

HOW PRIVATE OPERATING FOUNDATIONS USE PROGRAM-RELATED INVESTMENTS AS QUALIFYING DISTRIBUTIONS

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An exception to the jeopardizing investment rules under Section 4944(c) allows a private foundation to make an investment that might otherwise jeopardize the private foundation's ability to achieve its exempt purposes. Such program-related investments (PRIs), are allowed only if (1) the primary purpose of the investment is to accomplish one or more charitable purposes, (2) neither the production of income nor the appreciation of property is a significant purpose of the investment, and (3) neither influencing legislation nor participating or intervening in a political campaign on behalf of or in opposition to any candidate for public office is a purpose of the investment. PRIs are treated as grants,¹ and allowed as qualifying distributions of the investor private foundation² when the distribution is made.³

Private operating foundations (POFs) must make a certain amount of qualifying distributions directly for the active conduct of activities constituting the POF's charitable, educational, or other similar exempt purposes.⁴ Generally, the POF must use such qualifying distributions itself rather than by or through one or more grantee organizations.⁵

Because PRIs are used by the recipient organization, akin to a grantee organization, a question arises regarding when, if ever, a POF's PRI will be treated as a qualifying distribution made directly for the active conduct of activities, and countable toward the POF's satisfaction of the private operating foundation tests.

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Background and definitions

Non-POF private foundations. By default, all domestic or foreign organizations described in Section 501(c)(3) are private foundations, and it is only by satisfying one of several tests that the organization avoids private foundation status.⁶ Non-operating private foundations (non-POF) are subject to the strict set of laws found in Chapter 42 of the Code. These include the excise taxes on net investment income, self-dealing, the failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures.⁷ In addition, the income tax charitable contribution deduction limit for gifts to a non-POF foundation is less favorable than for gifts to public charities.⁸

Non-POF qualifying distributions. Non-POF foundations must distribute a certain amount of their assets each year on expenditures that constitute qualifying distributions. Qualifying distributions are defined generally as amounts paid to accomplish charitable purposes, capital purchases to carry out the organization's exempt purpose, and reasonable and necessary administrative expenses to accomplish the private foundation's charitable purposes.⁹ Non-POF qualifying distributions are calculated on the cash method of accounting.

The amount the non-POF foundation must spend is its "distributable amount," which is roughly equal to 5% of the foundation's average non-charitable use asset balance of the prior year.¹⁰ While non-POF foundations can engage in direct charitable activities, and many do, non-POF foundations generally spend the distributable amount on making grants to support the programs of other organizations. All qualifying distributions are counted, whether the activities supported by the non-

EXHIBIT 1

Data for Hypo 1 POF (Example 1)

Non-charitable use assets	\$ 1,000,000
Adjusted Net Income (Page 1, Part I, Line 27c)	\$ 30,000
Minimum Investment Return (Page 8, Part X, Line 6)	\$ 50,000
Qualifying Distributions (Page 8, Part XII, Line 4)	\$ 40,000

POF's grants are conducted by the non-POF foundation or by one or more grantees of the non-POF foundation. Failure to spend the entire distributable amount results in an excise tax on the undistributed portion.

Non-POF foundations must spend the distributable amount by the close of the following tax year.¹¹ That is, the distributable amount for a given year is based on the asset balance of the prior year.

Where to find this on Form 990-PF. POFs and Non-POF foundations both use Form 990-PF (Return of Private Foundation) to report that they are meeting the distribution requirements under Section 4942. There is some overlap in the way the two types of foundations approach the form, but there are also differences. The following sections on the Form 990-PF relate to calculating non-POF qualifying distributions:

- Page 8, Part X ("Minimum Investment Return").
- Page 8, Part XI ("Distributable Amount").
- Page 8, Part XII ("Qualifying Distributions").
- Page 9, Part XIII ("Undistributed Income").

Private operating foundations. In many ways, a POF works just like a non-POF foundation. A POF is equally subject to the operating restrictions found in Chapter 42, with one significant exception: Section 4942 qualifying distributions. A POF is not subject to the excise tax for failure to distribute income under Section 4942.¹² Instead, a POF's qualifying distributions must constitute direct charitable activity qualifying distributions (discussed below) and the amount a POF must spend each year is calculated differently

from a non-POF foundation. As described below, the required distribution amount is calculated using the "income test" and one of three alternative tests. The penalty for failure to meet the distribution requirements of a POF is reversion to non-POF status and the potential to fail the 5% minimum distribution requirement under Section 4942(d). Like a non-POF foundation, POF qualifying distributions are calculated on the cash method of accounting. In addition, the income tax charitable contribution deduction for gifts to a POF is the enhanced deduction limit available for gifts to public charities.¹³

Qualifying as an operating foundation. As described above, to qualify as an operating foundation, a POF must meet one mandatory test, the "income test," and one of three alternative tests—the "assets test," the "endowment test," or the "public support test."

