When we think of a private foundation supporting a charitable cause, most of us think in terms of grants—money given away with no expectation of it ever coming back. But loans, loan guarantees, and even equity investments can be made by foundations specifically to support a charitable purpose. These financial vehicles, called Program-Related Investments (PRIs), offer foundations an alternative beyond traditional grantmaking. Whereas grant dollars go out the door never to return, PRI dollars are generally recovered in part or in whole, and may even earn some return for the foundation in the form of interest or appreciation. PRIs offer several important advantages, including:

- The ability to comfortably give more funds to a worthy project than through a grant, knowing that the principal will eventually be repaid to the foundation.
- The ability to reuse or “recycle” the same dollars for the benefit of multiple organizations, as PRIs are paid back and then redistributed.
- Qualification towards the foundation’s 5% payout requirement in the year of disbursement, just like a traditional grant.

Meanwhile, recipients of PRIs benefit in several ways as well. Recipients can:

- Raise a larger pool of funds than with grants alone because investors expect to get their money back.
- Obtain financing for a project that would be considered too risky by traditional commercial lenders or investors.
- Attract other lenders or investors to a worthy project by having the lead funder take on early risk or accept lower returns to make room for more traditional sources of capital.
- Sharpen fiscal management practices by going through the steps necessary to complete a successful negotiation and repayment process.
- Shore up their credit history by seeing the loan to successful conclusion, making the organization more attractive to traditional sources of funding.
The potential uses of PRIs are extensive, as long as the foundation meets three requirements laid out by the IRS:

- The primary objective of the PRI must be to accomplish a charitable purpose.
- The production of income must not be a significant motivating factor.
- The investment must not attempt to influence legislation or elections; a PRI may not be used to support candidates for office or lobby elected officials.

Taken together, these requirements dictate that if the foundation were driven purely by financial considerations, it wouldn’t make the PRI. In practice, this means that the loan or investment will usually have some downside that makes it unattractive to commercial investors: high risk, low return, and illiquidity are common traits among PRIs. Foundation Source Chief Legal Officer Jeffrey D. Haskell has jokingly described PRIs as “bad investments for a good cause.” Evidently, the IRS concurs: because PRIs fulfill a foundation’s charitable purpose, they are exempt from the normal rules that prohibit the foundation from making so-called “jeopardizing” investments.

Because it fulfills the foundation’s charitable purpose, funds distributed as a Program-Related Investment count toward satisfying a foundation’s 5% payout requirement in the year in which they are distributed. When the PRI principal is paid back, the foundation’s payout is increased that year by the amount of the repayment (interest, dividends and capital appreciation are treated as regular income). If a PRI “fails,” and the funds are not paid back to the foundation, the effect is as though the foundation had given those funds away as a grant.

**Traditional PRIs**

Although relatively few private foundations currently use PRIs, and many have never even heard of this philanthropic tool, a small but steady cohort have employed PRIs since they were first defined by the Tax Reform Act of 1969. The Ford Foundation is widely recognized as an early advocate of Program-Related Investments, having served as cofounder of the first consortium of foundations that pooled their dollars to create a nonprofit loan fund in the early 1970’s.

Circumstances where foundations have employed PRIs include:

- Lending funds directly to a nonprofit (such as a charter school or church) so it can begin construction on a new facility while conducting a capital campaign.
- Placing a deposit with a community bank or community loan fund that pools it with other deposits and lends it to nonprofits or development projects in underserved neighborhoods.
- Assisting a nonprofit to secure a bank loan by pledging the foundation’s credit as security to guarantee the loan, or accepting a below-market interest rate on the foundation’s deposit, so the nonprofit receives a favorable interest rate on its loan.
- Providing support to help a nonprofit launch a revenue-generating service related to its mission, such as a job placement program focused on a landscaping business that provides temporary jobs and a successful work experience for those it serves.
- Investing in a small pharmaceutical company that produces an “orphan” drug.

Although a below-market interest rate for a loan to a charitable organization is often cited as an example of a typical PRI, recent IRS regulations look favorably on PRIs that have higher rates of return but retain some other feature that makes them unattractive to commercial investors, such as extremely high risk associated with lending in politically unstable and undeveloped countries.
Today, more foundations are incorporating PRIs into their larger social change strategy. For example, the Bill & Melinda Gates Foundation’s PRIs include $20 million to a German company to expand banking services in Africa; $20 million to spur commercial microcredit lending in Africa and Asia; and an $8 million equity fund investment to stimulate health-related ventures such as the distribution of mosquito nets to help prevent the spread of malaria in Africa. These PRIs (again, they aren’t grants) are intended to return dollars to the foundation while simultaneously advancing its philanthropic work. Foundations that are interested in PRIs might want to look into the well-established network of grantmakers (www.primakers.net), government regulated Community Development Financial Institutions (www.cdfi.org) and other intermediaries with deep experience using PRIs.

