

**The Price of Freedom:
Benefits and Burdens of Foregoing Exemption***

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“To what degree has the non-profit sector drifted toward the commercial sector, and to what extent should it be taxed like the for-profit sector?”

-- Remarks of Steven T. Miller, November 10, 2007

I. Introduction

In an ideal world, an organization doing social good would enjoy income tax exemption and deductibility of contributions under sections 170 and 501(c)(3) of the Internal Revenue Code (“IRC”),² as well as access to capital, for-profit-rate salaries, and freedom from the operating constraints contained in sections 170, 501(c)(3), and 4940 through 4945. Alas, we do not live in an ideal world, and we do have a social-good sector that is both imperfect and evolving. This paper looks at this state of affairs to observe the current benefits and burdens of foregoing tax-exemption while pursuing social good.

Current activities seem to fall into two general categories: first, organizations operating to provide a social good or service while foregoing section 501(c)(3) exemption and second, individuals and organizations making socially driven investments, sometimes characterized as recoverable grants, without seeking section 170 deductibility or section 501(c)(3) exemption.

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² All section references are to the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise specified.

II. Operating Without Code Section 501(c)(3) Exemption

Traditionally, an organization serving a social mission would structure its purposes and operations to obtain and retain federal income tax exemption pursuant to section 501(c)(3) and enjoy eligibility for section 170 deductions. But the organization would give up its ability to issue stock, to pay dividends on profits, to lobby more than insubstantially (or at all if a private foundation), to engage in political activity, to pay market-leading compensation, and to keep its tax returns private. The obvious alternative to explore is operating in a socially beneficial manor or in pursuit of a socially beneficial product or service without seeking tax exemption. There is a broad spectrum of variations on the non-exempt operations theme between these two nodes. Here are some of them.

A. **Operating Without Exemption**

1. **Creating a non-exempt subsidiary**

For years, one way that exempt organizations have utilized the for-profit form has been by creating a taxable subsidiary or affiliate in which to house some of their operations. The National Geographic Society, for instance, uses for-profit subsidiaries to hold certain of its media properties, such as National Geographic Television, Inc. and National Geographic School Publishing, Inc.³

The Mozilla Foundation recently chose to operate with a for-profit subsidiary as well. The Foundation was originally established as a public charity dedicated to openness and innovation on the Internet through the development and promotion of open standards and free open source software. In 2005, however, it also established a wholly-owned subsidiary, the Mozilla Corporation, to which is transferred responsibility for

³ See <http://www.guidestar.org/FinDocuments/2006/530/193/2006-530193519-0394047e-9.pdf>; Press Release, National Geographic Television, National Geographic Television and Thirteen/WNET's NATURE form Production Alliance to Step Up Production Ventures, (Jul. 14, 1998), *available at* http://www.nationalgeographic.com.au/tv/press/980715_c.html; National Geographic, About National Geographic School Publishing, <http://www.ngsp.com/Company/AboutNationalGeographicSchoolPublishing/tabid/170/Default.aspx> (last visited Oct. 6, 2008).

product development, marketing, and distribution. Mozilla has explained that it effected the transfer in order to be able to compete more effectively with for-profit non-open source software, that is, the non-exempt body could spend more freely on marketing, charge for software service and technical support, and offer higher pay to attract personnel.⁴

2. Purchasing and transferring activities to a non-exempt entity

Some organizations have turned to a for-profit model after finding operations too difficult to sustain as an exempt entity. That was the course followed by the creators of ePals when reaching their goals through a not-for-profit endeavor began to appear untenable. The idea behind ePals – to use books and online tools, such as email and blogs, to connect students in classrooms globally to build literacy and language skills – was originally pursued by Miles Gilburne and Nina Zolt in the form of In2Books, a charitable organization. But when the organization became difficult to sustain through charitable contributions, the pair decided to pursue a for-profit model instead. They utilized a group of angel investors to finance the purchase of the already-existing ePals, Inc., which they then revamped in order to pursue the original goals behind In2Books.⁵ In2Books itself remains a public charity and houses one branch of ePals programming – a utility that connects young readers with adult mentors online.

Thus, this example also illustrates the useful model of affiliated exempt and for-profit entities, a model used by the Omidyar Network and others as well.⁶

3. Operating a double- or triple-bottom-line business enterprise

Others elect to forego exemption by pursuing socially beneficial goals through businesses that operate in some capacity like charities or pledge of a portion of their profits to a charitable cause. These are sometimes referred to as “double-“ or “triple-

⁴ John Markoff, *When Tech Innovation Has a Social Mission*, N.Y. TIMES, Apr. 13, 2008; Steve Lohr, *A Capitalist Jolt for Charity*, N.Y. TIMES, Feb. 24, 2008.