The income test requires a POF to spend substantially all (defined as 85%¹⁴) of the lesser of the POF's adjusted net income (ANI) or its minimum investment return (MIR) on direct charitable activity.¹⁵ Stated differently, first look at the POF's ANI and its MIR. Then take the lesser of the two and multiply that number by 85%. The POF must spend at least that much in qualifying distributions for direct charitable activities to satisfy the income test.¹⁶ If the POF's qualifying distributions are greater than its MIR, or if MIR is less than ANI, the rule is slightly different and often overlooked, as the difference is not highlighted in Form 990-PF.¹⁷ All POFs must satisfy the income test.

Next, the POF must satisfy *one* of the three alternative tests:

1. The assets test is satisfied if substantially more than half (defined as 65% or more¹⁸) of the POF's assets are devoted directly to the foundation's direct charitable activities, to functionally related businesses,¹⁹ or to both.²⁰ In other words, the POF will satisfy the assets test if more than 65% of its assets are charitable use assets or functionally related businesses.
2. The endowment test is satisfied if the POF normally makes qualifying distributions for direct charitable activity in an amount not less than two-thirds of the foundation's MIR,²¹ or roughly 3.3% of the POF's

¹ Reg. 53.4945-4(a)(2).

² Reg. 53.4942(a)-3(a)(2).

³ Reg. 53.4942(a)-3(a)(1).

⁴ Reg. 53.4942(b)-1(a).

⁵ Reg. 53.4942(b)-1(b)(1).

⁶ Section 509(a).

⁷ Sections 4940-4945, respectively.

⁸ Section 170(b), Section 170(e).

⁹ Section 4942(g)(1)(A) and (B).

¹⁰ Section 4942(d).

¹¹ Section 4942(a).

¹² Section 4942(a)(1).

¹³ Section 170.

¹⁴ Reg. 53.4942(b)-1(c).

¹⁵ Section 4942(j)(3)(A).

¹⁶ *Id.*

¹⁷ Section 4942(j)(3) flush language and Reg. 53.4942(b)-1(a)(1)(ii). If the POF's qualifying distributions are greater than its MIR but less than ANI, then at least 85% of the POF's qualifying distributions must constitute direct charitable activity. However, if the POF's MIR is less than its ANI and the POF's qualifying distributions are equal to or greater than ANI, then only the portion of qualifying distributions equal to 85% of ANI must constitute direct charitable activity.

EXHIBIT 2

Form 990-PF Extract for Hypo 1 POF (Example 1)

Form 990-PF (2016)

Page **10**

Part XIV Private Operating Foundations (see instructions and Part VII-A, question 9)

1a If the foundation has received a ruling or determination letter that it is a private operating foundation, and the ruling is effective for 2016, enter the date of the ruling ▶

b Check box to indicate whether the foundation is a private operating foundation described in section 4942(j)(3) or 4942(j)(5)

2a Enter the lesser of the adjusted net income from Part I or the minimum investment return from Part X for each year listed

Tax year	Prior 3 years			(e) Total
(a) 2016	(b) 2015	(c) 2014	(d) 2013	
30,000				30,000
b 85% of line 2a	25,500			25,500
c Qualifying distributions from Part XII, line 4 for each year listed	40,000			40,000
d Amounts included in line 2c not used directly for active conduct of exempt activities	6,000			6,000
e Qualifying distributions made directly for active conduct of exempt activities. Subtract line 2d from line 2c	34,000			34,000
3 Complete 3a, b, or c for the alternative test relied upon:				
a "Assets" alternative test—enter:				
(1) Value of all assets				
(2) Value of assets qualifying under section 4942(j)(3)(B)(i)				
b "Endowment" alternative test—enter 2/3 of minimum investment return shown in Part X, line 6 for each year listed	33,500			33,500
c "Support" alternative test—enter:				
(1) Total support other than gross investment income (interest, dividends, rents, payments on securities loans (section 512(a)(5)), or royalties)				
(2) Support from general public and 5 or more exempt organizations as provided in section 4942(j)(3)(B)(iii)				
(3) Largest amount of support from an exempt organization				
(4) Gross investment income				

average asset balance for the year. The endowment test is the test POFs tend to meet most frequently.