**Different PRI Flavors: Loans, Loan Guarantees, and Equity Investments**

PRIs take one of three recognized forms: a loan, loan guarantee, or an equity investment. All three types of PRIs share these two attributes:

- They count toward a foundation’s 5% distribution requirement.
- They aim to recover principal but not necessarily make a profit.

Interestingly, unlike most foundation investments, PRIs are not subject to jeopardizing investment rules. Although private foundations are forbidden from making investments that are so speculative as to expose foundation assets to unreasonable risk, Internal Revenue Code 4944 includes an exception that allows foundations to make PRIs.

Let’s take a closer look at the three types of PRIs.

**Loans**

The majority of PRIs are below-market loans. The private foundation makes either a low- or no-interest, secured or unsecured loan and takes back a promissory note. Repayment schedules can vary widely from pre-set annual payments to balloon payments due after many years.

Whatever the terms, loans should be made to nonprofits that have a reliable revenue stream or repayment source lest they become unintentional grants.

Examples of PRI loans:

- Loaning funds to a hunger-relief agency to finance the purchase of refrigerated trucks to pick up and distribute food donations.
- Lending to a church, museum, or other nonprofit to begin construction on a new facility while conducting a capital campaign.
- Providing a low-interest student loan to a single mother re-entering the workforce.

**Loan Guarantees**

It is also possible to provide a loan guarantee instead of an actual loan. PRI loan guarantees are helpful to organizations and individuals whose ability to access capital from traditional banks is limited because of a lack of credit history or uncertainty about the eventual suc-
cess of a project. Under this scenario, the foundation pledges its credit or assets as security, thereby mobilizing credit for a grantee without liquidating the foundation’s current holdings or disbursing cash (unless the guarantee is called).

There are a number of ways that a foundation can extend credit to grantees:

• Deposit funds in a low-interest bank account at the grantee’s lender. In exchange for the foundation accepting the below-market interest, the grantee receives a favorable interest rate on its loan from the lender.
• Place a deposit with a community bank or credit union. These financial institutions resemble large banks in that deposits are federally insured and they provide typical banking services but they also serve a social purpose. They create “linked accounts” by pooling the foundation’s funds with those of other depositors to lend to nonprofits or development projects in underserved neighborhoods.
• Issue a letter of credit to enhance a charity’s credit-worthiness in a third party transaction. This gives the borrower an opportunity to build a favorable credit history.

It’s important to note that a loan guarantee does not automatically count as a qualifying distribution. The foundation can only take credit for distributions towards its 5% pay-out requirement if there is a default on the loan and the foundation is called upon to honor its guarantee.

Examples of Loan Guarantees:

• Immigrant families often lack the established credit necessary to rent safe and suitable places to live, even when their income is more than adequate. Providing a loan guarantee for their security deposits puts their applications on an equal footing with other potential tenants, making it possible for them to secure market-rate housing.
• Loan guarantees can expand financial services in underserved areas. The Erich and Hannah Sachs Foundation purchased a five-year, $200,000-certificate of deposit in the Santa Cruz Community Credit Union in California to expand access of low-interest loans and financial services to residents and small businesses in local farming communities.
• The MacArthur Foundation awarded $970,000 to MB Financial Bank to provide credit enhancement for their arts and culture grantees in the Chicago area.

Equity Investments

Beyond these well established forms of PRIs, which focus on loans and loan guarantees for nonprofits, there is growing interest among investors in making stock purchases in for-profit companies known as “social enterprises”—commercial ventures that also have a charitable purpose. PRI equity investments count toward the foundation’s 5% minimum distribution requirement provided the investee organization has a clear charitable mission and the foundation’s decision to invest is primarily motivated by a desire for social impact, not financial gain. When the foundation exits the PRI by sale or redemption, it triggers a PRI “recapture” requirement for the proceeds from the sale or redemption, up to but not in excess of the amount originally claimed as a qualifying distribution.

Foundations often make PRI equity investments in start-up companies or risky ventures in unproven markets that conventional investors would be unwilling to capitalize. As such, foundations can make these PRIs from their grantmaking budget in worthy business enter-
prises that they rejected as endowment investments due to their high risk profile or potential low return. As an example, Husk Power System is a social enterprise in India that developed a way to turn a product that is considered disposable waste—namely, rice husks—into electricity that is “reliable, eco-friendly and affordable for families that can spend only $2 a month for power.” Over 400 million people in rural India alone have no electricity, and the indoor burning of fuels for light and cooking causes respiratory illness, frequent burns and even deaths among the poor. Big utilities have no interest in extending their power lines to small rural villages because it is not worth their while economically. As such, a foundation dedicated to lifting people in rural India out of poverty might make an equity investment in Husk Power Systems, because the company’s mission—to bring low-cost, safe and reliable electricity to the underserved rural poor—dovetails perfectly with the foundation’s own goals.

