice. In summoning a concern for human welfare, it has also come to inform Jewish philanthropy’s responsibility to work toward the betterment of our lives for present and future generations.

Yet the scale of community and global needs increasingly outstrips the supply of traditional philanthropic capital. Foundations are seeking new ways to bridge the gap. Private foundations are finding ways to maximize the impact of their grant dollars by making **program-related investments (“PRIs”)**.

PRIs are powerful, versatile tools that foundations use to achieve their philanthropic goals alongside traditional grant-making. Like grants, PRIs make inexpensive capital available to non-profit or for-profit enterprises that address social and environmental challenges. Unlike grants, PRIs are expected to be repaid, often with a modest, risk-adjusted rate of return.

By deploying PRIs, foundations can leverage their financial resources and balance sheets more effectively than through grant-making alone. They are particularly useful when grants alone are not enough to bring a solution to scale, or when a time-limited infusion of capital is needed to jumpstart, grow, or sustain a social enterprise, and when that capital can be used to generate new resources. PRIs are often used to stimulate private-sector driven innovation, encourage market-driven efficiencies, and attract external capital to priority initiatives.

Once repaid, the money used for a PRI is recycled into new charitable investments. In that sense, a PRI can be viewed as a more efficient use of philanthropic capital.

PRIs allow private foundations and other philanthropic organizations to move beyond grant-making to deploy a wide range of financial tools. By providing the right kind of capital at the right time to not-for-profit or for-profit enterprises, foundations can fuel innovation, promote sustainability, and address persistent social and environmental challenges. Foundations and other philanthropists use PRIs to protect environmental ecosystems, develop socially beneficial new products or services, and create jobs. They also use PRIs to fuel the growth of social enterprises, expand affordable housing, and construct facilities for social and cultural organizations.

PRIs allow foundations to:

- ▶ act as an important source of capital for innovative strategies that may take a market-based approach to solving social problems;
- ▶ mobilize assets in the present while preserving them for the future;
- ▶ leverage public and private funding;
- ▶ generate significant social and environment returns; and
- ▶ assist in bringing solutions to scale.

Likewise, PRIs help charitable organizations and other social enterprises:

- ▶ access growth capital;
- ▶ build organizational capacity;
- ▶ establish a credit history;
- ▶ bridge for expected funding in the future; and
- ▶ attract new investors.

Examples include:

- ▶ In 2012, Max M. and Marjorie S. Fisher Foundation made a \$200,000 7-year interest-free PRI to the Hebrew Free Loan (“HFL”). HFL uses interest-free lending to help people transform their lives. This form of Jewish philanthropy is rooted in an age-old teaching that the highest form of charity consists in helping people become self-sufficient. The Fisher Foundation’s PRI has to date allowed HFL to make 52 interest-free loans enabling people to attend college, graduate school, start or expand a small business, or meet emergency needs. HFL anticipates that the Fisher’s PRI will be recycled 250% before the loan comes to term in 2019.
- ▶ In 2011, the Rockefeller Foundation made a \$750,000 PRI to the Disability Opportunity Fund (“DOF”). DOF is a certified Community Development Financial Institution (“CDFI”) that provides technical and financial services to individuals and organizations serving the disability market throughout the U.S., with a focus on affordable housing, schools, and vocational training centers. In addition, DOF has earned a national reputation for being a leading advocate for better housing solutions for people with disabilities and their families.
- ▶ In 2014, the Gates Foundation in Seattle, WA made an equity investment of \$11 million in bKash, a joint venture between BRAC bank in Bangladesh and Money in Motion. The venture offers a banking solution to the poor, increases penetration of agents and product awareness in rural and underserved markets, and develops additional financial services to be supported by the platform. bKash now serves more than 110,000 merchants supporting 16.5 million customers and 70 million monthly transactions.

Yet for all the advantages inherent in PRIs, many foundations remain reluctant to make full use of this tool. This reluctance may result from lack of familiarity with PRIs, supposed limited demand (compared to grants), or questions about legal or tax-related requirements associated with making PRIs.

This publication seeks to address these concerns by providing a basic reference for private foundations and legal advisors concerning the regulations, processes, and documentation requirements related to PRIs. It offers information and guidance in navigating questions about what qualifies as a PRI, what types of documentation are important, and when external legal counsel may be needed. It also offers samples of legal documents that may be useful in developing, negotiating, or managing a PRI. This publication is also relevant to social investors and any other organizations or investors that want to understand the legal issues confronting private foundations in making PRIs. We hope that this guide will help foundations move forward in using PRIs to accomplish their goals and fulfill their missions of *tikkun olam*.

Executive Summary

What is a PRI?

A PRI (program-related investment) is a type of mission or social investment that foundations make in order to achieve their philanthropic goals. The term “program-related investment” comes from the Internal Revenue Code from legislation that was passed by Congress in response to the interest of private foundations in helping communities and enterprises without access to investment capital.

PRIs employ various financing methods, including loans (senior and subordinated), loan guarantees, lines of credit, linked deposits, cash deposits, bonds, equity investments, and other innovative forms of financing. Depending on the purpose and scope of the investment, a PRI may be relatively simple (such as a working capital loan to a non-profit organization or a cash deposit in a community bank) or complex (such as an equity investment in a for-profit enterprise).

Why Do Foundations Make PRIs?

Foundations and other donors make PRIs in order to expand the reach and impact of their financial resources. PRIs are often part of a larger philanthropic strategy that may include grants, PRIs, and market-rate mission-related investments (MRIs). In addition, PRIs offer certain tax advantages to private foundations, as described more fully below. To benefit from these tax advantages, an investment must satisfy certain technical requirements to qualify as a PRI for tax purposes.

To qualify as a PRI:

1. The primary purpose of the investment is to accomplish one or more of the charitable, religious, scientific, literary, educational, and other exempt purposes described in section 170(c)(2)(B) of the Internal Revenue Code (the “Code”);
2. No significant purpose of the investment is the production of income or the appreciation of property; and
3. No purpose of the investment is to lobby, support, or oppose candidates for public office or to accomplish any of the other political purposes forbidden to private foundations by section 170(c)(2)(D) of the Code.

In addition to private foundations, other types of philanthropic foundations or donors make programmatic, or PRI-like, investments. PRIs are used as an effective tool to achieve a targeted goal, and are best used when it is expected that the recipient of funds will be able to repay the investment (often with a moderate, risk-adjusted rate of return).

How are PRIs Used?

PRIs are used for all kinds of charitable purposes, including affordable housing, arts, community development, cultural organizations, historic preservation, economic development (including entrepreneurship and micro-businesses), charter schools, health clinics, childcare centers, renewable and access to energy organizations, faith-based structures and programs, social services, sustainable agriculture, fisheries and forestry, and wildlife habitat protection. They are used to fund capital projects, bridge loans, and loan funds; to support microfinance institutions and promote economic development through loans to small and medium-sized businesses; to help organizations acquire property; to create jobs; and to develop new products or expand services.

What is the Right Size and Duration for a PRI?

PRIs range in size from \$1,000 to several million dollars. Generally, the amount of the PRI depends on the need and capacity of the recipient, the scope and size of the foundation, and the foundation's risk tolerance.

There are no limits on the duration of a PRI. PRIs commonly vary from several months to five years or longer. For example, a foundation may establish a revolving fund to provide short-term bridge payments that must be repaid within a few weeks. Conversely, PRIs may be used to support a multi-year community development project or fund a new business that requires long-term, patient capital.

Rate of Return and Repayment

The expected rate of return on a PRI is generally based on the borrower's needs and ability to make principal and interest payments over a specified period of time. But at the time the investment is made, the rate of return must be expected to be below prevailing market rates on a risk-adjusted basis in order for the investment to qualify as a PRI for tax purposes.

Required Documents

The type and level of documentation for PRIs varies depending on the purpose and the type of investment. To establish that an investment qualifies as a PRI for tax purposes, it is important to have an award letter that documents the charitable purpose of the transaction at the time the PRI was made. The primary document for a PRI made as a loan is the credit agreement, but background documents from the borrower will generally also be needed. Promissory notes and other certificates may also need to be provided and can either be included in the credit agreement as exhibits or be provided separately.

How are PRIs Reported?

Private foundations list PRIs on their Form 990-PF to mark the transactions as charitable activities. This

allows PRIs to be counted as part of a foundation's minimum payout in the year of distribution. Outstanding PRIs remain on a foundation's balance sheet as a separate asset category until they are repaid or written off. Periodic adjustments may be made to the carrying value of PRIs depending on the likelihood of collection. Return of PRI principal is equivalent to a refund of a grant and thus increases the annual payout requirement by the amount of principal repayment. Foundations should also consider how they will report any interest income or earnings from PRIs. Other entities, including community foundations, social investors, and corporate giving funds may use the term "PRI" to refer to a concessionary investment for a charitable purpose, but these entities will generally not have to satisfy the specific requirements for the investment to qualify as a PRI for tax purposes. (See Appendix A for a discussion Financial Statements and Tax Treatment for Program-Related Investments.)

Why PRIs: Why funders may want to consider PRIs

PRIs provide a well-established mechanism for foundations to use different forms of financing, in addition to grants, to achieve their programmatic goals. Like grants, PRIs make affordable financing available to non-profit or for-profit enterprises to address social and environmental challenges. Unlike grants, PRIs are expected to be repaid, generally with a modest rate of return. Once repaid, these funds can be used for subsequent charitable investments.

PRIs employ an array of established financing mechanisms to help organizations and communities acquire property; create jobs; develop new beneficial products or services; build or preserve affordable housing or community facilities; improve public health, and for a host of other social purposes. Often, PRIs are made to share risks and/or to attract commercial investments. PRIs also serve as points of leverage to promote public-private partnerships and to allow social and environmental organizations to raise funds from private and commercial sources.

PRIs employ various financing methods, including loans (senior and subordinated), loan guarantees, lines of credit, linked deposits, cash deposits, bonds, equity investments, and other transactions designed to help charitable organizations and social enterprises access capital funding. These types of investments are not necessarily complex (e.g., granting a loan that supports a programmatic goal and qualifies as a PRI can be as simple as a promissory note with supporting documentation and would be considerably less complex than, for example, obtaining a mortgage for a home). For example, the Internal Revenue Service (“IRS”) has ruled that a high-risk investment in low-income housing with the primary purpose of financing the purchase, rehabilitation, and construction of housing for low-income persons qualifies as a PRI.¹ Similarly, an interest-free loan that enables a socially and economically disadvantaged person to attend college also qualifies as a PRI.²

Examples of institutions leading the way in PRIs include:

- ▶ The Ford Foundation uses low-cost loans, loan guarantees, and equity investments to strengthen the work of its grantees and to provide risk-capital for cutting-edge initiatives. As of 2015, the Ford Foundation had committed over \$600 million for PRIs. It sets aside an average \$25 million annually for new investments.³
- ▶ Since 1980, the Packard Foundation has made over 250 PRIs totaling \$750 million to organizations that support the mission of the Foundation and generate both social and environmental returns. In 2004, the Packard Foundation made a \$10 million loan to the Sea Change Investment Fund, a venture

1 Treas. Reg. § 53.4944-3(b), *Example 10*.

2 *Id.*, *Example 9*.

3 <http://www.fordfoundation.org/grants/program-related-investment>

capital fund created to promote sustainable seafood companies. The Foundation's loan helped Sea Change attract private equity investors, who put in an additional \$10 million. The PRI leverage was a decisive factor in the fund's ability to attract capital from private equity investors. Starting in 2006, the Foundation hired dedicated staff and established a \$180 million mission investment portfolio, managed independently from its endowment.⁴

- ▶ The Bank of America Charitable Foundation uses PRIs to invest in community development financial institutions (CDFIs) to strengthen markets, encourage entrepreneurial businesses, and seed opportunities for individuals and families to attain economic self-sufficiency. In 2010, the Bank of America Charitable Foundation extended \$13 million in credit to national non-profit ROC USA Capital, including a \$10 million revolving line of credit for short-term liquidity needs and a \$3 million PRI to meet long-term capital requirements. ROC USA Capital provides financing to residents of manufactured home communities to purchase the land under their homes from private community owners. Bank of America financing enabled ROC USA to lend to seven manufactured home communities with 420 homes in five states.⁵

Smaller family foundations have also included PRIs as part of philanthropic strategy:

- ▶ The AVI CHAI Foundation, established in 1984 in New York City by the late Zalman C. Bernstein, is committed to the perpetuation of the Jewish people, Judaism, and the centrality of the state of Israel to the Jewish people. The objectives of the foundation are to encourage those of the Jewish faith towards greater commitment to Jewish observance and lifestyle by increasing their understanding, appreciation, and practice of Jewish traditions, customs, and laws; and to encourage mutual understanding and sensitivity among Jews of different religious backgrounds and commitments to observance. To further its mission, the AVI CHAI Foundation has made over \$175 million in PRIs including a \$250,000 loan to Aleph-Bet Jewish Day School, a \$500,000 loan to Beth Yeshurun Day School, and a \$500,000 Loan to Boca Raton Jewish Community Center.
- ▶ The Jacob and Hilda Blaustein Foundation, incorporated in 1957 in Baltimore, MD, promotes social justice and human rights through its five program areas: Jewish life, strengthening Israeli democracy, health and mental health, educational opportunity, and human rights. The foundation supports organizations that promote systematic change; involve constituents in planning and decision making; encourage volunteer and professional development; and engage in ongoing program evaluation. In 2010, the foundation made a \$250,000 PRI loan at 2% interest for a term of five years to the Koret Israel Economic Development Fund. The PRI provides loan capital for the expansion of the micro-finance fund for low-income women in Israel.

4 <https://www.packard.org/what-we-fund/program-related-investments/>

5 <http://ahead.bankofamerica.com/supporting-communities/bank-of-america-announces-second-year-results-of-10-year-1-5-trillion-community-development-lending-and-investing-goal/>

1 U.S. Federal Tax Considerations

When a private foundation makes a program-related investment, it generally needs to ensure that the investment qualifies as a PRI for U.S. federal tax purposes in order to realize several important tax benefits. These tax benefits are generally so important to a private foundation that the private foundation must ensure that a proposed program-related investment qualifies as a PRI for tax purposes before it commits to making the investment.

