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MEMORANDUM

To: Mike Rea, Executive Director
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From: David A. Levitt

Date: May 20, 2020

Re: Charity Mission-Related Investing

A charity mission-related investment, commonly referred to as an "MRI" or an "impact investment," is broadly defined as a financial investment that is aligned with the charity's mission.[1] By leveraging a higher percentage of the charity's assets towards furthering its charitable goals, and potentially generating a return that can increase funds available for future grants or investments, many charities have concluded that MRIs complement their charitable grant making in significant ways.[2]

1. Investments Made by a Public Charity Grantee

Grantmaking charities such as private foundations and donor advised funds ("DAFs") can make grants to a public charity that in turn makes equity and debt investments in early stage companies. This can be an effective strategy if the public charity grantee has the knowledge and expertise to identify and invest in impact opportunities.

[1] The Global Impact Investment Network defines impact investments as "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return." See https://thegiin.org/impact-investing/need-to-know/#s1.

[2] An MRI is distinguished from a program-related investment, or a "PRI," which is defined in Section 4944 of the Internal Revenue Code. The primary purpose of a PRI is to accomplish a charitable purpose and not to generate a financial return. PRIs therefore are typically below-market or concessionary investments and are not addressed in this memorandum.

Investments by a public charity using grants from private foundations or DAFs also provide certain tax benefits to the grantor. For instance, both private foundations and DAFs are subject to excess business holding limitations on how much equity they can own; these rules do not apply to a non-DAF public charity that receives grants and makes investments. In addition, a grant to a public charity counts toward a private foundation's annual payout requirement; this generally would not be the case if the foundation instead invested the funds in a market-rate investment.

The public charity grantee will have discretion to make investment decisions and will bear the risk of any investment it makes. However, grantmakers can choose to make recoverable grants that are to be returned to the funder under certain circumstances, including if the grantee generates a return with the grantor's funds. While a grantor private foundation might recapture a qualifying distribution that it will need to make again in a future tax year, the initial grant is still a charitable activity.

2. State Law: Prudent Investor Requirements

Because an MRI is a commercial investment, it must be made prudently and satisfy the same investment standards under state and federal law as other investments. Each state defines director fiduciary duties and how this fiduciary standard applies to investment decisions. With respect to charities formed as nonprofit corporations, almost all states have adopted some version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which includes a fiduciary standard for the management and investment of institutional funds.[3] This investment standard applies to all charities, not just charities with an endowment.[4]

Under UPMIFA, the standard for managing and investing a charity's assets includes consideration of "an asset's special relationship or special value, if any, to the charitable purposes of the institution."[5] A charity therefore may take into consideration its charitable purposes in making a commercial-rate investment that has a program-related purpose, even if it is not primarily program related (i.e., not a PRI). According to the National Conference of Commissioners on Uniform State Laws, UPMIFA "does not preclude a charity from acquiring and holding assets that have both investment purposes and purposes related to the organization's charitable purposes."[6]

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[3] As of April 2020, 49 states, the District of Columbia, and the U.S. Virgin Islands have adopted UPMIFA. UPMIFA has not been adopted by Pennsylvania or Puerto Rico.

[4] With respect to exempt organizations formed as trusts, the model act that generally applies is the Uniform Prudent Investor Act (UPIA).

[5] UPMIFA Section 3(e)(1)(H).

[6] *See* http://www.uniformlaws.org/home.

3. Federal Tax Law: Mission-Related Investments

Section 4944 of the Internal Revenue Code imposes an excise tax on a private foundation, and in some situations the private foundation's managers, for investments deemed "to jeopardize the carrying out of any of [the foundation's] exempt purposes." Private foundation managers must exercise ordinary business care and prudence in providing for the long-term and short-term financial needs of the foundation.

Internal Revenue Service Notice 2015-62 clarifies that when deciding whether to make an investment, foundation managers may consider *all* relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes. Foundation managers therefore are not required by federal tax law to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity, if other factors such as alignment with mission are relevant.

Notice 2015-62 provides guidance for mission-related investing, and it is consistent with the fiduciary standard set forth in UPMIFA described in Section 2. While the Notice specifically addresses private foundations, other charities also may look to it for guidance as to how the Internal Revenue Service will view charity mission-related investments.

4. Tax Deductibility of Donations Used for Investments

A charity may use donations it receives to make debt or equity investments that are consistent with its charitable purposes.[7] As long as the donor does not earmark the donation for a specific investment recipient or for a non-charitable purpose, the donation should be eligible for a charitable income tax deduction.

Earmarking can result from any oral or written understanding that the charity will provide the donor's contribution to a designated recipient. To avoid earmarking, the charity must have discretion and control over the use of the donated funds. A donor may restrict its donation for a specific charitable *purpose* (e.g., climate change or decarbonization) and still obtain a charitable income tax deduction, as long as the donor does not designate a specific *recipient* of the funds other than the charity.

5. Co-investment Considerations

The public charity and its donors may decide to invest in the same company or investment fund. Co-investment is permissible provided the charity is not using its investments or other resources to impermissibly benefit the other investors. Under Section 501(c)(3) of the Internal Revenue Code, a charity may not provide an undue private benefit to its insiders or to any

[7] This is the case unless the donation itself is subject to a more specific restriction, for instance imposed by the donor or as a result of the charity's representations regarding how it would use the funds at the time of the donation.

other individuals or for-profit entities. If the charity is not investing on terms that are any less favorable than those offered to the other investors, any benefit to the investment recipient or to the co-investors should be incidental to the charity's investment and therefore permissible.

In addition, the Internal Revenue Service has provided specific guidance to private foundations regarding how they can co-invest in a company or an investment fund along with their insiders. The foundation can avoid self-dealing by making sure its co-investment does not improperly benefit the co-investors. For instance, the foundation should ensure that its investment (a) does not provide any foundation insider with access to investments to which he or she otherwise would not have access, (b) does not reduce the minimum investment amount that is required of the insider, and (c) does not reduce the fees or other investment costs that the insider must pay in connection with the investment. These rulings indicate that co-investment is permissible if certain guidelines are followed.

This memo provides a brief introduction to certain aspects of charity mission-related investing. Please contact me if you have questions or are seeking a more detailed analysis.