- 3. The support test is satisfied if the POF is receiving a specified level of public support from the general public and other exempt organizations.²² It is very unusual for a POF to meet this test. It is comprised of three sub-tests, all of which must be met.

Practice tip. While all foundations' assets are irrevocably dedicated to charitable purposes, the assets test looks at the value of foundation's assets actually being used in the foundation's charitable programs. The foundation's assets held purely for investment are not included. To calculate whether a POF satisfies the assets test, divide the value of the foundation's charitable use assets by the foundation's total assets. Examples of the kinds of assets allowed as charitable use assets in the assets test are a museum building and its collection, a scientific laboratory, a library, and intangible assets such as patents, copyrights, and trademarks.

Timing. In contrast to a non-POF foundation, a POF must make its qualifying distributions by the close of the current tax year.²³ That is, the amount a POF must distribute in a given year is based on the assets and income of the POF for that current year. This can pose

planning challenges as it is impossible to know the ANI and the MIR for a year prior to the end of that year. There is some relief, however, in that a POF may meet the tests either on a three-out-of-four-years basis, or on a four-year aggregation basis.²⁴ A new organization generally must satisfy the tests in its first year, and must use the aggregation basis to satisfy the tests in its second and third tax years of existence.²⁵

Qualifying distributions for direct charitable activity. To qualify as a POF, the foundation must make qualifying distributions "directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated."²⁶ This frequently

¹⁸ Reg. 53.4942(b)-2(a)(5).

¹⁹ Reg. 53.4942(a)-2(c)(3)(iii). A functionally related business is one that is not an unrelated trade or business, or an activity that is not carried on either within a larger aggregate of similar activities or within a larger complex of other endeavors related to the charitable, educational, or other similar exempt purpose of the foundation.

²⁰ Section 4942(j)(3)(B)(i).

²¹ Section 4942(j)(3)(B)(ii).

²² Section 4942(j)(3)(B)(iii).

²³ Section 4942.

²⁴ Reg. 53.4942(b)-3(a).

²⁵ Reg. 53.4942(b)-3(b)(1).

²⁶ Section 4942(j)(3).

EXHIBIT 3

Form 990-PF Extract #1 for Hypo 2 POF (Example 2)

Part XII Qualifying Distributions (see instructions)	
1	Amounts paid (including administrative expenses) to accomplish charitable, etc., purposes:
a	Expenses, contributions, gifts, etc.—total from Part I, column (d), line 26
1a	40,000
b	Program-related investments—total from Part IX-B
1b	20,000
2	Amounts paid to acquire assets used (or held for use) directly in carrying out charitable, etc., purposes
2	0
3	Amounts set aside for specific charitable projects that satisfy the:
a	Suitability test (prior IRS approval required)
3a	
b	Cash distribution test (attach the required schedule)
3b	
4	Qualifying distributions. Add lines 1a through 3b. Enter here and on Part V, line 8, and Part XIII, line 4
4	60,000
5	Foundations that qualify under section 4940(e) for the reduced rate of tax on net investment income. Enter 1% of Part I, line 27b (see instructions)
5	
6	Adjusted qualifying distributions. Subtract line 5 from line 4
6	

Note: The amount on line 6 will be used in Part V, column (b), in subsequent years when calculating whether the foundation qualifies for the section 4940(e) reduction of tax in those years.

is referred to as direct charitable activity. The regulations define direct charitable activity as follows:

[Q]ualifying distributions are not made by a foundation “directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose” *unless such qualifying distributions are used by the foundation itself, rather than by or through one or more grantee organizations which receive such qualifying distributions directly or indirectly from such foundation.* Thus, grants made to other organizations to assist them in conducting activities which help to accomplish their charitable, educational, or other similar exempt purpose are considered an indirect, rather than direct, means of carrying out activities constituting the charitable, educational, or other similar exempt purpose of the grantor foundation, regardless of the fact that the exempt activities of the grantee organization may assist the grantor foundation in carrying out its own exempt activities.²⁷ (Emphasis added.)