The first benefit is a “safe harbor rule” that protects foundations and their managers from a punitive excise tax.⁶ Under the Code, private foundations and their managers are subject to a punitive excise tax if they make improper investments that jeopardize the carrying out of any of the foundation’s exempt purposes.⁷ Investments that fail to provide for the long-term and short-term financial needs of a foundation because they do not provide for an adequate risk-adjusted financial return may be treated as jeopardizing investments that trigger this excise tax. Because a program-related investment by a foundation is made primarily for programmatic purposes rather than for financial gain, foundations typically make these investments on favorable terms in support of the recipient’s venture. Such an investment may therefore be subject to this punitive excise tax, unless it qualifies for the specific exemption available for PRIs.⁸

In addition to offering “safe harbor,” a PRI carries several other important benefits.

- ▶ **Qualifying Distribution.** To avoid the imposition of an excise tax due to a failure to distribute sufficient income,⁹ a private foundation must make a minimum 5% annual distribution. Because PRIs constitute qualifying distributions, the amount that a private foundation expends on PRIs counts towards this 5% distribution requirement.¹⁰
- ▶ **Charitable Use Asset.** While outstanding, the PRI is treated as a charitable-use asset.¹¹ It is therefore not included in total assets considered for calculating the amount of the foundation’s annual 5% distributable amount.¹²
- ▶ **Exemption from Excess Business Holdings Tax.** The recipients of PRIs are excluded from the definition of “business enterprise” under Section 4943 of the Code. Therefore, PRIs are not subject to the penalty tax on the excess business holdings of a private foundation.¹³

In the year when a PRI is repaid or redeemed, or proceeds are received by the foundation, the proceeds are included as part of the foundation’s annual distributable amount.¹⁴

Proceeds must therefore be reinvested as a new PRI or other qualifying distribution. If the foundation earns an investment return from the PRI, it will need to determine how to treat that investment return

6 I.R.C. § 4944.

7 I.R.C. § 4944.

8 I.R.C. § 4944(c).

9 I.R.C. § 4942(a).

10 Treas. Reg. § 53.4942(a)-3(a)(2)(i).

11 I.R.C. § 4942(e).

12 Treas. Reg. § 53.4942(a)-2(c)(3)(ii)(d).

13 Treas. Reg. § 53.4943-10(b).

14 I.R.C. § 4942(f)(2)(C).

(as discussed in greater detail in Section 1.3 below). Private foundations should also consider the rules against self-dealing when making a PRI (as discussed in Section 1.4 below).

1.1 Qualifying as a PRI

To qualify as a PRI, the programmatic investment must satisfy three conditions:¹⁵

- i. The primary purpose of the investment must be to accomplish one or more of the foundation's exempt purposes;
- ii. No significant purpose of the investment is the production of income or the appreciation of property; and
- iii. The investment must not be made for lobbying or other improper political purposes.

1.1.1 Primary Purpose

The primary purpose of the investment must be to accomplish one or more of the foundation's exempt purposes.

This requirement will be satisfied if two subtests are met: (i) the investment "significantly furthers" the accomplishment of the private foundation's exempt activities, and (ii) the investment was only made because of its connection with accomplishing the foundation's exempt activities.¹⁶ In general, to satisfy the first "significantly furthers" subtest, a foundation should review its own organizational documents and operating rules to determine whether a PRI is consistent with its programmatic mission. The foundation should also ensure that the PRI promotes one of the charitable purposes permitted under Section 501(c)(3).

Investments will not satisfy this first requirement merely because the income generated by the investment will be used for exempt purposes¹⁷. Instead, the investment itself must bear a relationship to the foundation's programmatic interests. For example, in one ruling, a private foundation invested part of its assets in a limited partnership that traded in futures and commodities.¹⁸ The limited partnership was also owned by an endowment fund for a public charity. Although the limited partnership was owned by tax-exempt organizations and predominantly all of its income was allocated to the endowment fund, the IRS ruled that the investment by the private foundation in the limited partnership was solely to produce investment returns rather than to serve the programmatic goals of the foundation, and, therefore, did not qualify as a PRI.

15 Treas. Reg. § 53.4944-3(a)(1).

16 Treas. Reg. § 53.4944-3(a)(2)(i).

17 Treas. Reg. § 53.4944-3(b), *Example 7* (investment in common stock of taxable corporation does not qualify as PRI merely because dividends are used to fund charitable and programmatic activities).

18 T.A.M. 200218038 (Apr. 23, 2001).

The requirement to support an exempt purpose does not mean that PRIs are restricted to not-for-profit organizations. PRIs may be made in for-profit corporations and enterprises.¹⁹ Regardless of the status of the recipient, however, when making a PRI, it is advisable for a foundation to document the reasons for making an investment and explain how the investment furthers its charitable and programmatic goals. This type of documentation is particularly important when a foundation is making a PRI that may earn a substantial investment return. Evidence of a strong investment return after the fact might be used to cast doubt on the motive and purpose of the foundation in deciding to make the investment, even if the investment had been considered unlikely to generate a high return at the time of making the PRI.

1.1.2 No Significant Investment Purpose

No significant purpose of the investment is the production of income or the appreciation of property.

This requirement can be satisfied if the investment is made on terms that provide for a rate of return lower than would likely be the case if the investment were made by investors solely seeking a profit.²⁰ In general, an investment that is expected to generate a market rate of return will not qualify as a PRI, even if the investment serves a charitable purpose. For example, the IRS held that investments by a private foundation in a camp rental facility for use by a public charity for emotionally disturbed and delinquent children did not qualify as a PRI when the foundation charged a commercial rate of rent for the facility.²¹ In that ruling, the IRS rejected the foundation's argument that the investment should qualify as a PRI because the foundation had agreed that it would only charge rent to the charity if government funds were available to the charity to pay for the rent, and that the rental income would only be used to make capital investments in the camp.

In many circumstances, this second requirement can be satisfied by providing for a below-market rate of return or a lower rate of return than what profit-seeking investors would demand, taking into account the riskiness of the investment and (in case of a loan) the creditworthiness of the borrower. Some private foundations reportedly use the long-term rate of inflation plus 1% as their targeted investment return to satisfy this requirement.²²

19 Treas. Reg. § 53.4944-3(b), *Example 1* (investment in a small business enterprise in a deteriorated urban area qualifies as PRI); P.L.R. 8810026 (Dec. 8, 1987) (holding that a low-interest loan to a taxable insurance company qualified as a PRI when the insurance company was created to help charitable organizations obtain access to insurance coverage).

20 Treas. Reg. § 53.4944-3(a)(2)(iii).

21 T.A.M. 8023005 (Feb. 13, 1980).

22 Guide to Impact Investing, Grantmakers in Health, May 2011, available at http://gih.org/usr_doc/GIH_Guide_to_Impact_Investing_FINAL_May_2011.pdf. The Gaylord and Dorothy Donnelley Foundation determines the rate of interest on a loan based on the long-term rate of inflation (20-year rolling average) to satisfy the "no significant investment purpose" standard. The Gaylord and Dorothy Donnelley Foundation staff compares the long-term inflation rate to the risk-adjusted prime rate to verify that the long-term inflation rate is lower than the prime rate, and then charges the long-term inflation rate. (Communication with Tom Trinley of the Gaylord and Dorothy Donnelley Foundation, January 17, 2012.)

In several rulings, the IRS has confirmed that this requirement can be satisfied even when a private foundation makes an equity investment on the same terms as individuals or non-charitable organizations.²³ In each case, however, the private foundation established that the investment was not expected to generate a risk-adjusted market rate of return.²⁴ In general, foundations that seek to make a PRI on the same terms as individuals or non-charitable foundations should seek advice from outside counsel to determine if the investment qualifies as a PRI. One common strategy is for the foundation to request an Opinion Letter from outside counsel stating that a particular investment qualifies as a PRI.

1.1.3 No Lobbying or Improper Political Purpose

The investment must not be made for lobbying or other improper political purposes.

This third requirement can be satisfied by documenting the borrower's activities and including restrictions in the PRI documents that prohibit the use of the funds for lobbying or political purposes.

1.1.4 Changes in PRIs: Retesting Investments Following Change

If a change is made to the terms of a PRI, the investment should be retested to ensure that it continues to qualify as a PRI. Provided the changes are made primarily for exempt purposes and do not have a significant investment purpose, the investment should continue to qualify as a PRI.²⁵ A change that is made for the prudent protection of the foundation's investment will not normally cause the investment to cease to qualify as a PRI. For example, the IRS ruled that a loan that (i) changed from a construction and operating loan to a loan that could only be used to fund operating deficits, and (ii) decreased in the amount, continued to qualify as PRI.²⁶

A "critical change in circumstances" may cause an investment to cease to qualify as a PRI, such as serving an illegal purpose or serving the private purpose of the foundation or its managers.²⁷ Under these rules, however, the investment will not be treated as a jeopardizing investment for purposes of the excise tax if the foundation terminates the investment within 30 days after the foundation (or its managers) has actual knowledge of the critical change.

23 P.L.R. 8710076 (Dec. 10, 1986) (investment in limited partnership interests qualified as a PRI when investors included a small group of private foundations and individuals); P.L.R. 200610020 (Mar. 10, 2006) (investment in membership interests of LLC qualified as a PRI when members of LLC included a restricted number of qualifying individuals).

24 See, e.g., P.L.R. 8807048 (Nov. 23, 1987) (holding that equity investment in a holding company, on the same terms as other investors, satisfied the "no significant purpose" requirement for a PRI in part because total return was capped at 5%).

25 Treas. Reg. § 53.4944-3(a)(3)(i).

26 P.L.R. 8637120 (June 19, 1986).

27 Treas. Reg. § 53.4944-3(a)(3)(i).

1.1.5 Considerations for Seeking a Private Letter Ruling (“PLR”) from the IRS

Because of the time and expense involved in obtaining a formal ruling from the IRS on an investment qualifying as a PRI, private foundations typically make their own determination as to whether these three conditions are satisfied or rely on advice of outside counsel rather than seeking a ruling from the IRS.

U.S. Treasury Regulations provide several examples of the types of investments that qualify as PRIs. On April 19, 2012, the Department of Treasury and the IRS released proposed regulations providing new guidance to private foundations regarding PRIs. The proposed regulations introduce nine modern-day examples of PRIs that satisfy the tests of Internal Revenue Code Section 4944. These new examples, as well as the statements of principle articulated in the preamble to the proposed regulations, are welcome as much for their specific findings as for the signal that they send to private foundations that the IRS considers PRIs to be a valid tool for private foundation charitable activity.

Section 4944(c) of the Internal Revenue Code, which defines PRIs, has not changed since it was first enacted as part of the Tax Reform Act of 1969. The PRI regulations, promulgated in 1972, have not been amended or supplemented until recently. The regulations were designed to provide real-life examples of what large private foundations were doing at the time. For the most part, foundations were making loans rather than equity investments; they were making these loans domestically, and the loans were made in deteriorating urban communities. Virtually all of the guidance since the 1972 regulations has been in the form of nonbinding published private letter rulings issued to individual foundations.

Including new examples in the tax regulations, as opposed to scattered non-precedential private rulings, should facilitate PRIs by reducing uncertainty in the field and providing a greater number of foundations and their advisors with information regarding the different investment possibilities.

The proposed regulations do not modify the existing regulations. Instead, they offer nine new examples of the wide range of investments that may qualify as PRIs. All nine examples (numbered 11 through 19 to follow the ten examples already included in the existing regulations) demonstrate favorable fact patterns; in each case, the IRS concluded that the investment is a PRI.

The preamble to the proposed regulations reflects the Treasury and the IRS’ interest in making private foundations more comfortable engaging in PRIs. After summarizing the requirements to qualify as a PRI, the preamble states that the proposed regulations are being issued because “[t]he existing examples focus on domestic situations principally involving economically disadvantaged individuals and deteriorated urban areas. The Treasury Department and the IRS are aware that the private foundation community would find it helpful if the regulations could include additional PRI examples that reflect current

investment practices and illustrate certain principles.”²⁸ Examples included in the U.S. Treasury Regulations have clarified that:²⁹

- ▶ if an activity is charitable in the United States, it is likewise charitable outside the United States;
- ▶ efforts to preserve and protect the environment are deemed charitable;
- ▶ recipients of PRIs need not be within a charitable class (i.e., can be for-profit entities) if they are the instruments for furthering a charitable purpose;
- ▶ providing credit enhancement may qualify as a PRI; and
- ▶ the use of an “equity kicker” should not disqualify an investment as a PRI.³⁰

Still, there is relatively little specific guidance on which investments qualify as PRIs. In contrast to public rulings, the IRS has issued publicly available PLRs to taxpayers regarding whether a specific investment qualified as a PRI.³¹ While PLRs provide useful insight into how the IRS has ruled on certain issues in the past and, therefore, how they might be likely to treat similar situations, only the taxpayer that requested the ruling may rely on the PLR.

The requirements for qualifying an investment as a PRI are factual and context-specific. The exempt purposes of a private foundation may evolve over time. Further, in many cases the requirement that a PRI have no significant investment purpose requires a private foundation to estimate the market rate of return for a given investment. This estimate will depend on the terms of the investment, the characteristics of the borrower or recipient, as well as general market conditions at the time. Given the fact-specific nature of this inquiry, private foundations that have little experience with PRIs, or that are seeking to make a new type of PRI, may want to obtain an opinion from outside counsel on qualifying the investment as a PRI. In other cases, the private foundation may be able to make this determination using its own staff and perhaps relying on precedents and know-how developed from making earlier PRIs.

1.2 Expenditure Responsibility: Making PRIs in For-Profit or Foreign Organizations

Many private foundations have made or are interested in making cross-border PRIs, as well as PRIs in recipients that do not qualify as Section 501(c)(3) organizations. When making a PRI to an Israeli organization, for example, that does not have a Section 501(c)(3) determination letter, the foundation generally seeks to ensure that the PRI will be treated as a qualifying distribution rather than a taxable expenditure under Section 4942.

28 <https://www.missioninvestors.org/system/files/tools/addendum-to-strategies-to-maximize-your-philanthropic-capital-a-guide-to-program-related-investments-primer-new-irs-guidance-on-program-related-investments-david-a-levitt-and-robert-a-wexler.pdf>

29 https://www.irs.gov/irb/2012-21_IRB/ar11.html

30 *Ibid.*

31 *Ibid.*

To ensure qualifying distribution treatment for a PRI in a foreign organization, the private foundation must either make an equivalency determination or exercise expenditure responsibility.³² Expenditure responsibility is also generally required when making a PRI in a for-profit organization. Exercising expenditure responsibility means ensuring that the PRI is used for charitable purposes. Making an equivalency determination means making a good-faith determination that the recipient of the PRI is the “equivalent” of a U.S. public charity. The rules concerning expenditure responsibility and equivalency determination are quite complex and technical. (An overview of these rules is provided in Section 8.2 of this report.)