Social enterprises like Husk Power Systems, which aim to survive on their earned revenue and provide a return to their investors, might qualify to receive a PRI from a foundation if the risk associated with serving the poor in developing countries is high, the potential return is relatively modest, and there is likely a long time horizon before the company can provide any kind of return to investors. All these factors make a commercial venture less attractive to traditional sources of capital and therefore a good candidate for investments in the form of PRIs—especially during the start-up phase.

Although PRI equity investments are a relatively new arena for private foundations, entrepreneurial donors who made their money starting or growing a business, and who have an appetite for risk and reward, are pushing the boundaries of PRIs in this direction. To give just a few other examples:

- The Bill and Melinda Gates Foundation made a $10 million equity investment in Liquidia, a for-profit company whose technology could help accelerate the development of vaccines for diseases such as malaria that primarily affect poor people in the developing world.
- The Annie E. Casey Foundation made an equity investment of $1.65 million in the Bay Area Equity Fund to capitalize companies that create jobs in low- and moderate-income communities in California’s Bay Area. One company in the fund, Revolution Foods, provides affordable and healthy school meals for over 120,000 children every day.
- The KL Felicitas Foundation invested $100,000 in Pico Bonito to acquire land in Honduras and reforest these areas for the benefit of local community and national interests while creating various forestry, agroforestry and carbon credit-based products for distribution and sale.

An Evolving Legal Framework

To avoid being fined for running afoul of jeopardizing investment rules, foundations must take care to ensure that their PRIs are indeed charitable and do not compete unfairly with for-profit players. For this reason, some foundations ask their attorneys to draft an opinion letter validating the charitable purpose before making a PRI or seek a private letter ruling from the IRS (a time-consuming method that does not guarantee approval). In 2010, in an effort to encourage the IRS to update decades-old regulations and lower the obstacles to PRIs, the American Bar Association (ABA) Section on Taxation submitted to the IRS a set

of proposed case examples meant to supplement the existing PRI regulations. In April of 2012, the IRS responded with new proposed regulations.

Why was this needed? Because the original regulations were issued long ago, foundations had to rely on private letter rulings for any PRI that presented a new direction. As these letters only covered the foundation that requested it and only for that one instance, the practice of applying for private letter rulings increased the cost associated with all such PRIs and had the net effect of dissuading foundations from pursuing them.

In these recently proposed regulations, the IRS provided contemporary examples of charitable activities that qualify as PRIs and therefore do not require opinion letters or private letter rulings. These examples, based on private letter rulings published over the last several decades, establish that a PRI may be made domestically or abroad to advance science, combat environmental deterioration, or promote the arts. The proposed regulations also clarify that the existence of a high potential rate of return on an investment does not automatically preclude the investment from qualifying as a PRI. By increasing certainty about what qualifies as a PRI, these new regulations should encourage more foundations and their advisors to explore their use.

**How Do Program-Related Investments Affect the Bottom Line?**

Despite the apparent benefits of Program-Related Investments, many foundation managers are hesitant to use them because of concerns about the financial repercussions of putting social returns ahead of investment performance. However, many foundations actually enhance their returns—as well as their mission—by engaging in Program-Related Investing. As one example, the F. B. Heron Foundation, a role model for foundations seeking to leverage their resources through the use of Program-Related Investments, has invested about 6% of its endowment in PRIs, mostly in the form of low-interest loans to nonprofits. Not only are these funds in the service of its mission, but in years where the bulk of its endowment lost value in the markets, the foundation’s PRI portfolio continued to earn consistent returns of about 3% per year.³

All told, PRIs allow the foundation to use “more for mission” as funds invested in Program-Related Investments are “given away” to worthy recipients, yet returned to the investment pool to maintain or increase the foundation’s endowment. Foundation Source’s clients are expanding the uses of PRIs to address social problems and provide new solutions. Our team of advisors provides guidance and support to help them explore the application of PRIs to accomplish their goals.

If you are intrigued by the possibilities of Program-Related Investments, contact Foundation Source at 1-800-839-0054 to learn more about how we support innovative philanthropy.

**About Foundation Source (www.foundationsource.com)**

Foundation Source is the nation’s largest provider of comprehensive support services for private foundations, bringing unparalleled knowledge and expertise to clients across the country. The company’s administrative services, online foundation management tools and philanthropic advisory services provide a total outsourced solution for private foundations. The result: better-run, more effective foundations and more enjoyable philanthropy. Our clients supply the funds, the vision and the philanthropic goals; we provide everything else.

Today, Foundation Source provides its services to more than 1,100 family, corporate and professionally staffed foundations coast to coast, ranging in size from $250,000 to over $500 million. The company provides its services directly to philanthropically focused families and institutions as well as in partnership with the nation’s leading private wealth management firms, law firms and accounting firms. Foundation Source is headquartered in Fairfield, Connecticut, with auxiliary locations in Atlanta, Chicago, Dallas, Denver, Los Angeles, New York City, Philadelphia, San Francisco, South Florida, and Washington, D.C.