Stated plainly, to count as a distribution for direct charitable activity, a POF must use the distribution for its own programs and not merely to support the programs of another organization. Support for the programs of another organization typically involves a grant to the beneficiary organization. Grants, without the significant involvement described below, do not count as direct charitable activity. Similarly, PRIs, described more fully below, are debt or equity investments used by the investee organization, not directly by the POF. As with grants, a PRI will not ordinarily constitute direct charitable activity.

Where to find this on Form 990-PF. As stated above, POFs and non-POF foundations both use the Form 990-PF to report that they are meeting the distribution requirements under Section 4942. POFs report their direct charitable activity qualifying distributions on Form 990-PF, Page 10, Part XIV. The following sections on the Form 990-PF relate to calculating the POF qualifying distributions:

- Page 8, Part X (“Minimum Investment Return”).

- Page 1, column (c) (“Adjusted Net Income”).
- Page 8, Part XII (“Qualifying Distributions”).

Putting it together so far

The challenge, therefore, is understanding which of the POF’s activities constitute direct charitable activity, and then tracking them accordingly.

Example 1. Hypothetical Foundation (“Hypo 1 POF”) was formed on 1/1/16 and is a POF. Hypo 1 POF does not hold significant charitable use assets and does not receive support from the general public. In 2016, Hypo 1 POF made grants totaling \$6,000. Hypo 1 POF’s finances for the 2016 tax year are as shown in Exhibit 1.

The extract from Hypo 1 POF’s Form 990-PF, shown in Exhibit 2, illustrates how Hypo 1 POF satisfies the POF tests.

First, because Hypo 1 POF is a private operating foundation, it must satisfy the income test. Second, because Hypo 1 POF does not have significant charitable use assets, it will not satisfy the assets test. Similarly, because Hypo 1 POF does not have public support, it will not satisfy the support test. Hypo 1 POF must therefore satisfy the endowment test. As a new foundation, it is required to meet the tests by the close of year one.

Exhibit 2 shows that to satisfy the income test, Hypo 1 POF needed to spend at least \$25,500 on direct charitable activity qualifying distributions (Line 2b). To satisfy the endowment test, Hypo 1 POF needed to spend at least \$33,500 on direct charitable activity qualifying distributions (Line 3b).

Exhibit 2 also shows Hypo 1 POF’s total qualifying distributions for the year of \$40,000 (Line 2c). However, the \$6,000 of grants, which do not constitute direct charitable activity, must be subtracted from total qualifying distributions (Line 2d). This results in direct charitable activity qualifying distributions of

EXHIBIT 4

Form 990-PF Extract #2 for Hypo 2 POF (Example 2).

Part XIV Private Operating Foundations (see instructions and Part VII-A, question 9)					
1a If the foundation has received a ruling or determination letter that it is a private operating foundation, and the ruling is effective for 2016, enter the date of the ruling ▶					
b Check box to indicate whether the foundation is a private operating foundation described in section <input type="checkbox"/> 4942(j)(3) or <input type="checkbox"/> 4942(j)(5)					
2a Enter the lesser of the adjusted net income from Part I or the minimum investment return from Part X for each year listed	Tax year	Prior 3 years			(e) Total
	(a) 2016	(b) 2015	(c) 2014	(d) 2013	
	30,000				30,000
b 85% of line 2a	25,500				25,500
c Qualifying distributions from Part XII, line 4 for each year listed	60,000				60,000
d Amounts included in line 2c not used directly for active conduct of exempt activities	26,000				26,000
e Qualifying distributions made directly for active conduct of exempt activities. Subtract line 2d from line 2c	34,000				34,000
3 Complete 3a, b, or c for the alternative test relied upon:					
a "Assets" alternative test—enter:					
(1) Value of all assets					
(2) Value of assets qualifying under section 4942(j)(3)(B)(i)					
b "Endowment" alternative test—enter 1/3 of minimum investment return shown in Part X, line 6 for each year listed	33,500				33,500
c "Support" alternative test—enter:					
(1) Total support other than gross investment income (interest, dividends, rents, payments on securities loans (section 512(a)(5)), or royalties)					
(2) Support from general public and 5 or more exempt organizations as provided in section 4942(j)(3)(B)(iii)					
(3) Largest amount of support from an exempt organization					
(4) Gross investment income					

\$34,000 (Line 2e). This is greater than the amounts needed to satisfy the income and endowment tests. Accordingly, Hypo 1 POF will qualify as a POF in 2016.