⁵ Lohr, *supra* note 4; *see also* www.epals.com.

⁶ *See* text paragraphs III(A)(1) and (2) below.

bottom-line” organizations. Organizations professing to follow a double bottom line seek to build profitable companies that also pursue the owners’ targeted social goal. Those professing a triple bottom line add operating in an environmentally conscious manner to the mix. Some commentators also refer to these organizations as creating a “fourth sector.”⁷

Evergreen Lodge is one example of this type of organization. It is a hotel outside of Yosemite National Park which runs a seasonal internship program through which it hires youths from low-income areas, training them in the hospitality trade, providing access to a rural environment, and supporting their development with a full-time “counselor.”⁸

Other organizations follow the multiple-bottom-line approach by dedicating part or all of their profits to charitable works. Stonyfield Farm is a New Hampshire-based yogurt company that donates “10 per cent of its annual pre-tax profits to environmental groups through its ‘Profits for the Planet’ program.”⁹ In addition, Stonyfield pursues ecologically sound operations by “us[ing] only organically grown fruit, recycl[ing] most of its waste, [and] incorporat[ing] ecology messages into its marketing.”¹⁰ Another example of this model, which has been setting a high bar since the 1980s, is Newman’s Own, the manufacturer of specialty foods that has contributed over \$250 million to charitable causes since its inception by giving away 100 per cent of its after-tax profits.¹¹ Similarly,

⁷ See Stephanie Strom, *Make Money, Save the World*, N.Y. TIMES, May 6, 2007; Joel C. Dobris, *SRI – Shibboleth or Canard (Socially Responsible Investing, That Is)*, 42 Real Prop., Probate and Trust J. 758, 768.

⁸ Michael Fitzgerald, *Capital Ideas and Social Goals*, N.Y. TIMES, Dec. 23, 2007; Evergreen Lodge, About Us, <http://www.evergreenlodge.com/youthprogram.html> (last visited Oct. 6, 2008).

⁹ Susan Gray, *Entering Another World*, CHRON. OF PHILANTHROPY, Apr. 9, 1998; Stonyfield Farm, Giving 10 Percent of Our Profits to the Planet, <http://www.stonyfield.com/EarthActions/GivingProfitstothePlanet.cfm> (last visited Oct. 6, 2008).

¹⁰ *Id.*; Stonyfield Farm, On-Pack Messages to Support Health and Environmental Initiatives, <http://www.stonyfield.com/Lids/index.cfm> (last visited Sept. 10, 2008); Stonyfield Farm, Using the Best Environmental Practices We Can Find, <http://www.stonyfield.com/EarthActions/MakingAWorldOfDifference.cfm> (last visited Oct. 6, 2008).

¹¹ Newmand’s Own, <http://www.newmansown.com> (last visited Oct. 6, 2008).

Working Assets, founded by Peter Barnes in 1985, currently operates mobile phone and long distance calling services and a credit card program that direct a portion of profits to charitable endeavors; the organization calculates that it has donated \$60 million since its inception.¹²

Some would observe that any profitable business that treats its employees well and operates environmentally sensitively can claim to pursue multiple bottom lines, even law firms and for-profit healthcare providers.

4. Pursuing a joint venture or a commercial co-venture

Other examples of utilizing for-profit and not-for-profit synergies are the joint venture and the commercial co-venture. These vehicles are sometimes utilized by a charitable organization to provide services or to raise funds that might otherwise not be available. A charity's participation in a joint venture has been recognized since the Ninth Circuit upheld the Tax Court's ruling in *Plumstead Theatre Society v. Commissioner* in 1982.¹³ In 1998 the Service provided guidance for charitable organizations structuring joint ventures in the hospital context,¹⁴ and today those principles are being applied in other areas as well, including low-income housing provision and university services.¹⁵

¹² Gray, *supra* note 9; Working Assets, About Us, <http://www.workingassets.com/About.aspx> (last visited Oct. 6, 2008).

¹³ Michael I. Sanders, *New Horizon for Nonprofits*, BUSINESS LAW TODAY, Jul./Aug. 2000, available at <http://www.abanet.org/buslaw/blt/blt7-sanders.html>.