1.3 Income and Gain Earned from PRIs: Treatment as Investment Income or UBTI

A private foundation generally will also have to consider how it will characterize any gain or income from a PRI for U.S. federal income tax purposes. While a return of principal will simply be treated as resulting in an increase in the foundation’s distributable amount for that year,³³ any income or gain beyond the principal investment will generally have to be specifically characterized. In particular, foundations should consider whether the income or gain will constitute investment income or unrelated business taxable income (“**UBTI**”).³⁴

Investment income is subject to a 1% or 2% excise tax,³⁵ while UBTI is subject to full U.S. federal income tax.³⁶ If an item of income is treated as UBTI, it will not be treated as investment income subject to the 1% or 2% excise tax.³⁷ Although a full discussion of the UBTI tax is beyond our scope here, a trade or business is treated as unrelated if it is not substantially related to the charitable or tax-exempt purposes of the organization.³⁸ A trade or business will be treated as substantially related to the charitable or tax-exempt purposes of the organization if the conduct of the business has a substantial causal relationship to the achievement of these purposes.³⁹

The IRS has not issued any public rulings on the issue, but it has ruled in several PLRs that income from PRIs will not constitute UBTI in a variety of different circumstances and types of investment.⁴⁰

32 If the foreign organization has a determination letter from the IRS, the foreign organization will be treated in the same way as a U.S. Section 501(c)(3) organization, and, thus, there will be no need for an equivalency determination or expenditure responsibility.

33 I.R.C. § 4942(f)(2)(C).

34 I.R.C. § 512(a)(1).

35 I.R.C. §§ 4940(a), (e).

36 I.R.C. § 511(a)(1).

37 I.R.C. § 4940(c)(2).

38 I.R.C. § 513(a).

39 Treas. Reg. § 1.513-1(d)(2).

40 P.L.R. 8310090 (Dec. 13, 1982) (lending activities of a private foundation were not treated as an unrelated trade or business when the foundation wanted to establish a revolving fund for loans to local charities); P.L.R. 8842067 (foundation’s ownership, operation, improvement and maintenance of hotel and restaurant on the grounds of a large game preserve and wilderness area did not produce unrelated income when the foundation intended to operate the preserve and wilderness area as a privately-owned state park that would be open to the public); P.L.R. 9226073 (Apr. 21, 1992) (rental income generated from land primarily leased to a religious order that would be primarily used to operate a treatment facility for Alzheimer’s disease was not treated as UBTI, and the property qualified as a PRI); P.L.R. 9608039 (Nov. 30, 1995) (income from a PRI loan to a public charity was not treated as UBTI when the loan was used to fund a limited partnership that was primarily devoted to developing a cure of a particular disease).

1.4 Acts of Self-Dealing in the Context of PRIs

When granting PRIs to recipients that have a connection with the private foundation, private foundations should be aware of the rules against “self-dealing” under the Code. Under these rules, transactions between private foundation and “disqualified persons” are subject to an excise tax.⁴¹ For these purposes, disqualified persons include foundation managers and substantial contributors, as well as persons and entities related to or controlled by foundation managers and substantial contributors.⁴²

There is an exemption from this excise tax when the disqualified person does not receive compensation for providing goods, services, or facilities that are used for valid charitable purposes.⁴³ Further, the excise tax on self-dealing will not apply if the benefit received by the disqualified person is “incidental or tenuous.”⁴⁴ The IRS has more than once ruled that this exception applies in the PRI context.⁴⁵

2 Private Loans and Promissory-Note PRIs

Although PRIs need not take the form of loans, most of them do. This is true despite the fact that the growth in equity PRIs is tangible, and the terms and conditions of these loans are relatively flexible. In structuring the commercial terms of a programmatic loan, a foundation should ensure that its loan will qualify as a PRI for U.S. tax purposes. PRI loans can either directly support charitable activities by providing a term loan or can be used to support a revolving loan fund used for purposes of charitable on-lending or investing. In general, the private foundation may only obtain credit for loans at the time that amounts are actually paid and transferred to the borrower rather than at the time a commitment is made.

This section describes the general commercial considerations for a foundation that wishes to make a loan that qualifies as a PRI.

41 I.R.C. § 4941(a)(1), (d)(1). Generally, transactions subject to these rules are any direct or indirect: (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (B) lending of money or other extension of credit between a private foundation and a disqualified person; (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person; (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and (F) agreement by a private foundation to make any payment of money or other property to a government official, other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.

42 I.R.C. § 4946(a). Most entities that qualify as exempt charities under Section 501(c)(3) are excluded from the definition of disqualified persons. Treas. Reg. § 53.4946-1(a)(8).

43 I.R.C. § 4941(d)(2)(C).

44 Treas. Reg. § 53.4941(d)-2(f)(2).

45 Rev. Rul. 85-162, 1985-2 C.B. 275 (no self-dealing when Bank that was disqualified person lent funds to same borrowers that received PRIs); P.L.R. 199906053 (Feb. 16, 1999) (holding that the purchase and development of real estate by a private foundation in an area where a company was located was not an act of self-dealing, when the company was a disqualified person, because the benefit to the company was incidental or tenuous); P.L.R. 199950039 (Dec. 20, 1999) (contribution of assets by private foundation to an LLC jointly owned by the private foundation and a disqualified person was not self-dealing because it primarily benefited the private foundation rather than the disqualified person).

2.1 Loan Types and Features

A PRI loan can include terms and conditions that (i) specify the timing, funding and repayments of any loans; (ii) provide for any guarantees or collateral to secure the loans; (iii) provide for multiple lenders to fund the loans; or (iv) set forth various priorities of payment among multiple creditors (via an intercreditor agreement). As discussed in more detail below, PRI loans can be, among others, stand-alone term loans, revolving loans or delayed draw loans.

2.1.1 Term Loans

Term loans are generally used for the financing of an acquisition or a particular project that is being consummated in conjunction with the signing of the credit agreement. The funds are typically drawn in a lump sum on the date the credit agreement is signed (or shortly thereafter) and repaid in regular installments pursuant to a schedule set forth in the credit agreement or in full on the maturity date. Once a term loan is drawn, the borrower may not make any further borrowings under the loan even if it has made payments toward the loan balance. Interest will be payable on the amount drawn either on a periodic basis or at maturity. The maturity date of term loans will vary by lenders and borrowers, but ranges typically between 3 and 10 years.

The Rockefeller Foundation, for instance, provides term loans with a maximum term of 10 years.⁴⁶ In contrast, the David and Lucille Packard Foundation currently provides term loans with a maturity of between 3 and 7 years.⁴⁷ Some foundations and other PRI lenders will only agree to provide term loans. The Bank of America Charitable Foundation currently only makes term loans to CDFIs.⁴⁸ These term loans typically match the loans or the long-term asset/liability plans of the borrowing CDFI.⁴⁹

2.1.2 Revolving Loans

Revolving loans are generally used for working capital purposes and to meet current payments, such as payroll, taxes and payments to suppliers. They are designed so that a lender commits to lend up to a stated maximum amount of funds. The borrower may then draw any amount under the loan, up to the maximum amount. Interest will be payable only with respect to the amounts outstanding. In addition, the payment of a commitment fee is typically required for any portion of the revolving loan that has not been borrowed.⁵⁰ Revolving loans may be repaid by the borrower as it receives cash (from its customers or

46 <https://www.rockefellerfoundation.org/strategic-approach/market-based-solutions/#program-related-investments>

47 <http://www.packard.org/what-we-fund/program-related-investments/how-to-get-support/>

48 http://www.bankofamerica.com/community/index.cfm?template=cdb_progrelinvest

49 *Id.*

50 The commitment fee would typically be less than the rate of interest on the outstanding loans, but is generally required to offset the lenders' obligation to keep any committed amounts available for the borrower.

otherwise) in the ordinary course of its business, and the borrower may re-borrow any amounts (up to the stated maximum amount of funds) from time to time until the maturity date. On the maturity date, all amounts borrowed and outstanding under the revolving loan must be repaid in full.

2.1.3 Delayed Draw Loans

Delayed draw loans are generally used for financing acquisitions, refinancings, or other limited-purpose projects. They permit a borrower to make several borrowings over a set period of time to utilize the full amount of the loan. Repayment occurs either through an amortization schedule provided in the credit agreement or in full on the maturity date. As with traditional term loans, the borrower may not re-borrow any amounts that have already been drawn and paid. However, similar to revolving loans, interest on the delayed draw loans will be payable only with respect to any amounts outstanding, and a commitment fee would typically be paid in respect of any portion of the delayed draw loan that has not yet been borrowed.⁵¹

Delayed draw loans are typically used when the borrower anticipates the need for a specific amount of funding in the near future. For example, if a foundation is providing a loan for the construction of a community center where payments are scheduled to be staggered according to completion of certain portions of the project, a delayed draw loan would allow the borrower the necessary flexibility to borrow under the loan in accordance with the staggered construction payments without paying interest on any amounts that have not yet been borrowed.

2.2 Process and Timetable

The lending procedure generally includes several stages. First, the foundation undertakes a preliminary review to assess the feasibility of delivering the desired social return and loan repayment.⁵² In the second stage, the foundation assesses whether the proposed loan satisfies the necessary requirements under the foundation's program rules and determines whether the proposed loan qualifies as a PRI for tax purposes. After completing this initial diligence, if the parties want to enter into the loan, they will enter a third stage: they define the terms and conditions of the loan (including whether any collateral or guarantees will be required), draft and

51 As with the commitment fee for a revolving loan, the commitment fee for undrawn amounts under a delayed draw loan would typically be less than the interest payable on such amounts were they drawn.

52 If the foundation is required to exercise expenditure responsibility for the loan, it will also have to ensure that the initial stage of diligence satisfies the requirement for making a pre-PRI inquiry, as described in Section 8.2.1(i) above.

negotiate the documents, and complete the due diligence review process.⁵³ In the closing and post-closing phase, the documents are signed and delivered, and the loan is funded.

2.2.1 Initial Review and Negotiation

Each foundation has its own internal approval process. This may require additional documentation from the borrower (such as prior tax filings and the borrower's organizational documents). Once the loan is approved, the terms may be memorialized in a commitment letter, which usually includes a term sheet specifying the material terms of the loan (e.g., amount of the loan, repayment terms, collateral, guarantees, conditions to closing, etc.). Although commitment letters are not required, they help in setting forth a clear understanding among the parties as to the terms of the credit agreement, and can be either binding or non-binding on either party. In a typical transaction, the lender (in this case, the foundation) will provide the form of the credit agreement and security documents, while the borrower will draft any certificates or corporate resolutions that may be necessary to complete the loan transactions.

2.2.2 Drafting and Review

The parties can begin drafting the credit agreement using the commitment letter and/or term sheet, if any, as a starting point. Because loans have been the most prevalent form of PRIs, large foundations have developed standard forms for documentation for various types of loans.⁵⁴ In addition to the credit agreement, promissory notes, officer's certificates and legal opinions may also need to be drafted (collectively, the "loan documents").

A credit agreement will typically contain specific representations and warranties from the borrower about its business, its financial statements, and the loan documents. These representations and warranties provide a snapshot of the borrower and are deemed to be made as of the closing date and, in the case of a revolving loan or a delayed draw loan, any future date on which the borrower makes a borrowing. If the borrower misrepresents its condition or if any of its representations or warranties is inaccurate or misleading, the borrower will be in breach of the credit agreement and the lender will be able to require full repayment of any outstanding amounts under the loan on an accelerated basis.

53 If the foundation is required to exercise expenditure responsibility for the loan, it will also have to ensure that the loan satisfies the requirement for a written commitment, as described in Section 8.2.1(ii) above, as well as that the loan documentation includes a requirement for the recipient to deliver reports to the foundation, as described in Section 8.2.1(iii) above.

54 Sample credit agreements from the Ford Foundation, the Conrad N. Hilton Foundation, and the Helen Bader Foundation, among others, are available at the Mission Investors Exchange website, available at <https://www.missioninvestors.org/>.

In the case of a PRI, the lender will sometimes not insist on the same set of representations and warranties that would be required by a commercial lender because the loan is program-related. To the extent the borrower does agree to representations and warranties, both the borrower and the lender should generally undertake a due diligence review to ensure that the borrower's representations and warranties are correct, true, and accurate.⁵⁵

2.2.3 Closing and Post-Closing

When the loan documents are finalized, and all of the pre-closing conditions (if any) in the commercial letter and/or the credit agreement are satisfied, the parties may proceed to closing. In a typical acquisition closing, several closings may occur at once. For example, if an organization is purchasing land to create a community park, the borrower will want to schedule the closing for the loan on or prior to the closing for the sale of the real estate, so that the funds are available for the acquisition. Typically, all documents will be signed prior to closing and delivered in escrow. Once all parties agree that all of their conditions precedent have been met, the documents will be released from escrow and circulated to all parties. At this point, the parties will commence the funding process, typically by electronic funds transfers. Certain conditions to a closing may not be under the control of the borrower or the lender. Obtaining certified charters, good standing certificates, third-party guarantees (if any), and lien searches, among others, will require the involvement of third parties and governmental agencies. Therefore, additional attention should be paid to the delivery of these documents and the satisfaction of these conditions prior to closing.

2.3 Principal Documents and Main Components

Foundations of all sizes should maintain records of documents received throughout the course of due diligence. The complexity of the documentation involved in setting up a loan varies. The primary document for a loan is the credit agreement, but background documents may also include requests or proposals to the foundation requesting the funding of a particular project, proof of tax-exempt status, etc. Promissory notes and other certificates may also need to be provided, and can be included in the credit agreement as exhibits or provided separately.⁵⁶

2.3.1 Commitment Letter

A commitment letter is an agreement (which could be binding or non-binding) by the lender to make loans to the borrower on specified terms, subject to the satisfaction of stated conditions

55 Samples of due diligence questionnaires and checklists are available on the Mission Investors Exchange website, available at <https://www.missioninvestors.org>.