Practice tip. Many POFs make grants in addition to actively conducting programs. It is important to subtract any grantmaking or other expenditures that do not constitute direct charitable activity from the amount shown on Line 2c, as illustrated in Exhibit 2.

Program-related investments ordinarily do not constitute direct charitable activity. As described above, private foundations, including POFs, are subject to an excise tax on investments that jeopardize the foundation’s ability to conduct its charitable programs.²⁸ An exception is made for an investment satisfying the requirements of a program-related investment.²⁹ Among other requirements, the primary purpose of the investment must be to accomplish one or more charitable purposes.³⁰

The intersection of PRIs and grants. Under the Regulations, program-related investments count toward qualifying distributions³¹ and they are treated as grants under Section 4945.³² As also noted above, expenditures for direct charitable activity generally mean those used by the POF and not by or through a

grantee (or investee) organization. Thus, PRIs ordinarily do not constitute direct charitable activity and will not be included in the POF’s expenditures made directly for the active conduct of exempt activities, unless the POF retains “significant involvement,” described below. Disbursements for a PRI appear on Page 7, Part IX-B of the Form 990-PF in the year the investment is made. The total for all PRIs made during the year is carried forward to Page 8, Part XII, Line 1b for Qualifying Distributions. Unless the requirements for significant involvement are met, a POF must subtract the PRI amount from its qualifying distributions for the active conduct of exempt activities on Part XIV, line 2d. This is illustrated in Exhibits 3 and 4.

Example 2. The facts surrounding Hypothetical 2 Foundation (“Hypo 2 POF”) are the same as those for Hypo 1 POF, except that Hypo 2 POF makes

²⁷ Reg. 53.4942(b)-1(b)(1).
²⁸ Section 4944(a).
²⁹ Section 4944(c).
³⁰ *Id.*
³¹ Reg. 53.4942(a)-3(a)(2)(i).
³² Reg. 53.4945-4(a)(2).
³³ Reg. 53.4942(b)-1(b)(2).
³⁴ Reg. 53.4942(b)-1(b)(2)(ii).

\$60,000 in qualifying distributions (Part XII, Line 4); of that, \$20,000 is for a PRI (Part XII, Line 1b) and \$6,000 is for a grant (Part I, Line 25, *not shown*). Illustrated in Exhibit 3.

Unless Hypo POF retains “significant involvement” in the PRI (described below), the \$20,000 PRI is pulled out of Hypo POF’s direct charitable activity qualifying distributions (Part XIV, Line 2d). Illustrated in Exhibit 4.

Significant involvement

In limited situations, a POF’s grants to individuals and PRIs will count toward its direct charitable activity qualifying distributions if the POF retains a “significant involvement” in the grant or PRI.³⁵ Such grants and investments will be treated as qualifying distributions made directly for the active conduct of exempt activities. As the phrase suggests, “significant

such as a partnership or limited liability company, can qualify for significant involvement. However, Ltr. Rul. 9834033 and Ltr. Rul. 200431018, discussed below, involve a POF that made grants and investments to a limited liability company. The Service concluded that the POF had maintained significant involvement in both instances.

Reg. 53.4942(b)-1(b)(2)(i) continues by explaining determination as to whether significant involvement is present depends upon the facts and circumstances of each instance.

Whether the making or awarding of grants, scholarships, or other payments constitutes qualifying distributions made directly for the active conduct of the foundation’s exempt activities is to be determined on the basis of the *facts and circumstances of each particular case*. The test applied is a qualitative, rather than a strictly quantitative one. Therefore, if the foundation maintains a significant involvement . . . it will not fail to meet the general rule . . . solely because more of its funds are devoted to the making or awarding of grants, scholarships, or other payments than to the active programs which such grants, scholarships, or other payments support. [emphasis added].

Reg. 53.4942(b)-1(b)(2)(i) goes on to state that if the foundation does nothing more than “select, screen, and investigate” applicants for grants or scholarships, and if the recipients will simply work or study either alone or exclusively under the direction of some other organization, said grants or scholarships will not be treated as qualifying distributions made directly for the active conduct of the foundation’s exempt activities. The one exception is for the administrative expenses of the screening and investigation. Such administrative expenses may be treated as qualifying distributions made directly for the active conduct of the foundation’s exempt activities.