56 Further information on types of loan documents can be found in David S. Chernoff, *Private Foundation Investments Program-Related Investments: A User-Friendly Guide*, Family Foundation Advisor, November/December 2005, at 3.

and the completion of satisfactory loan documentation. Typically, a commitment letter:

- ▶ describes the charitable purposes for which the loan is being made;
- ▶ either confirms the borrower's tax-exempt non-private foundation status or provides for the appropriate safeguards for the foundation to exercise expenditure responsibility (see Section 1.1.5 for a discussion of expenditure responsibility);
- ▶ requires that books and records be maintained;
- ▶ requires that annual financial and narrative reports and certificates of compliance be furnished;
- ▶ restricts the use of the loan proceeds for charitable (and other tax-exempt) purposes;
- ▶ prohibits the use of the loan proceeds for lobbying or influencing legislation or political campaigns; and
- ▶ contemplates the execution of a credit agreement at a later date.

As mentioned, the commitment letter will also often include a term sheet setting out the material terms of the loan, including the amounts and repayment terms of the loans, collateral, guarantees, and conditions to closing.

Some foundations, such as the Ford Foundation, have chosen to bypass the commitment letter stage in order to simplify the process.

2.3.2 Credit Agreement

The credit agreement is the primary agreement governing the relationship between the lender and the borrower. A credit agreement typically evidences one or more different types of loans, which may include revolving loans or term loans. Although there is no general form of credit agreement that is used by all lenders and borrowers in the United States,⁵⁷ the terms and conditions generally follow the same format and include the following provisions:

- ▶ **Defined terms:** sets forth the meaning of any defined terms in the credit agreement.
- ▶ **Mechanics and borrowing provisions:** sets forth the amounts and types of loans, the applicable interest rates, the applicable commitment fees, if any, and the mechanics of borrowings and repayments.
- ▶ **Conditions precedent:** sets forth the conditions to closing and funding.
- ▶ **Representations and warranties:** statements of fact with respect to the borrower's existence, financial condition, etc. as of the closing date and any future funding dates.

57 Contrast this with the LMA (Loan Markets Association) form that is often used by lenders and borrowers in Europe and Asia.

- ▶ **Covenants** (including affirmative covenants, negative covenants and financial covenants): promises by the borrower and/or guarantor to take or refrain from taking actions in the future.
- ▶ **Events of default:** events which, upon their occurrence, will permit the lender to terminate its commitment to lend, accelerate the maturity of all outstanding loans, and exercise its legal and contractual rights in respect of any collateral.
- ▶ **Miscellaneous:** standard provisions, including indemnity and payment of lender's expenses, requirements to amend the credit agreement, governing law, etc.

2.3.3 Loan Collateral and Credit Support

Lenders may require that the borrower provide some sort of credit support (e.g., collateral or a third-party guarantee) to support the borrower's obligation to repay the loans. A guarantee may either be provided in the credit agreement, where the documentation will bind the guarantor in the same way as the borrower is bound, or in a separate stand-alone guarantee agreement. Similarly, collateral can be provided either in the credit agreement or, more often, through a separate stand-alone security agreement.

Unlike the credit agreement, guarantees and security agreements are typically not heavily negotiated, as the majority of the provisions are necessary to give the lenders the rights they are entitled to under law. For example, a security agreement will include the following key elements: (i) the present grant of a security interest; (ii) the description of the collateral (which should conform to the definitions provided in Article 9 of the Uniform Commercial Code (the "UCC")); and (iii) the rights and remedies of the lender in respect of the collateral. There are, however, different forms of security agreements depending on the types of assets being secured.⁵⁸

Collateral can take the form of any assets in which the borrower has an ownership interest (currently and/or in the future), including owned or leased real estate, inventory, cash accounts, stock, and accounts receivable. While it is relatively inexpensive to obtain a security interest in the majority of assets, obtaining a security interest in certain assets (such as real estate, motor vehicles, securities, and intellectual property) involves filing fees and taxes that could make the cost of obtaining the security interest exceed the potential benefits to the lenders. As an alternative or for additional security, a lender can obtain a guarantee from a third party to be responsible for all or a part of the liabilities and obligations of the borrower. The guarantee may either be provided in the credit agreement, where the documentation will bind the guarantor with covenants and other provisions in the same way as the borrower is bound, or through a separate stand-alone guarantee

⁵⁸ Real estate security agreements, for instance, are often referred to as deeds of trust or mortgages (depending on the state in which the real estate is located), and security agreements in relation to the pledge of equity are often referred to as pledge agreements.

agreement, which can be entered into in connection with the borrower's liabilities under a particular credit facility.

It is important for the lender to confirm that a third party has not perfected a prior security interest in the same collateral. Otherwise, the lender faces the risk that the third party will have a prior claim on the collateral. A lender will typically obtain comfort with respect to its priority by (i) the borrower representing and warranting that there are no existing liens on the collateral; (ii) conducting lien searches in the appropriate state recording offices; and (iii) in some instances, obtaining legal opinions that the lender's security interest has been validly created and perfected. As conducting certain lien searches may take a few weeks or months to process, they should, therefore, be requested from the applicable recording offices early in the process.

In order for a lender to be able to enforce its security interest in the collateral, the lender must have a properly perfected security interest. Article 9 of the UCC (which has been adopted with minor modifications in all 50 states) sets forth the requirements to perfect a security interest.⁵⁹ There are three primary methods of perfection: (i) filing a UCC financing statement, (ii) obtaining possession of the collateral, and (iii) obtaining "control" of the collateral.⁶⁰

2.3.4 Promissory Notes

Promissory notes may be used to enforce the loan. Some lenders' internal policies require that the borrower deliver an original of the promissory note as evidence of the amount that has been borrowed under the credit agreement, and to entitle the lender, in certain instances, to expedited enforcement proceedings.⁶¹ Only one original of each promissory note should be executed at the closing (unlike the other loan documents which are executed in a sufficient number of counterparts so that all of the parties and their counsel can obtain original executed copies). Promissory notes evidencing revolving loans often attach a grid or schedule (in a paper or electronic version) on which the lender holding the note can make entries of the amounts of principal paid and re-borrowed from time to time so as to keep a record of the outstanding amount of the revolving loan.⁶²

59 As the perfection rules in Article 9 of the Uniform Commercial Code will vary by state, we suggest that lenders contact legal counsel prior to closing their transaction to discuss the perfection steps that will need to be completed.

60 Note that certain types of assets (e.g. bank accounts) can only be perfected by control or possession, while others can be perfected by filing a UCC financing statement.

61 As an alternative to entering into a credit agreement, some lenders and borrowers may enter into a promissory note, which will set out all the terms and conditions of the loan.

62 The Helen Bader Foundation, the Ford Foundation, the F.B. Heron Foundation, and the Conrad N. Hilton Foundation offer sample forms of promissory notes, copies of which can be found at the PRI Makers website.

2.3.5 Certifications and Certified Transaction Documents

Lender's counsel will typically review the resolutions adopted by the borrower's board of directors that authorize the transactions being consummated. The resolutions will then be attached to a certificate executed by the borrower's secretary. This certifies that (i) the attached resolutions were adopted by the borrower's board of directors and remain in full force and effect as of the closing date, (ii) the signatures of the officers of the borrower who are signing documents at the closing are true and correct, and (iii) attached to the certificate are true, correct, and complete copies of the borrower's certificate of incorporation and by-laws which are in full force and effect as of the closing date.

2.3.6 Legal and Tax Opinions

While not required, in most commercial loan transactions, the borrower provides a legal opinion. The opinion is a fairly standardized document that sets forth legal conclusions as to the borrower and the guarantors, their legal and corporate existence, the enforceability of the transaction documents, and that no conflicts exist with any applicable law or the borrower's and/or guarantors' (as applicable) constitutional documents. Typically, this opinion is given by outside counsel to the borrower from the following jurisdictions: (i) any state in which the borrower and/or any guarantors are organized, (ii) the governing law of the transaction documents, and (iii) each state where the collateral is located. However, where no outside counsel is used, the head of the legal department of the borrower may be qualified to give this opinion. The main opinions that are typically requested are opinions related to due authorization and execution of the loan documents, enforceability of the loan documents in accordance with their terms, and the valid creation and perfection of security. The foundation may also want a tax opinion from outside counsel that the loan qualifies as a PRI for tax purposes.

2.3.7 Other Documents

When there is a need to obtain a third-party valuation on a particular asset, the parties may try to obtain solvency opinions or valuation opinions. These letters constitute a written examination by valuation experts of the values of the underlying purchased assets or companies and are typically used in a leveraged acquisition or recapitalization.

2.4 Tax Rulings in Relation to PRI Loans

The IRS has approved PRI loans for a wide variety of charitable purposes. Some of the more unusual rulings include loans to:

- ▶ commercial media enterprises in former Soviet-bloc countries and other regions of the world to help them operate independently from government control;⁶³

63 P.L.R. 200034037 (Aug. 28, 2000); P.L.R. 9551005 (Dec. 22, 1995).

- ▶ foreign governments, foreign banks, other foreign financial institutions, and to foreign business enterprises to support economic development in underdeveloped countries,⁶⁴ and
- ▶ a not-for-profit cooperative organization formed to provide low-cost communication services exclusively to member not-for-profit organizations.⁶⁵

The IRS has indicated flexibility in approving the terms of PRIs to satisfy the “no significant investment purpose” condition (described in Section 1.1.2 above), as long as the foundation can demonstrate that it is earning a lower rate of return than it would earn for commercial investments with comparable degrees of risk. A PRI may, for instance, charge a high interest rate, provided that the interest rate is below the market rate for commercial loans with comparable risk (e.g., if there is a high risk of default or inadequate collateral to secure the loan).⁶⁶

In one ruling, for example, the IRS determined that a loan qualified as a PRI despite having an interest rate of 15% when the loan granted by the private foundation lacked an important feature providing for a contingent annual payment that was present in parallel investments by private investors.⁶⁷ Although the PRI loan earned a high rate of interest, the foundation was earning a lower rate of return than private commercial lenders that were lending alongside the foundation. This helped the foundation demonstrate that it was earning a rate of return that was below the commercial risk-adjusted rate. If private commercial lenders are not making an investment alongside a foundation, the foundation will have to consider how it will establish that it is earning a rate of return that is below the rate for commercial loans with comparable risk, and, therefore, that the loan satisfies the “no substantial purpose” requirement to qualify as a PRI.

3 Guarantees/Credit Default Protection

In some cases, instead of acting as a lender themselves, foundations may guarantee a loan to the borrower. In this case, a third-party lender will extend credit on market or commercial terms and the foundation will act as a guarantor of the loan. If the borrower does not pay the loan, the third-party lender will have recourse to the foundation for the balance of any amounts owed to it. By guaranteeing the loan, the foundation will assume part or all of the borrower’s credit risk, the borrower’s creditworthiness will increase and the borrower will be able to access credit on terms that might not otherwise be available to it. The amount of the guarantee does not count toward the IRS-mandated payout. Rather, only funds demanded by the lender and paid by the guarantor (the foundation) are eligible to be counted against payout. Charitable use expenses, such as legal and other transaction costs, may also be applied against payout.

64 P.L.R. 199943058 (Nov. 1, 1999); P.L.R. 9826048 (June 26, 1998).

65 P.L.R. 8445096 (Aug. 13, 1984).

66 See, e.g., Treas. Reg. § 53.4944-3(b), *Example 1* (loan qualifies as PLR even though it may earn a rate of return comparable to or greater than conventional portfolio investments because it is made at a rate below the market rate for commercial loans with comparable risk).

67 P.L.R. 8301110 (Oct. 8, 1982).

In 2013, the Kresge Foundation provided a \$5 million guarantee to the Collaborative for Healthy Communities, a \$130 million, three-year national initiative that will provide a new source of capital for community health centers across the country. Kresge's guarantee catalyzed other lenders—such as the Goldman Sachs Urban Investment Group, Low Income Investment Fund (LIIF), Primary Care Development Corporation (PCDC), the Rockefeller Foundation, and The Reinvestment Fund (TRF)—to come together to and to bring critical capital to help meet the growing healthcare needs of low-income communities. The \$130 million in investments through the initiative includes \$55 million in debt and \$75 million in tax credits and other subsidies.⁶⁸

While a guarantee does not require a foundation to provide funding to the borrower, it does put the foundation's balance sheet at risk. Providing a guarantee can be an effective means for a foundation to use its balance sheet without requiring an immediate expenditure, but it creates a contingent liability for the foundation. A foundation cannot report a guarantee or letter of credit as a charitable distribution until such time as they are drawn on, and the foundation makes a payment.

3.1 IRS Rulings and Tax Considerations for PRI Guarantees

The IRS has ruled that a number of credit support arrangements qualify as PRIs. For example, a private foundation that deposited funds with a commercial lender as collateral to cover its potential liability as a guarantor obtained a ruling that the deposits constituted a PRI. In that ruling, the foundation guaranteed commercial loans to non-profit childcare providers and the guarantee was required for the borrower to qualify for the loan.⁶⁹ Even though the lender required that the funds on deposit be invested in high-quality, liquid-fixed income instruments, the IRS explained that because the deposits supported loans to the childcare providers and the rate of return on the deposits did not reflect the added risk that the funds would be used to cover the foundation's liability from its guarantees, the deposits qualified as a PRI.

In another ruling, the IRS explained that a private foundation providing an indemnity to a public charity qualified as a PRI, where the indemnity enabled the public charity to satisfy the guarantee agreement necessary to support financing for a redevelopment project in a depressed urban neighborhood.⁷⁰ The foundation did not receive compensation for providing the indemnity. The foundation would only be required to make a payment under the indemnification agreement if the public charity defaulted under the terms of the financing arrangement. Thus the foundation had a low likelihood of recovering any amounts that it paid under the indemnification. Therefore, the foundation had little, if any, investment motive for agreeing to indemnify the public charity, and the IRS ruled that the indemnification qualified as a PRI.

The IRS has also ruled that credit support arrangements that generate guarantee fees qualify as PRIs. For example, the IRS ruled that a letter of credit qualified as a PRI when the foundation

68 <http://www.pcdc.org/news/press-releases/healthco-announcement.html?referrer=https://www.google.com/>

69 P.L.R. 200043050 (July 25, 2000).

70 P.L.R. 8105112 (Nov. 10, 1980).

received a fee equal to 1% of the maximum amount of its exposure under the letter of credit.⁷¹ The private foundation participated in a letter of credit that provided credit support for financing to build and maintain a natural history museum. The letter of credit was considered to carry a high degree of risk, demonstrating that generating a financial return was not a significant purpose behind the foundation's participation in the letter of credit.

In general, merely providing a guarantee does not result in a qualifying distribution because an unfunded guarantee merely creates a contingent liability. Such an unfunded guarantee only results in a qualifying distribution to the extent the foundation is required to make a payment under the guarantee. But a foundation that was required to make a deposit as collateral to cover its potential liability as a guarantor obtained a ruling that the deposit qualified as a PRI.

4 LLCs and Limited Partnerships

Many equity PRIs take the form of interests in limited partnerships ("LPs") or member interests in limited liability companies ("LLCs"). Private foundations also frequently play a role in the formation and management of LPs and LLCs that raise funds from different sources to promote specific programmatic goals.

LPs are often used as financing vehicles when investors are to have no role in management and a simple or flexible governance structure is needed. An LP must be comprised of one or more limited partners and at least one general partner. The primary governing document of an LP is the limited partnership agreement between the general partner and the limited partner(s), which may be tailored to reflect the desired economic, governance, and other terms as between the partners. Limited partners have limited liability with respect to the debts and obligations of the LP, analogous to shareholders of a traditional corporation. In order to maintain this limited liability status, a limited partner may not exert control or exercise management authority over the business of the LP. Rather, it must limit its role to that of a passive economic participant (protective voting rights, such as the right to consent to amendments to the partnership agreement, are permitted, however). The general partner is responsible for the management of the LP, and is fully liable to third parties for the debts and obligations of the LP. Because of the "unlimited liability" status of the general partner, special limited liability entities are often formed to function as the general partner of an LP in order to "ring fence" the liability. The manager or other similar person(s) with respect to the general partner would then, practically speaking, be the operational driver behind the activities of the LP.

LLCs are hybrids of corporations and partnerships, incorporating certain advantages of both forms. An LLC's members are analogous to a corporation's shareholders. Like shareholders, LLC members enjoy limited liability status. Like the limited partnership agreement of an LP, parties have broad latitude to tailor the limited liability company agreement of an LLC to meet their respective needs. Unlike an LP, however, there need not be a member like the general partner who has unlimited liability for the debts and obligations of the LLC. Rather, as a default, an LLC is managed by its members, or by a specified "managing member."

71 P.L.R. 9033063 (May 24, 1990).

Notwithstanding the default governance authority vested in the general partner of an LP and members of an LLC, both vehicles may delegate management authority, in whole or in part, to a “management company” which acts as agent for the vehicle under a management agreement or similar contract.

LLCs and LPs provide a number of advantages as a choice of investment entity, including:

Taxation. If the members of an LLC or partners of an LP include taxable investors, the investors will have the flexibility to elect to be taxable as a separate corporation, or on a pass-through basis to the members/partners.

Limited Liability. As discussed above, LLCs and LPs each offer a form of limited liability vehicle through which private foundations may directly finance charitable investment activities, investing as a member of an LLC or a limited partner of an LP. In terms of governance, the private foundation may serve (directly or indirectly) as the general partner of an LP, or as the managing member in an LLC. The private foundation may also serve as the manager or similar person of a management company which acts as agent on behalf of the vehicle. If the private foundation does become involved in the overall governance of an LP or LLC, it should observe the following best practices to help ensure that limited liability is respected (i.e., to avoid “piercing the corporate veil”):

- ▶ Control over the day-to-day operations of the general partner or management company should be in the hands of employees of the general partner entity or management company (not an employee, officer, or director of the private foundation);
- ▶ The general partner or management company should be adequately capitalized in light of the purpose and activities of the LP or LLC;
- ▶ The general partner or management company should maintain its own separate governance functions; and
- ▶ Any services or facilities provided by the private foundation to the general partner or management company should be pursuant to a written agreement which incorporates terms typical of a contract negotiated at arm’s length.

Ease of Formation and Paperwork. LLCs and LPs are relatively cheap and easy to form and have fewer requirements than corporations (e.g., no requirement for periodic board meetings or reports, unless agreed by contract). To form an LLC or LP, a very simple “certificate of formation,” “certificate of limited partnership,” or similar document must be filed with the Secretary of State of the relevant state.

(Forms of such documents may generally be found on the website of the relevant Secretary of State.)

The limited partnership agreement or limited liability company agreement should then be entered into simultaneously with or within a reasonable period of time after the formation of the entity. Evidence that formation has occurred can typically be received within a matter of days. Most states typically require a relatively nominal annual filing fee or tax. Lastly, if an LP or LLC is formed in a state other than the state in which it operates, it may be required to make a filing to qualify to do business as a “foreign company” in the state in which it operates. This determination and filing depends upon the relevant state(s) involved.

Flexibility in Management and Allocating Profits and Losses. The limited partnership agreement of an LP or limited liability company agreement of an LLC may be drafted to allocate management powers, profits, and losses in any manner that is in accordance with specific programmatic objectives. For example, a private foundation could form an LLC that gives it voting control over the LLC (e.g., as managing member) while also limiting the financial return to a preferred return that is capped.⁷² This type of structure ensures that the private foundation retains control over the LLC, that the LLC is being operated for exempt purposes, and also helps the private foundation to demonstrate that there is “no significant investment purpose” for the investment. Private foundations that hold limited partner interests in an LP can:

- ▶ appoint a Section 501(c)(3) organization as the general partner to ensure that the LP is controlled by a tax-exempt organization;⁷³
- ▶ issue PRI loans to LPs that have private taxable investors as limited partners, but that have an exempt organization as the general partner;⁷⁴ and
- ▶ make PRI loans to LPs that have for-profit entities as the general partner.⁷⁵

5 Debt Securities

In the case of debt securities, such as notes or bonds, the issuer promises to pay the holder of such debt security the amount borrowed plus an amount representing compensation for the time value of money. This compensation for the time value of money can take the form of a periodic interest payment (e.g., semi-annually), a discount in the price of the bond relative to its stated principal amount, or some combination of the two. In contrast to a bank loan, the lenders (namely the holders of, or the investors in, the debt security) are not direct parties to the instrument. Debt securities are particularly useful for an issuer when dealing with a large number of investors or when the issuer wants to facilitate public trading of the security and market liquidity. While debt securities potentially increase the number of investors, they also give rise to federal and state securities laws concerns for the issuer. (Some of these concerns are addressed in greater detail in Section 7 below.)

In general, PRIs have not taken the form of notes or bonds. This is probably because if a foundation were to acquire the debt security at the publicly-traded or market price, it is not clear how the security would satisfy the “no significant investment purpose” requirement for an investment to qualify as a PRI. However, if the issuer takes the necessary steps, it is possible for publicly-offered notes or bonds to qualify as PRIs.

72 P.L.R. 199950039 (Sept. 21, 1999) (private foundation equity investment in LLC qualified as a PRI when the LLC was formed as a partnership with another for-profit member).

73 P.L.R. 199910066 (Dec. 15, 1998) (two related private foundations established LP and appointed an LLC as General Partner, with other Section 501(c)(3) organizations as members of the LLP).

74 P.L.R. 9148052 (Sept. 6, 1991) (private foundation loan to LP qualified as PRI when general partners were exempt organizations and limited partner was a for-profit limited partnership); PLR 9016078 (private foundation loan to LP with for-profit limited partners qualified as PRI when general partner was generally an exempt organization).

75 P.L.R. 9112013 (Dec. 24, 1990) (private foundation’s loan to LP qualified as PRI, when private developer was general partner of LP).

The Calvert Foundation offers the Community Investment Note as a publicly-offered debt security that qualifies as a PRI.⁷⁶ These Community Investment Notes are not publicly traded in any commercial market. Instead, they are generally acquired only by private foundations and other socially-concerned investors.

Debt securities are of particular relevance to financial intermediaries (such as loan funds and microfinance institutions) that seek funding from a variety of sources to engage in their programmatic activities. Some Section 501(c)(3) organizations that have received PRI funds from private foundation have, in turn, set up programs to offer debt securities to the public. For example, the Deutsche Bank Microcredit Development Fund, initially funded through PRIs in the form of private loans, offered notes in reliance on the exemption from the registration requirements of the Securities Act of 1933, as amended (the “**Securities Act**”), for charitable organizations.

6 Other Equity and Equity-Linked Programmatic Investments

Non-profit organizations that qualify as Section 501(c)(3) organizations are not permitted to issue equity interests.⁷⁷ Equity PRIs involve for-profit organizations such as LLCs and corporations. New types of low-profit limited liability companies (“**L3Cs**”) and benefit corporations and Certified B corporations (“**B-Corps**”) are discussed at greater length in Section 6.1 below.

In general, to satisfy the “no significant investment purpose” requirement, equity PRIs have been organized as private offerings or as offerings that are restricted to a group of investors who are not primarily motivated by seeking a market rate of return.⁷⁸ In addition, when foundations make a PRI in a for-profit organization, they are required to exercise expenditure responsibility. (Expenditure responsibility may also be required when making a PRI in a foreign charitable organization, as discussed in Section 8.2 below.)

6.1 L3Cs, Benefit Corporations and B-Corps Certification

Recently, new types of hybrid entities have been formed by socially-oriented organizations seeking investments from socially-oriented investors. L3Cs were created to form for-profit entities whose operations are restricted to charitable or social purposes. Benefit corporations, which are frequently confused with corporations that have received B Corporation certification, were established to provide for-profit corporations with a legal framework for their environmental and social activity. Like LLCs, these entities allow investors to take equity stakes in the entity and may provide equity returns to investors, although, in the case of an L3C, it would be a limited return.

⁷⁶ See <http://www.calvertfoundation.org/invest/investing>.

⁷⁷ Section 501(c)(3) organizations are not permitted to issue equity interests because no part of their net earnings may inure to the benefit of any private shareholder or individual and they are also prohibited from engaging in certain transactions that provide private benefits or an “excess benefit” to disqualified persons. I.R.C. § 4958. See the discussion of the rules against self-dealing in Section 1.4 above.

⁷⁸ P.L.R. 200610020 (Mar. 10, 2006) (members of fund restricted to private foundation and certain athletes); P.L.R. 200136026 (Sept. 10, 2001) (financial intermediary intends to seek funds from socially conscious investors); P.L.R. 8549039 (Sept. 10, 1985) (equity offered in a private offering).

A benefit corporation is a corporation with a particular legal status conferred by the state, while a Certified B Corporation is a corporation (not necessarily a benefit corporation) that has been certified by B Lab, an independent nonprofit organization. B Corps are for-profit companies certified by the nonprofit B Lab to meet rigorous standards of social and environmental performance, accountability, and transparency. Benefit corporations are not required to be certified by B Lab – the certification simply indicates that the corporation has met a high standard of overall social and environmental performance as measured by the B Lab’s impact assessment.⁷⁹

In the majority of states that have adopted benefit corporation legislation, benefit corporations are required to publicly publish an annual benefit report that includes an assessment of overall social and environmental performance against a third-party standard. Benefit corporation status can make a company more attractive to investors as a company with increased legal protection, accountability, and transparency. Benefit corporations can also speed up investor due diligence since they produce an annual benefit report, which describes their qualitative activities aimed at producing general public benefit. Benefit corporation legislation in most states defines this third-party standard as one that guides the process of defining, reporting, and assessing overall corporate social and environmental performance in a comprehensive, independent, credible, and transparent manner.⁸⁰

6.2 Preferred Equity

Preferred shares are shares in a company that usually receive a fixed dividend each year and that, if redeemed, are redeemed at par value. The fixed dividend is not guaranteed, although the issuer is sometimes restricted from making any distributions on its common stock until it makes its fixed dividend distribution on its preferred shares. Foundations may choose to subscribe for preferred equity PRIs for a variety of reasons, such as (i) to provide for a more predictable rate of return, (ii) to limit or cap the foundation’s total return on an equity investment so as to induce the recipient to engage in the intended charitable or programmatic activity, or (iii) in the case of non-voting preferred shares, to distance the foundation from any control over the for-profit activities, if any, of the recipient.

Preferred shares can be structured in a wide variety of ways. If the company fails to pay the preference dividend, it will generally not be allowed to pay an ordinary dividend for the year to ordinary shareholders. Some preference shares are cumulative, where any arrears of preference dividends will also have to be paid prior to the ordinary dividend being paid in any year. Preferred shares may be redeemable at a set date or they may be perpetual. They may also be convertible into common stock. Finally, they may be participating, which means that in addition to the fixed dividend they will receive a variable dividend dependent on the performance of the company.

79 <http://www.bcorporation.net/what-are-b-corps>.

80 <http://www.benefitcorp.net/selecting-a-third-party-standard/criteria-for-acceptable-third-party-standards>.

6.3 Special Tax Considerations for Equity PRIs

The IRS has long accepted that equity investments may qualify as PRIs.⁸¹ Equity PRIs were originally sanctioned as investment in stock of corporations. But the IRS has also approved the use of limited partnership interests and membership interests in LLCs.⁸² However, an equity investment allows the investor to potentially control the recipient and creates a potentially unlimited upside for the investment. Because of this potential for profit, foundations must be cognizant of satisfying the requirement that the PRI cannot have any significant investment purpose.

- ▶ **Capped return.** One way to satisfy this requirement is by making PRIs with a capped return, such as preferred stock with a rate of return that is significantly below the market rate.⁸³ The IRS ruled that a private foundation's investment in a financial intermediary qualified as a PRI when the intermediary was formed to raise funds from other socially conscious investors to support the expansion of environmentally-oriented businesses.⁸⁴ In that case, the financial intermediary was targeting a rate of return for investors that was significantly less than the acceptable rate of return on international venture capital funds of comparable risk.
- ▶ **Highly speculative investment.** In some rulings, the IRS has accepted the expectation that an investment is highly speculative and is not expected to earn a market return as evidence satisfying the PRI requirements, even if there was no cap on the return.⁸⁵ For example, the IRS ruled that an investment in the common stock of a redevelopment corporation that was formed to renovate an economically blighted area qualified as a PRI, after explaining that the investment was speculative and that the company was restricted from operating in the most profit-making manner.⁸⁶
- ▶ **Controls for charitable uses of funds.** An equity investment can qualify as a PRI if the foundation demonstrates that appropriate controls will be in place to ensure that the funds are used for charitable purposes. For example, the IRS ruled that an investment in the common stock of a small business investment company qualified as a PRI. In that case, the recipient stated that it understood that the purpose of the investment was to promote new employment and economic opportunities for residents of an economically depressed region, and that it would use the funds to support that purpose.⁸⁷

81 Treas. Reg. § 53.4944-3(b), (investment in common stock of small business enterprise in deteriorated urban area owned by members of economically disadvantaged minority group qualifies as PRI when enterprise was unable to raise funds from conventional sources unless it increased its equity capital).