The regulations describe two methods of satisfying the significant involvement requirement, each with three elements.³⁴

The first method involves an operating foundation that has as an exempt purpose the relief of the poor or distressed. To qualify as significant involvement, all of the following three criteria must be met:

- An exempt purpose of the POF is the relief of poverty or human distress and its exempt activities are designed to ameliorate conditions among a poor or distressed class of persons or in an area subject to poverty or national disaster.
- The private operating foundation makes grants directly to poor or distressed persons without an intervening organization.
- The private operating foundation maintains a staff (salaried or volunteer) of qualified individuals who supervise and direct the activity on a continuing basis.³⁵

PRIs are treated as grants, and allowed as qualifying distributions of the investor private foundation when the distribution is made.

involvement” requires that the POF be more than a passive grantmaker or investor; instead, the POF must be so involved in the grant or investment that the grant or investment is considered a direct charitable activity of the POF. Reg. 53.4942(b)-1(b)(2)(i) provides:

If a foundation makes or awards grants, scholarships, or other payments to individual beneficiaries (*including program-related investments within the meaning of section 4944(c) made to individuals or corporate enterprises*) to support active programs conducted to carry out the foundation’s charitable, educational, or other similar exempt purpose, such grants, scholarships, or other payments will be treated as qualifying distributions made directly for the active conduct of exempt activities . . . only if the foundation, apart from the making or awarding of the grants, scholarships, or other payments, otherwise maintains some significant involvement . . . in the active programs in support of which such grants, scholarships, or other payments were made or awarded [emphasis added].

First, note that Reg. 53.4942(b)-1(b)(2)(i) discusses program-related investments made to “individuals” or to “corporate enterprises.” It is silent on whether a program-related investment in a pass-through entity,

³⁵ Reg. 53.4942(b)-1(b)(2)(ii)(A).

³⁶ Reg. 53.4942(b)-1(b)(2)(ii)(B).

³⁷ *Id.*

³⁸ *Leckie Scholarship Fund*, 87 TC 251 (1986), *acq.* 1987-2 CB 1.

The second method of retaining significant involvement requires that all of the following three criteria be met:

- The private operating foundation has some specialized skill or expertise in a particular area (e.g. medical research, social work, etc.).
- The private operating foundation maintains a salaried staff who supervise or conduct programs or activities that support the private operating foundation's work in this area.
- As part of that program, the private operating foundation makes payments to encourage the recipient's involvement in the POF's particular area of interest and programs.³⁶

In both methods, the POF is directly carrying out some portion of the charitable programs. For instance, a POF's program to make grants to individuals qualifies as direct charitable activity where "the recipients, in addition to independent study, attend classes, seminars, or conferences sponsored or conducted by the [private operating] foundation."³⁷

Practice tip. While in some situations a POF's involvement in a functionally related business (discussed above in connection with the assets test) could give rise to direct charitable activity, this is not always true. Whether PRIs made to a functionally related business constitute direct charitable activity turns on whether the POF has retained significant involvement in the investment.

Relevant rulings and holdings

The following rulings deal with significant involvement generally. Only Ltr. Rul. 9826048, Ltr. Rul. 9834033, and Ltr. Rul. 199947038 specifically address program-related investments and significant involvement. However, all of the rulings cited provide examples of the involvement needed to constitute significant involvement.

Leckie Scholarship Fund. The "Miss Elizabeth" D. Leckie Scholarship Fund made scholarship grants to high school graduates in an economically depressed county to enable them to attend college. The Fund was a private operating foundation the purpose of which was to raise the standard of living in the specific county by aiding students with college tuition and encouraging them to return to the county to live and work. The Fund's volunteer board of trustees not only selected recipients, but also maintained contact with the students throughout the year, assisted them in finding summer jobs in the county, introduced them to business and other leaders in the county, conducted county

tours, and compiled data and statistics to promote the county as a desirable place to live and work.

The Tax Court found that this level of involvement far exceeded the "mere selection, screening, and investigation" of applicants to the Fund, and held that the Fund maintained significant involvement in the grants.³⁸

If the facts of the case had differed in a single regard—the Fund making PRI loans to the students

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rather than grants—it is reasonable to conclude that the PRIs would also have been considered direct charitable activity because the Fund retained significant involvement in them.

Ltr. Rul. 9826048. The POF in Ltr. Rul. 9826048 sought a ruling that its proposed economic development program would qualify as a PRI, and that the PRI distributions made pursuant to the program would constitute distributions for the active conduct of a charitable program because the POF maintains significant involvement in the investments. The POF planned to make investments (such as loan guarantees, loans, and equity investments) and to offer financial assistance (such as deposit insurance to financial institutions and businesses). The POF's investment activity was focused in economically depressed areas to create jobs and stimulate the local economies. Along with the investments and deposit insurance, the POF would "hire, train, and/or finance technical assistance groups," to work with financial institutions that qualified for the POF's investments.