82 See, e.g., P.L.R. 8710076 (Dec. 10, 1986) (limited partnership interests qualified as PRI); P.L.R. 200610020 (Mar. 10, 2006) (investment in membership interests of LLC qualified as PRI).

83 P.L.R. 7813108 (Dec. 30, 1977) (purchase of preferred stock with cumulative dividends at a rate of 5% issued by a minority bank qualified as PRI); P.L.R. 8807048 (Nov. 23, 1987) (return on equity investment in holding company is capped at 5%).

84 P.L.R. 200136026 (Sept. 10, 2001).

85 P.L.R. 9834033 (May 27, 1998) (50% capital and profits interest in LLC formed as a partnership for federal income tax purposes qualified as a PRI when the partnership was formed to operate a family service support center and was not expected to generate any significant financial return); P.L.R. 8004102 (Oct. 31, 1979) (ownership of taxable subsidiary qualified as PRI because foundation was devoted to perpetuate living performing arts, and its subsidiary operated theaters, which is a highly volatile activity expected to produce minimal returns).

86 P.L.R. 8549039 (Sept. 10, 1985).

87 P.L.R. 8526084 (Apr. 5, 1985).

Similarly, an investment in a limited partnership qualified as a PRI when the limited partnership used its funds to make investments in new businesses in a particular area, as well as to fund the location of new operations of established businesses in that area.⁸⁸ In that ruling, the foundation investors demonstrated that the limited partnership was subject to substantial restrictions in its use of its funds.

Finally, in another ruling the private foundation demonstrated both that an investment fund would be subject to restrictions to ensure that the funds were being used for charitable purposes and that the fund was expected to generate a lower rate of return than typical commercial investment funds.⁸⁹

- ▶ **Non-voting stock.** Making an investment in the form of non-voting stock will generally not be sufficient to qualify the investment as a PRI. For example, the IRS ruled that an equity investment in non-voting stock of a small business investment company would not qualify as a PRI, even though the stated goal of the investment was to create employment opportunities in an area with high unemployment.⁹⁰
- ▶ **Debt funding.** Private foundations have funded limited partnerships with PRI loans to support low-income housing projects while taxable investors have invested as limited partners. This structure enables the taxable limited partners to obtain low-income housing credits, while ensuring that the limited partnership obtains the necessary debt funding at an appropriate interest rate in light of its charitable purpose.⁹¹

7 Securities Laws Exemptions

In general, securities (including both debt and equity securities) may be offered and sold in the United States only:

- ▶ if a registration statement is filed with and declared effective by the U.S. Securities Exchange Commission (the “**SEC**”);
- ▶ in accordance with an exemption from registration requirements of the Securities Act;
- ▶ pursuant to compliance with the applicable state securities laws (“blue sky laws”); or
- ▶ in accordance with an exemption from the registration requirements of the applicable blue sky laws in the state where the securities are being issued and sold.

88 P.L.R. 199910066 (Mar. 15, 1999).

89 P.L.R. 200610020 (Mar. 10, 2006) (private foundation’s capital contributions to fund organized to invest in businesses in low-income communities qualified as PRI).

90 P.L.R. 7742062 (July 25, 1977).

91 P.L.R. 9112013 (Dec. 24, 1990) (private foundation loan to Limited Partnership at 9% interest rate qualified as PRI when equity investors in Limited Partnership were expected to be eligible for low-income housing credits); P.L.R. 9016078 (Jan. 25, 1990) (private foundation made PRI loan to community organization which, in turn, provided funding to limited partnerships, each of which was organized to build a low-income housing project). See also P.L.R. 8923017 (Mar. 16, 1989).

In addition, securities issuances may be subject to regulation pursuant to the Investment Company Act of 1940 (the “**Investment Company Act**”). Failure to comply with the applicable federal securities and blue sky laws may result in liability of the issuer and the managers or underwriters.

The exemption for charitable organizations is of particular interest for Section 501(c)(3) organizations that seek to raise funds from a broad group of investors, including intermediaries. Section 3(a)(4) exempts from registration any security issued by “a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual; or any security of a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940.”

To claim this exemption, an issuer must demonstrate that (1) it is organized “exclusively” for religious, educational, benevolent, fraternal, charitable, or reformatory purposes, and (2) no part of its net earnings inure to the benefit of any person, private stockholder, or individual. The first requirement is normally satisfied by a ruling from the IRS that it qualifies as a tax-exempt organization.

8 Documentation and U.S. Tax Discussion of Expenditure Responsibility and Equivalency Determination

8.1 Formation Documentation: Section 501(c)(3)

In order to form a corporation that qualifies for exemption under Section 501(c)(3), an organization must first incorporate under the provisions of applicable state law. Generally, each state requires an organization to file articles of incorporation with either the secretary of state or the attorney general. Most states provide template articles of incorporation requesting basic information, such as the name, address, and purpose of the corporation.⁹² However, because the requirements can vary from state to state, an organization wishing to incorporate as a non-profit organization under state law should check with the appropriate state agency to determine its specific state obligations.

To qualify for exemption under Section 501(c)(3), an organization must generally apply for recognition of tax-exempt status from the federal government within a certain time frame. This is accomplished by filing Form 1023 with the IRS.⁹³ If an organization wishes its Section 501(c)(3) status to relate back to its date of formation, Form 1023 must generally be filed within 27 months of its formation.⁹⁴ An organization that qualifies for tax-exempt status at the federal level will

92 For specific examples, see California (http://www.sos.ca.gov/business/corp/pdf/articles/corp_artsnp.pdf), Delaware (<http://corp.delaware.gov/incnstk.pdf>), District of Columbia (<http://dcra.dc.gov/DC/DCRA/For+Business/Corporate+Registration/Articles+of+Incorporation+of+Nonprofit+Corporation>) and New York (http://www.charitiesnys.com/pdfs/how_to_incorporate.pdf).

93 Available for download at <http://www.irs.gov/pub/irs-pdf/f1023.pdf>.

94 Treas. Reg. § 301.9100-2(a)(2)(iv).

usually be deemed to qualify as tax-exempt in the relevant state. However, certain states, such as California, require a separate application before they will recognize an organization as tax-exempt.

8.2 Making PRIs in Foreign and For-Profit Organizations: Expenditure Responsibility and Equivalency Determination

As discussed above (in Section 1.2), when a private foundation makes a PRI in an organization that is not (i) a public charity, (ii) an exempt operating foundation, or (iii) a foreign organization that is determined to be the equivalent of a public charity or exempt operating foundation, the foundation will need to exercise expenditure responsibility to avoid the excise tax on taxable expenditures.⁹⁵ Exercising expenditure responsibility involves ensuring that the PRI is used for proper charitable purposes. Expenditure responsibility is not required if the private foundation makes an equivalency determination for a foreign recipient. An equivalency determination involves making a good-faith determination that the foreign organization is the “equivalent” of a U.S. public charity.

8.2.1 Expenditure Responsibility

To exercise expenditure responsibility, a private foundation must make reasonable efforts and establish adequate procedures to ensure that the PRI is used solely for its intended charitable purpose, obtain reports from the PRI recipient describing how the PRI is spent, and make full and complete reports on the PRI to the IRS.⁹⁶ A private foundation is also required to exercise diligence procedures prior to making the PRI, at the time of the PRI, and during the term of the PRI.

(i) **Pre-PRI Inquiry**

Before entering into a PRI, a private foundation should conduct a limited inquiry of the PRI recipient that is sufficient to give a reasonable person assurance that the PRI will be used for the intended purposes.⁹⁷ A private foundation should determine the history, experience, management, and practices of the PRI recipient. The scope of the inquiry depends on the context of the PRI, such as the amount, duration, and terms of the PRI. There is no need to conduct a pre-PRI inquiry when making a PRI to an organization that has made proper use of all previous grants or PRIs in the past.

(ii) **Written Commitment**

A private foundation must obtain a written commitment from an appropriate officer, director, or trustee of the PRI recipient.⁹⁸ The commitment must specify the purpose of

95 I.R.C. § 4945(a).

96 I.R.C. § 4945(h).

97 Treas. Reg. § 53.4945-5(b)(2)(i).

98 Treas. Reg. § 53.4945-5(b)(4).

the PRI, and the recipient must agree to use the funds only for the specified purposes and to repay any amounts not used for these purposes.⁹⁹ The recipient must agree not to use the funds for any impermissible political purposes,¹⁰⁰ as well as to comply with the information reports described below.

(iii) **Information Reports from PRI Recipient**

As part of the written commitment, the PRI recipient must agree to provide full and complete financial reports at least annually and a statement that the recipient has complied with the terms of the PRI.¹⁰¹ These reports should be the same as would be required by commercial investors under similar circumstances. The reports should also describe the progress made by the recipient towards achieving the goals of the PRI.¹⁰² In addition, the recipient must maintain the same types of books and records as would ordinarily be required by commercial investors and to make these books and records available to the private foundation at reasonable times.¹⁰³ The private foundation may rely on the validity of the reports unless it has reason to doubt their accuracy or reliability.¹⁰⁴

(iv) **Information Reports to IRS**

A private foundation must report certain information on its Form 990-PF regarding PRIs subject to expenditure responsibility that were made during the taxable year, as well as any outstanding PRIs that were subject to expenditure responsibility during the taxable year.¹⁰⁵ This information includes the name and address of the PRI recipient, the date and amount of the PRI, the purpose of the PRI, the amounts expended by the PRI recipient, a description of any diversion of the funds from their intended purpose, the dates of any reports received from the PRI recipient, and the dates and results of any verification by the private foundation of the PRI recipient's information reports.¹⁰⁶

8.2.2 Equivalency Determination

A private foundation does not need to exercise expenditure responsibility if the recipient is a foreign organization that is determined to be equivalent to a public charity or exempt operating foundation based on the good faith and reasonable judgment of the private foundation.¹⁰⁷ According to the relevant U.S. Treasury rules, this good-faith determination can be based on an appropriate affidavit from the recipient or opinion of counsel.¹⁰⁸

99 Treas. Reg. § 53.4945-5(b)(4)(i).

100 Treas. Reg. § 53.4945-5(b)(4)(iv).

101 Treas. Reg. § 53.4945-5(b)(4)(ii).

102 Treas. Reg. § 53.4945-5(c)(1).

103 Treas. Reg. § 53.4945-5(b)(4)(iii).

104 Treas. Reg. § 53.4945-5(c)(1).

105 Treas. Reg. § 53.4945-5(d)(1).

106 Treas. Reg. § 53.4945-5(d)(2).

107 Treas. Reg. § 53.4945-5(a)(5).

108 Rev. Proc. 92-94, 1992-2 CB 507 (Nov. 16, 1992).

A form of affidavit is provided in detail in Revenue Procedure 92-94, although this specific form is not required. This affidavit requires a substantial amount of documentation in English, including:

- ▶ the charter, bylaws, and other organization documents;
- ▶ statutory law or governing rules providing that assets would be distributed to other exempt organizations upon liquidation or winding up;
- ▶ financial statements for the previous four years if the status of the foreign organization depends on its financial support;
- ▶ a statement that the recipient is not permitted to engage in political activities or campaigning; and
- ▶ a statement of the activities of the PRI recipient.

The advantage of the equivalency determination is that it does not require ongoing reporting or keeping funds in a separate account as under expenditure responsibility. The main disadvantage is that the affidavit requires collecting a substantial amount of information in English.

9 PRIs for Funders of Jewish Causes

We conclude this guidebook with a concise six-step guide to how philanthropists who fund Jewish causes in particular can most effectively use PRIs to support non-profits and for-profits both in the U.S. and in Israel. This is followed by three case studies that offer real and hypothetical examples of funders making PRIs in the US and Israel.

Step 1: Investment Policy

Prior to making a PRI, it is prudent to invest time in articulating an “investment policy.” The simplest way a foundation can translate its charitable goals for PRIs into an implementation plan is by crafting a program-related investing policy statement. Like an investment thesis, this might range from guiding principles to detailed financial and social parameters. The investment policy statement spells out a program’s principle objectives and constraints, and serves as a guide for well-informed investment decisions.

A sample “investment policy” could include the following.¹⁰⁹

The PRI program will be managed according to the following principles:

1. The program will seek to fund projects that provide both social and financial returns.
2. The program will focus on both for-profit and not-for-profit organizations.
3. The program, funded from the distinct PRI Fund, will not be integrated into the foundation’s traditional investment pool.
4. The program will make investments directly or in partnership with other individuals or organizations.

Investment Parameters:

Instrument: The foundation may invest using debt or equity structures and can provide guarantees

Size: The foundation will invest in deals ranging in size from \$500,000 to \$3,000,000

Geography: The foundation will invest in Israel and Southern Africa

Return: In addition to positive social impacts in the foundation’s service area, the program seeks long-term capital preservation and an overall annualized return, net of fees. The rate of return for each PRI will be established based on various factors including, but not limited to: social returns, level of risk, and familiarity and history the foundation has with the prospective organization.

Impact: The program will consist solely of investments that further the foundation's mission of creating positive and sustainable changes in the area. The foundation generally seeks to make strategic investments where its capital is crucial or catalytic to success, e.g. leveraging third-party investments.

Collateral: The foundation strongly prefers that the collateral for its PRI is structured as a loan. It likewise prefers that the collateral is equal in value to that of the underlying PRI.

Miscellaneous:

- ▶ The foundation prefers to invest in entities with a proven track record of repaying invested capital and/or entities led by a management team with such experience.
- ▶ Repayment schedules will be negotiated on a case-by-case basis based on the borrower's anticipated sources of repayment.
- ▶ Investees will be expected to pay closing costs equal to legal fees incurred by the foundation.
- ▶ The foundation will only invest in USD.
- ▶ Any investment commitment that remains unused or inactive after XX years from the date of its issuance shall immediately revert to the foundation.

** For additional Investment Policy examples, see <https://www.missioninvestors.org>.

Step 2: Deal Sourcing

Once you have guidelines in place, you can begin to generate potential deal leads. A critical part of the investment process involves sourcing deals by matching the foundation's charitable purpose with a potential investee who will further the foundation's mission. Selecting partners both in the U.S. and in Israel should be driven primarily by your programmatic goals rather than by expectation of returns.

Investments may originate through a number of channels:

- ▶ Referrals from program staff.
- ▶ Relationships with other impact investors, foundations, funds, commercial banks, and private investors active in target regions. By educating the market of your foundation's interest in active sourcing relationships, you will ensure that your networks of investors, entrepreneurs, community activists, government officials, and social impact leaders will be able to identify high-potential opportunities and send them your way.
- ▶ Participation in relevant industry networks such as the Global Impact Investing Network (GIIN), the Aspen Network of Development Entrepreneurs (ANDE), Mission Investors Exchange, Impact Investing Israel, and JFN.
- ▶ Stay in contact with the JFN Israel office (jfn@jfunders.org).

- ▶ Attendance at relevant industry conferences and investor events such as SoCap’s annual flagship event in San Francisco, the Jewish Funders Network’s annual conference, and impact investing programming in the U.S., Israel, and online.
- ▶ Issue requests for proposal.
- ▶ Cold introductions as a result of general industry awareness and visibility.

Step 3: Initial Screening

Once sourced, foundation staff perform an initial screening through a desk review for each potential investment. (Depending on the size and structure of your foundation, initial review of investment opportunities may be a function for the board or staff.) This involves creating a clear point of access for organizations seeking investment, and an initial screening to determine whether an investment is suitable for further review.

This initial review should at a minimum assess fit with mission, goals, and strategy; potential for social return; and potential for financial and social return.¹¹⁰

At this stage of the assessment, it would be wise to be asking the following types of questions:

1. Does this investment opportunity align with the mission of my organization? (See above for detailed discussion on what qualifies as a PRI.)
2. Does this opportunity have the potential to deliver the type of social impact that my organization needs?
3. Is this the right management team / fund manager to invest with (e.g. what is their track record)?
4. What are the high-level risks and mitigants associated with the deal?
5. What kind of financial returns can my organization expect? How likely will we be able to achieve those financial returns?

A “teaser” or “concept note” often provides enough information to allow for a determination regarding fit with these criteria; a majority of opportunities will not pass the initial screen. When a potential investment passes the initial screen, foundation staff conduct a more detailed review. A common template for an initial screen of a potential program investment can help streamline this process.

At this stage, parties may begin drafting an initial term sheet to come to a basic understanding of deal terms.¹¹¹

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111 <http://knightfoundation.org/knight-news-challenge/program-related-investment-terms/>

Step 4: Due Diligence

Due diligence for PRIs, if conducted with sufficient rigor, takes more time and effort than a typical grant review. In PRI transactions, the due diligence process will vary depending on the type of company/fund and type of investment/position in the capital structure (i.e., equity, debt, or credit enhancement).

Due diligence in impact investing may be more rigorous than due diligence carried out in traditional investment scenarios because investors are conducting both programmatic and financial due diligence.

Due diligence, or underwriting, helps determine the likelihood that the results sought by the investor are achievable. The purpose of the due diligence is to identify and analyze the risks involved in making the investment, verify that the transaction complies with the investment criteria, and provide a basis for the investment decision.

Throughout the initial screen and due diligence of an opportunity, foundation staff should consider the following (please note this is not a complete list of questions but rather a sample of the types of questions required during the due diligence phase):

Investment thesis

- ▶ What impact is the company aiming to achieve and how does this fit in with the foundation's programmatic objectives?
- ▶ How can your foundation's capital make a strategic and valued-added intervention in the business, organization, or fund in which it is considering investing?

Business model and operations (including employees/labor, suppliers, and customers)

- ▶ Do you understand the breakdown of the company's products and markets?
- ▶ What unmet need does the business address? What is the quality of its competitive landscape analysis, and how reasonable are its projections? What is the size of its potential market?
- ▶ What is the business model? How does the business make money?
- ▶ What are the company's cash flow requirements?
- ▶ What is the timing and level of potential return?

Industry and competitive analysis

- ▶ Who are the other major players in the market, and what percentage of the market do these competitors control?
- ▶ Does the company have direct competitors?

- ▶ Does the company operate in a declining, mature, or growing market? Can the market be expanded by the company's efforts?
- ▶ Are the company's customers trending toward purchasing or using substitute products? Are they deviating from the company in substantial ways?

Management team and track record

- ▶ How does management's past experience relate to present job requirements?
- ▶ Have you assessed management's ability to manage economic, industry, or regulatory changes?
- ▶ What is management's record as a whole? Has management succeeded in meeting goals? How do its successes compare to industry benchmarks?
- ▶ Check references, including suppliers, customers, lenders, investors. If fund manager, check with co-investors, other board members, and CEOs of investee companies. If appropriate, conduct background and credit checks.
- ▶ Compensation (salary, stock ownership, options, profit sharing, benefits, etc.)
- ▶ Length of time at company
- ▶ Composition of board and advisory committee
- ▶ Existing shareholders

Deal structure

- ▶ Will the deal require debt or equity?
- ▶ What is the time span of the investment?
- ▶ What interest rate or rate of return will the deal demand?

Expected returns and possible exit scenarios

- ▶ Ask the company for projected investment returns scenarios, including a base case and various downside cases.
- ▶ If the deal is not self-liquidating (e.g. not debt), how easily can you sell your equity in the company?

Financial statements

- ▶ When you assess past and projected financial performance and cash flows, you might ask: why does the company think this time it will be different? Have factors in this sector changed? Has new research come out?

- ▶ Who are existing investors? Valuation of last funding round?
- ▶ Has the company regularly filed tax returns?

IT systems and controls

- ▶ Does the company have a good IT system?
- ▶ Is the IT system secure (both physically and from cyber-attacks)?
- ▶ Does the company have a back-up system?

Other investors

- ▶ What other funders have invested in this deal?
- ▶ Are the other funders mission driven?
- ▶ If not, how will that affect the relationship among investors?

Mission alignment

Does this investment clearly align with your foundation's mission?

Social and/or environmental impact

- ▶ What is the management team's mission, how clearly have they articulated it, and how committed to it are they?
- ▶ What is their theory of change?

Incorporation of the intended impact into the business model

- ▶ At what point is the theory of change built into the way they do business (e.g., who they employ, which clients they serve, who their suppliers are, etc.)?

Second screen: determine ability to execute a theory of change and intent

- ▶ How is management's intent built into the business model?
- ▶ What safeguard do they have in place to avoid mission drift?
- ▶ What is their 5-10 year vision?
- ▶ How do they plan either to maintain the current focus or to evolve?
- ▶ What will happen if they sell?
- ▶ Have they given any thought to measuring outputs and/or outcomes?

- ▶ Who are the other investors and how will they influence the management team?
- ▶ How does the management team think about a trade-off – if any – between social and financial consideration?

Delivering on the intended impact

- ▶ What kind of social impact do they expect to achieve?
- ▶ Which groups most acutely feel the impact (e.g., customers, suppliers, distributors, employees, etc.)?
- ▶ How sound is the theory of change? Can you distinguish true intent from marketing/“greenwashing”?
- ▶ What risks do you foresee and what plans are in place to mitigate those risks?

Note: Financial and social performances are often intertwined; financial merits cannot be determined in isolation from social merits of an investment. Rarely will an investment generate social impact if it is unable to deliver financial returns.

Besides these broad categories of analysis, due diligence will usually include a field visit ranging from 2-5 days. The field visit will include substantial time with the management team as well as visits to clients or any portfolio companies, if applicable.

Due diligence costs depend on the scope and duration of the effort, which in turn depend on the complexity of enterprise, project, or organization. Costs are typically viewed as an essential expense far outweighed by the anticipated benefits and the risks of failing to conduct adequate due diligence. Typically the foundation investor (or a consortium of investors) covers the costs of due diligence. Some foundations rely on trusted third-party due diligence. Others work with advisers when making investment decisions. Smaller foundations may find it more economical to rely on trusted partners or advisors on the ground in Israel to do their due diligence.¹¹²

Again, a common template or investment memorandum that is created at the culmination of the due diligence phase can help institutionalize this process. Several examples of templates and previously used investment memorandums can be found at the Mission Investors Exchange website.¹¹³

Step 5: Deal Structuring and Legal Closing

Once a deal has passed the due diligence stage, the foundation commences a more detailed negotiation of structure, terms, and legal documentation. For the sake of prudence, the foundation’s general counsel will at this stage often work in conjunction with outside counsel. Foundations will typically ask outside counsel to deliver an opinion of the investment’s treatment as a PRI under the IRS code. In addition, the foundation will structure the investments to ensure that all investment criteria are met and to provide maximum protection against investment risk. Investments are also structured

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113 <https://www.missioninvestors.org/tools/>

to facilitate post-investment monitoring and participation, including regular financial and social reporting. The frequency of monitoring each covenant should be clearly defined in the investment agreement. In order to execute investments effectively, foundation board members and staff can either build the capacity required to structure investments or outsource investment structuring and execution to an experienced consultant. *{Please reach out to JFN Israel (jfn@jfunders.org) or the author directly to receive contact information for advisors or organizations that have experience in the Impact Investing and Program Related Investing fields}.*

Step 6: Monitoring Financial and Social Impact

Executing a PRI agreement does not mean you have reached the finish line. In fact, it represents the beginning of a long and perhaps fruitful relationship. After closing the deal, the foundation must regularly monitor the performance of its investment to ensure financial health and intended impact. Most foundations who use PRIs buy or build a monitoring system that can track reporting compliance, financial and social performance, and cash inflows and outflows. Monitoring systems can be as basic as a spreadsheet that tracks cash inflows and outflows. However, at some point an organization may want to invest in a more institutional system. Klipfolio, for instance, is an online dashboard platform that integrates and retrieves information from multiple sources to real-time user-friendly dashboards that can monitor social and financial information. Another well-known system is eFront, which offers an integrated, web-based approach for optimizing the management of both direct and indirect investments.

Unlike traditional investors that only measure their financial returns, PRIs must be assessed for both financial and social performance.

(i) Assessing Financial Performance:

Assessing the financial performance of an investment involves the relatively straightforward measuring of profit, cash flow, and balance sheet strength. Investors may track financial ratios, including those that measure net assets, liquidity, and asset quality. PRI terms may include financial and programmatic performance conditions in a covenant, or investment agreement. These agreements require or prohibit the investee from doing certain things. Covenants typically cover financial targets or allowable uses of the investment proceeds. Monitoring will therefore include determining compliance with those covenants. The frequency of monitoring each covenant is clearly defined in the investment agreement. Most covenants are monitored quarterly or annually throughout the term of the investment.¹¹⁴

(ii) Assessing Social Impact:

As with grants, foundations must assess the social impact of an impact investment. Investors typically include in the investment agreement key programmatic or social indicators—a core set of metrics customized for individual transactions. Examples of key indicators include jobs created, affordable housing units financed, numbers of individuals accessing financial services, levels of energy conservation achieved, or number of childcare slots financed. Some foundation investors believe that they get better impact data from their PRIs than from their grants; the former require clear metrics and regular reporting and legally binding contracts from the investees.¹¹⁵

114 https://www.missioninvestors.org/system/files/tools/FieldGuide_102113_PRINT_v3.pdf

115 https://www.missioninvestors.org/system/files/tools/FieldGuide_102113_PRINT_v3.pdf

APPENDIX A:

Many foundation members understand the parameters of qualified program-related investments (PRIs). But that clarity does not extend to how a PRI affects both a foundation's financial position and its requisite tax reporting (Form 990-PF).¹¹⁶

The primary difference between a PRI and a corpus investment is that a PRI is counted toward a foundation's minimum distribution requirement (MDR) of charitable investments in the year that the investment is made. How a PRI is structured has implications for a foundation's financial statements. For instance, if an investment is structured so that the entire principal is repaid at term, the foundation will have a "bump" in MDR in that year. If the principal payments are amortized for a steady repayment over the life of the investment, the MDR effect is smoothed. One option is not intrinsically better than the other; the foundation should simply plan its giving and investing with a clear picture of what to expect in the MDR calculation.¹¹⁷

The chart below illustrates how the accounting treatment differs between a corpus investment and a program-related investment on financial statements. The final section of the chart lists some ethical criteria that may restrict corpus or PRI investment options.

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Accounting implications of PRI vs. Corpus Investments¹¹⁸		
	Investment Method	
	PRI	Corpus
On the balance sheet	Loans create an asset called PRI or Note Receivable.	Loans create an asset called PRI or Note Receivable.
	Equity can create an asset called PRI or it can be recorded as “other investment.”	Equity can create an asset called PRI or it can be recorded as “other investment.”
Minimum Distribution Requirement	MDR is credited, as though a grant were made.	MDR is not affected.
As principal is repaid	The asset decreases.	
	Every year that principal is paid, MDR increases by the entire amount of principal payments received.	MDR is not directly affected.
As interest or other financial return is received	For loans: interest income is recorded.	
	For equity: dividends, realized or unrealized gains, or other investment income is recorded.	
Interest income is taxable	Interest income is usually taxable at the 1-2% federal excise rate. Rarely, the income is considered unearned business income and is taxed at corporate or trust tax rates.	
If investment is lost	A loan loss is taken as bad debt expense, a decrease in a balance sheet allowance, or both.	
	An equity loss is taken as a loss on investments on the balance sheet.	
	The asset disappears from the balance sheet.	
	MDR is not affected because the amount was already credited when the investment was made.	MDR is not directly affected.
Other restrictions may apply		
Jeopardizing investments	No	Yes
Excess business holdings	No	Yes
Self-dealing	Yes	Yes
Expenditure responsibility	Yes	No

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Illustrative Examples of PRIs:

Actual Case Study¹¹⁹

Max M. and Marjorie S. Fisher Foundation and Artesian Farms

Investor	Asset Class	Amount	Investee	Investment Made	Investment Termination
Max M. and Marjorie S. Fisher Foundation	Loan	\$50,000	Artesian Farm	2014	2018

Introduction: The Max M. and Marjorie S. Fisher Foundation, based in Michigan, aims to strengthen and empower children and families in need. The foundation gives priority to opportunities that provide for the needs of and ensure the future of the Jewish people while respecting its founders' commitment to the Detroit community. It supports initiatives that attract investment to local Detroit businesses from venture capitalists, institutions, individuals, and philanthropic organizations. The PRI program at the Fisher Foundation, active for the past three years, centers on the Detroit area in its support of early education, success in college, and access to jobs. Phillip Wm. Fisher, the foundation's vice-chairman, is the founder of Mission Throttle, an impact-investing firm dedicated to propelling the success of social entrepreneurs. His familiarity with the space has helped the foundation to be well-versed in the need for capital to flow to Detroit's small businesses—especially ones with the promise of stable job creation and training for the community.