The Service ruled that the POF met the requirements under the second method, set out above, for determining significant involvement in the PRI activities. In so ruling, the Service noted that the POF:

... has salaried staff of administrators with specialized skills, expertise, or involvement in international economic development conducting and supervising the economic development program. As part of the program, [the POF] will make program-related investments to businesses and financial institutions to promote jobs and economic growth in the targeted geographic areas. These program-related investments will be under [the POF]'s general direction and supervision. As another part of the economic development program, [the POF]'s staff will approve development schemes, based on the advice of affiliat-

ed nonprofit organizations; will develop and oversee a standardized small business lending training program; will establish standardized credit policies and procedures for participating financial institutions; will hire, train, and/or finance [technical assistance groups] in the designated countries; and will provide ongoing training and guidance to foreign financial institutions. Thus, [the POF] will do more than merely select, screen, and investigate applicants for investments, and will be significantly involved in its economic development program.”

Ltr. Rul. 9834033. In Ltr. Rul. 9834033, the Service ruled that a POF’s capital contributions to a controlled limited liability company were a program-related investment and, because of the POF’s significant involvement, the capital contributions

ing and a number of services to help prepare the foster youth to live independently. The POF provided training and assistance to help the public charity develop its programs and also provided direct assistance to the individuals that the public charity serves. In addition, the POF provided funding to the public charity in the form of a PRI.

The Service concluded that the funding constitutes a PRI, that the POF is “actively involved” in the management of the public charity, and that it is “assisting it to accomplish its exempt purposes through the provision of both personnel and technical assistance.” The ruling states that the POF is “maintaining a “significant involvement” in the activities carried on by [the public charity], both through [the POF’s] direct involvement in various aspects of [the public charity’s] program and through [the POF’s] role in directing [the public charity’s] activities.”

The Service therefore held that the POF’s “initial investment in [the public charity] and subsequent expenditures to assist [it] in carrying on its program are considered qualifying distributions made ‘directly for the active conduct of activities constituting [the POF’s] exempt purpose’ within the meaning of” Reg. 53.4942(b)-1(b)(1).

TAM 9203004. While only grants are involved, and not a program-related investment, TAM 9203004 provides a useful analysis of when a POF’s significant involvement in a grant program is sufficient to establish that the grants qualify as direct charitable activity.

The exempt purpose of the POF involved was to assist families and individuals involved in a particular industry. Individuals in need applied to the POF for services. The POF, through an intake process, took on qualified applicants as “clients.” The POF made grants directly to its clients, and also to public charities that assisted clients whom the POF referred for outside services. The POF had four “staff.” One was a volunteer who had experience interviewing indigent individuals at a clinic. The other three were paid staff who were licensed social workers. The POF typically helped the same families “year after year.” As a result, the POF’s staff come to “know these families, and aid recommendations are based upon the [staff’s] understanding of the psychological needs of clients.”

In technical advice, the Service ruled that the POF maintained significant involvement in grants directly to needy individuals as well as in grants to intervening organizations. The Service said that “the qualitative facts and circumstances [lead] to a conclusion that [the POF] maintains a significant involvement with its clients who receive assistance through counselling and referral to other agencies.” The Service also noted

were disbursements that constituted direct charitable activity.

The POF provided long-term care to children through foster homes and had a large staff that included 135 social workers. The POF and a public charity that provided family support formed a limited liability company to operate a family services support center. The POF and the public charity each owned 50% of the capital and profits interest in the LLC, which was treated as a partnership for tax purposes. The LLC was actively engaged in providing family services, both through its own employees and through contracts with specialized organizations that conducted various treatment services for families or family members. The facts in the ruling state that even when the LLC was working with an outside service provider, it would “remain involved in the treatment through participation in the design of the program and monitoring.”

Thus, the POF’s 50% investment in establishing the LLC, as well as the POF’s ongoing portion of the LLC’s activities and expenditures, were ruled to be qualifying distributions directly for the active conduct of the POF’s exempt activities.