Background: Artesian Farms is a hydroponic produce-growing facility in the Brightmoor neighborhood of northwest Detroit. It aims both to run a thriving business and to revitalize the lives of its employees in an economically depressed area. The Fisher Foundation already knew and trusted Artesian Farm's founder, Jeff Adams. Furthermore, Mission Throttle was involved in the early stages of the enterprise, and the neighboring Skillman Foundation was a co-investor.

Process: This opportunity arose out of existing relationships with the business' founder, Mission Throttle, and the Skillman Foundation. It took almost 18 months from the time the social entrepreneur contacted the foundation for an impact investment until the deal closed. During that time, various funders came together to provide technical assistance to the entrepreneur and share due diligence in order to guide the transaction to the point where it was investment-ready. Although the potential investment was fully vetted and the players trustworthy, it was still high-risk. The Fisher Foundation however, was ready to lead by example, and lent Artesian Farms \$50,000, matched by an identical amount from the Skillman Foundation. The venture raised an additional \$300,000 from a group of investors for a total of \$400,000 in start-up funding. Ultimately, it relied on Mission Throttle's expert due diligence and risk assessment of Artesian Farms.

Financial Impact: The investment will return 4% interest over a 3-year amortization, with interest only in year one and repayment of principal scheduled for years 2 through 4.

Social Impact: The intended social impact is to create jobs, promote economic development, and provide healthy food alternatives in the hard-hit neighborhood of Brightmoor.

Fictional Case Study 1:

The Klein Family Foundation and Opportunity Center

Investor	Asset Class	Amount	Investee	Investment Made	Investment Termination
Klein Family Foundation	Loan	\$100,000	Opportunity Center	2013	2019

Introduction: The Klein Family Foundation is a century-old, New York-based family initiative that focuses on community-development projects in New York City and Israel. It chose Opportunity Center as its investee for a \$100,000 loan to grow its job-training and employment programs to extend longer-term programming to marginalized Israeli populations.

Background: Opportunity Center, a Tel Aviv based certified B-Corp, recognizes the correlation between education and employment and aims to change the opportunity landscape for disadvantaged citizens of Israel. To date, Opportunity Center has provided 2,500 at-risk young adults with vocational training through an economic-development initiative called “Tech Drive.” The initiative delivers professional-skills workshops, technical-knowledge seminars, and follow-up job placement support for quality jobs in Israel’s communications and tech sectors. The \$100,000 loan will help Opportunity Center keep participants active in the network by rolling out a new mentorship program. “Tech Connect,” as the program is called, links business executives with program participants to help open new doors to employment networks. Opportunity Center receives a finder’s fee for every successful referral that results from its job-training programs.

Process: The Klein Family Foundation’s \$100,000 PRI was made in the form of a senior loan with an interest rate of 3 percent, interest-only payments through the call period, and straight amortization for five years with balloon payment after two years. The investment supported the roll-out of the “Tech Connect” program with 100 “Tech Drive” graduates and 100 mentors.

Financial Impact: “Tech Connect” participants improve their employment opportunities and incomes. The Klein Family Foundation earns interest at 3% on its investment.

Social Impact: The program has led to 80% successful job placements for 2,500 participants with 90% of those graduates remaining in their jobs for a year or longer.

Fictional Case Study 2:

The Tikkun Olam Foundation and Israel Health First Fund (“IHFF”)

Investor	Asset Class	Amount	Investee	Investment Made	Investment Termination
Tikkun Olam Foundation	Equity Fund	\$1,000,000	Israel Health First Fund	2015	2025

Introduction: The Tikkun Olam Foundation is a U.S.-based philanthropy seeking to improve health services for poor and under-privileged people around the globe. To this end, the foundation provides financial and technical support to various global healthcare companies and initiatives. Recently the foundation selected the Israel Health First Fund (“IHFF”) for a \$1 million PRI in a \$20 million social impact venture capital fund. IHFF invests in early-stage Israeli healthcare companies. Illustrative investment pipeline ideas include: a medical technology company focused on heart disease diagnostics for low-income populations and a company that provides affordable breast cancer detection using only smart cell phones. These are just two of the promising companies that IHFF will consider as portfolio investments.

Background: Israel Health First Fund is a social impact venture capital fund that invests in promising early-stage healthcare businesses in Israel. Each company that IHFF invests in will target healthcare solutions for low-income populations worldwide. IHFF is managed by a seasoned team of venture capitalists, experienced doctors, and investment professionals.

Process: The Tikkun Olam Foundation’s \$1 million dollar investment comes in the form of an equity investment in U.S. dollars. This was the foundation’s first PRI. The foundation worked with outside team of investment advisors to get comfortable with both the financial and legal nuances of making a PRI. The due diligence process was completed in six months.

Financial Impact: The targeted internal rate of return (IRR) for the fund will be 15% net of all fees.

Social Impact: Israel Health First Fund aims to expand access to quality healthcare to millions of disadvantaged individuals worldwide. The fund has set target goals of directly improving 1 million lives and indirectly improving an additional 4 million lives worldwide. The fund has teamed up with a third-party monitoring and evaluations company to help track and measure social impact.

Fictional Case Example 3:

The Jewish Education Foundation and Sefer2GO

Investor	Asset Class	Amount	Investee	Investment Made	Investment Termination
Jewish Education Foundation	Equity (Series A)	\$750,000	Sefer2Go	2015	TBD

Introduction: The Jewish Education Foundation (“JEF”), founded in 1985 in Los Angeles, CA, promotes Jewish learning by supporting initiatives that promote Jewish values, tolerance, and cross-cultural understanding. In its three decades of operations, JEF has made over \$250 million dollars in grants and \$15 million in PRIs. Having made its first PRI in 1997, JEF is considered an early pioneer in the PRI space. Recently, JEF made a \$750,000 Series A equity investment in Sefer2GO, an innovative education technology company that offers iPad-ready lesson plans to Jewish day schools.

Background: Sefer2GO, jointly created by an Israeli data scientist and a retired U.S. Hebrew school administrator, aims to provide high-quality Jewish-study lessons. Sefer2Go currently provides affordable lesson plans to 15,000 students. Each lesson plan uses an algorithm that adapt to the pupil’s learning style and capabilities. With seed-stage funding, Sefer2GO rolled out its programming in thirty schools in New York City, Atlanta, Chicago, Los Angeles, and Houston, and will use its Series A funding to broaden its lesson plans from K-3 to K-middle school while also increasing its school distribution by 200 percent. Additionally, Sefer2Go seeks to broaden its platform to include monthly subscription-based online adventures based on the Bible. Each month, an adventure kit arrives by mail with an online sign-in code to start a new journey.

Process: The Jewish Education Foundation’s \$750,000 Series A equity investment in Sefer2GO is being invested in a \$1.5 million round. In addition to a 20% stake in the company, the foundation negotiated one board seat.

Financial Impact: JEF invested in Sefer2GO directly to provide the long-term capital it needed to build out its vision. JEF expects to exit ten years after its original investment, with a minimum internal rate of return (IRR) of 10%.

Social Impact: Sefer2GO will expand its quality, iPad-ready lesson plans and reach twice as many student as they currently do. Sefer2Go will also build out their adventure programs business line to promote interactive Jewish studies while promoting understanding, tolerance, and civic engagement.

Glossary of Terms

“Acceleration” is the right of the lender, in the case of borrower default, to declare all of the borrower’s debt due and payable immediately.

“Amortization” is the process of loan payment over time by regular payments of interest and principal. The “amortization period” refers to a fixed period during which regular loan payments are made. The payment includes interest due each period, plus a gradually increasing amount of principal.

“Assets” are anything having commercial or exchange value owned by an organization.

“Bridge loan” is temporary financing to a borrower who has secured a loan at a point in the future but who needs funding before that loan is put in place.

“CDFIs” are a financial institution such as a community development corporation, bank, credit union, or loan or venture capital fund, that has as its primary mission to provide credit and financial services to underserved markets and economically disadvantaged populations.

“Closing” is the time when the borrower signs final loan documents and the lender transfers at least some portion of funds to the borrower

“Code” means the Internal Revenue Code of 1986, as amended.

“Collateral” is personal or real property that the borrower pledges to assure repayment of a loan.

“Commitment letter” is an agreement by the lender to make loans to the borrower on specified terms, subject to the satisfaction of stated conditions and the completion of satisfactory loan documentation.

“Convertible note” is a form of short-term debt that converts into equity, typically in conjunction with a future financing round; in effect, the investor would be loaning money to a startup and instead of a return in the form of principal plus interest, the investor would receive equity in the company.

“Covenant” is a clause in a loan agreement in which a party promises to do, or to refrain from doing, certain things while the loan is outstanding. Covenants that require a party to do something are called “affirmative covenants.” Those that prohibit certain actions are called “negative covenants.” Covenants are designed to protect the lender’s interest.

“Credit agreement” is an agreement governing the relationship of the lender and the borrower.

“Delayed draw loans” are a specific type of term loan that permits the borrower to make several borrowings over a set period of time to utilize the full amount of the loan.

“Due diligence review” is an in-depth process of evaluating the opportunities and risks of a particular investment, including the careful confirmation of all critical assumptions and facts presented by a borrower. This includes verifying sources of income, accuracy of financial statements, value of assets that will serve as collateral, the tax status of the borrower, and other material legal and financial information.

“Endowment fund” is an established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted.

“Equity investment” typically takes the form of an owner’s share in a for-profit business, and return on equity involves a share in the profits. An equity investment typically takes the form of ownership of a business entity, such as shares of stock, membership interest in an LLC, or a partnership interest in a limited partnership.

“Expenditure responsibility” is the requirement for a private foundation to follow procedures to take care that a grant or a PRI is used only for the purpose for which it is made. This includes obtaining full and complete reports on expenditures from grantee or borrower organizations and full and detailed reporting to the IRS.

“Financial Intermediary” is an organization that raises funds from depositors or investors, including individuals and organizations, and re-lends these funds to other individuals and organizations. Non-profit financial intermediaries raise funds through grants, program-related investments, and social investments and re-lend to non-profit or other organizations that will undertake projects such as affordable housing development or targeted business assistance.

“Guarantee” is a pledge to cover the payment of debt or to perform some obligation if the primary obligor defaults. When a third party guarantees a loan, it promises to pay in the event of default by the borrower.

“Internal Rate of Return” (IRR) is the interest rate at which the net present value of all the cash flows (both positive and negative) from a project or investment equal zero. Internal rate of return is used to evaluate the attractiveness of a project or investment.

“IRS” means the Internal Revenue Service.

“Jeopardizing investments” are investments that financially imperil the carrying out of the charitable activities of a private foundation. They are defined in the Code and are subject to a punitive excise tax.

“Leverage” is the level of debt in a project. Highly leveraged projects have a high level of debt compared to equity as a source of funds.

“Liabilities” represent financial claims on the assets of an organization – excluding ownership.

“Lien” is a legal right to have a debt repaid out of specifically identified property of the debtor.

“Liquidity” refers to the availability of cash or “near cash resources” for meeting an organization’s obligations. “Near cash resources” typically refers to liquid investments, inventory, accounts receivable and other assets expected to be available in cash within three months.

“Loan documents” means the credit agreement, promissory notes, officer’s certificates and opinions from counsel.

“Mortgage” is an instrument through which a lender secures a legal right to repayment of debt by taking title to the real estate pledged by the borrower. Usually, a promissory note creates the obligation to repay

the loan in accordance with the terms of the mortgage. The mortgagor is the borrower; the mortgagee is the lender.

“PLR” means private letter ruling. PLRs are specific rulings by the IRS, binding on the IRS solely in respect of the taxpayer that requested the ruling, issued on certain issues in the past and giving some guidance as to how the IRS might be likely to treat similar situations.

“PRI” means a program-related investment. PRIs are a well-established mechanism for foundations to use different forms of financing, other than grant-making, to support their tax-exempt purposes through loans, loan guarantees, equity investments, and recoverable grants.

“Prime rate” is the interest rate banks charge to their most credit-worthy corporate customers.

“Principal” means the stated amount of a loan, notwithstanding interest or other premiums or discounts.

“Promissory notes” are documents that evidence the funds that have been borrowed under the credit agreement.

“Qualifying distribution” means an amount, including program-related investments and reasonable and necessary grant administration costs, a private foundation pays to accomplish religious, charitable, scientific, literary, or other public purposes. It is as defined in Section 4942(g) of the Code. Private foundations must distribute annually as a minimum qualifying distribution 5% of the average fair market value for the preceding year of all foundation assets that are not directly used for charitable purposes.

“Recourse” is the right to demand payment from the borrower. In a full recourse loan, the lender has the right to take any of the borrower’s assets that are not otherwise pledged or secured if the loan is not repaid. In a limited recourse loan, the lender can only take assets named in the loan agreement. In a non-recourse loan, the lender’s rights are limited to the particular asset financed by the loan.

“Recoverable grant” is an agreement under which a grantee commits to repay a grant under certain circumstances, generally, if the project financed by the grant is financially successful. If the conditions that trigger the repayment obligation are not met, the grantee is under no obligation to repay and no default is triggered.

“Revolving loans” are loans designed so that a lender commits to lend up to a stated maximum amount of funds. The borrower may then draw any amount under the loan, up to the maximum amount. Interest on the revolving loans will be payable only with respect to the amounts outstanding.

“SEC” means the Securities and Exchange Commission.

“Security interest” means a pledge of value to assure the performance of an obligation or the repayment of a debt. Security on a loan can include real estate, personal property, stocks and mortgages.

“Term loans” are typically loans drawn in a lump sum on the date the credit agreement is signed (or shortly thereafter) and repaid in regular installments pursuant to a schedule set forth in the credit agreement or in full on the maturity date. Once a term loan is drawn, the borrower may not make any further borrowings under the loan even if it has made payments towards the loan balance. Interest will be payable on the amount drawn either on a periodic basis or at maturity.

“UBTI” is gross income from any unrelated trade or business, as defined in Section 512(a) of the Code.

“UCC” means the Uniform Commercial Code.

“Working capital” is the difference between an organization’s assets that can be converted to cash within one year and liabilities payable within one year.

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The original Strategies to Maximize your Philanthropic Capital: A Guide to Program Related Investment:

<https://www.missioninvestors.org/tools/strategies-maximize-your-philanthropic-capital-guide-program-related-investments-primer>



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