Ltr. Rul. 199947038. This letter ruling may involve the same POF as the one described in Ltr. Rul. 9834033, above. The facts of Ltr. Rul. 199947038 again describe a POF that provides long-term care to children through foster homes in several cities and that has a large staff again employing 135 social workers. A public charity in one of the cities where the POF also had an office provided hous-

Whether PRIs made to a functionally related business constitute direct charitable activity turns on whether the POF has retained significant involvement in the investment.

IRS Notice 2015-62 and Mission-Related Investments

As a companion to making PRIs, many foundations engage in mission-related investing as another way to further their charitable purposes. A mission-related investment is one for which alignment with the foundation's mission is a factor in determining whether or not to make a particular investment. In other words, while the investment is motivated by profit and does not qualify as a PRI, a foundation might nevertheless forego some economic profit in favor of pursuing a goal that is related to or consistent with the foundation's mission.

Prior to 2015, this practice called into question whether some of these investments might be considered jeopardizing investments under Section 4944. In Notice 2015-62, 2015-39 IRB 411, the Service clarified that "foundation managers may consider all relevant facts and circumstances [surrounding an investment], including the relationship between a particular investment and the foundation's charitable purposes." The Notice went on to state that "[f]oundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity so long as the foundation managers exercise the requisite ordinary business care and prudence under the facts and circumstances prevailing at the time of the investment in making investment decisions that support, and do not jeopardize, the furtherance of the private foundation's charitable purposes." The Notice appears to bless an investing standard aligned with the standard set forth in the Uniform Prudent Management of Institutional Funds Act, adopted in all states except Pennsylvania.

that "the fact that [the POF] does reimburse other agencies for assistance provided to its clients does not detract from the significant involvement maintained by [the POF] in the welfare of such clients. [The POF] maintains ongoing oversight over the aid provided to its clients through a system of follow-up reports, recently upgraded, and through its total approach to client welfare. In other words, the referrals are merely a part of a total program of providing assistance to a particularly distressed population."

Ltr. Rul. 200431018. Ltr. Rul. 200431018 also does not involve a PRI. It is, however, an example of when distributions made by a private operating foundation through its single member limited liability company constitute qualifying distributions directly for active conduct of activities constituting its exempt purpose, and includes a number of factors that the Service identified as important in concluding the POF had maintained significant involvement.

The facts in the ruling state that a POF formed a single member limited liability company ("the LLC") that was disregarded for federal income tax purposes. The LLC then purchased a school and what the ruling referred to only as "the U program" from a uni-

versity. It operated the school and administered the U program through a management agreement with the university. The Service ruled that in spite of the management agreement, the school and U program were a program of the POF and expenditures made in connection with the school and the program constituted direct charitable activity. The Service cited several factors in drawing this conclusion:

- The management agreement with the university made clear that the university was acting under the authority and direction of the POF (through the LLC, a disregarded entity).
- The POF had the authority to review all expenditures and programmatic aspects of the school and the program.
- The name of the school and the program were changed to reflect the POF's involvement.
- The academic program was supervised by a board of overseers and the POF appointed a majority of the members of that board.

Conclusion

Few rulings specifically address the circumstances under which a POF's involvement in a PRI satisfies the significant involvement test, allowing treatment of the PRI expense as a direct charitable activity, and thus countable toward satisfaction of the POF tests. It is important to note that a POF can make PRIs and not retain significant involvement. While doing so will not count toward satisfaction of the POF tests, there may nevertheless be a benefit to making a non-significant involvement PRI. For instance, a PRI is not treated as a business enterprise and is excluded from treatment as an excess business holding.³⁹ Accordingly, even if the POF holds more than 20% of a business enterprise, if the investment qualifies as a PRI, it will not be treated as an excess business holding. In addition, the value of a PRI is excluded from the calculation of the spending amount required under the income and endowments tests because PRIs are treated as charitable use assets instead of investment assets.⁴⁰ Finally, a POF can also determine the investment is not a PRI but a mission related investment as discussed in Notice 2015-62 (discussed in the sidebar). These investments are generally motivated by both profit as well as alignment with the foundation's mission.

Knowing and understanding the facts of a POF's investment—whether it is a mission-related investment, a PRI, or a significant involvement PRI—is essential, not only for reporting the investment correctly on the Form 990-PF, but in understanding the investment's treatment for purposes of calculating minimum investment return and adjusted net income. ■

³⁹ Reg. 53.4943-10(b).

⁴⁰ Reg. 53.4942(a)-2(c)(3)(ii)(d).