¹⁴ Rev. Rul. 98-15, 1998-1 CB 718 (comparing two joint ventures involving tax-exempt hospitals and ruling that one hospital would retain its exempt status because it continued to operate exclusively for charitable purposes; the governing documents of its joint venture required provision of services to the community and board control by the hospital allowed it to ensure that charitable purposes would remain paramount).

¹⁵ See Rev. Rul. 2004-51, 2004-22 IRB 974 (ruling that a university would not lose its exemption or generate unrelated business income with respect to its joint venture with a for-profit to administer a distance learning program where the university controlled the charitable aspects of the program and appointed half of the board and the activities of the joint venture were insubstantial compared to those of the university and contributed substantially to its exempt purposes; entire control of a joint venture was not necessary since the exempt organization controlled the charitable aspects); see generally Michael I. Sanders, *Joint Ventures Involving Tax-Exempt Organizations* 1-36 (3d ed. 2007).

Commercial co-ventures may also provide welcome revenue to charitable organizations, although sometimes not as much as they may expect.¹⁶ Examples of recent commercial co-ventures include PRODUCT(REL) contracts with companies such as Gap, Inc., Apple, Inc., Dell and Windows, and Emporio Armani to raise money for efforts to fight AIDS in Africa, as well as the limited edition sale by Ben & Jerry's of Goodbye Yellow Brick Road ice cream to benefit the Elton John Aids Foundation.

One recent highly successful commercial co-venture was Sony BMG Music Entertainment, Inc.'s contribution to the Robin Hood Relief Fund of proceeds from sales of DVDs and CDs of the Concert for New York after September 11, 2001.¹⁷ Since sales began, the Robin Hood Relief Fund has received \$6.4 million in co-venture contributions from Sony BMG. The most recent contribution was made in April of 2008, and relief grants are still being paid by Robin Hood from these earmarked contributions.

B. Potential Burdens of Operating Without Exemption

The burdens that an organization foregoing exemption while pursuing social goals will face are obvious when compared to the tax treatment of a section 501(c)(3) public charity or private foundation.

1. Federal, state, and local taxation

Obviously, the organization would not be exempt from federal income tax or state and local taxes. Taxation, however may be offset by the degree of profitability of the organization and/or any charitable contributions that it might make. Because a business enterprise can deduct from its income its ordinary and necessary operating expenses, an organization operating on a break-even basis could pay little or no income tax despite its for-profit status. Further, an organization can reduce its federal income tax

¹⁶ See David Barstow and Diana B. Henriques, *9/11 Tie-Ins Blur Lines of Charity and Profit*, N.Y. TIMES, Feb. 2, 2002, *attached at Appendix A*.

¹⁷ See *id.*

liability by making charitable donations, although a corporation's deductibility limit is ten per cent of its income.¹⁸

2. Contributions

Persons contributing to a for-profit entity would not be eligible to claim a section 170 deduction for those payments. Payments from private foundations and public charities to for-profits generally must either be used for exclusively charitable purposes or else qualify as program-related investments under section 4945.¹⁹ Investments that are not program-related are treated under the law as portfolio investments. While one of the goals of operating in a for-profit capacity may in fact be to escape the need for outside financial support, an organization may at least need start-up capital, and traditional for-profit investors may be hesitant to invest in an entity that does not have profit generation as its first priority. Therefore, charitable investors may be sought by for-profits.

C. Potential Benefits of Operating Without Exemption

The benefits of operating to provide a social good or service without seeking section 501(c)(3) status often involve freedom from some of the regulatory constraints imposed upon charitable organizations.

1. Possibility of self-sustaining operations

An organization operating under section 501(c)(3) would generally be expected to provide goods or services below cost.²⁰ In contrast, a non-exempt

¹⁸ 26 U.S.C. § 170(b)(2)(A).

¹⁹ Attached at Appendix B is a copy of a document submitted to the Service in 2002 by several members of the American Bar Association Committee on Tax Exempt Organizations that proposed 19 new program-related investment examples to be added to Treasury Regulation section 53.4944-3(b). The goal of the examples is to clarify the application of the current rules on program-related investments by adding updated illustrations. Further discussion of the need for clarified illustrations, specifically in the context of investments in foreign organizations, can be found in the following article: David S. Chernoff, *Outdated Regulations Hamper Foundations Making Foreign Program-Related Investments*, J. TAX'N OF EXEMPT ORG., May/June 2001.

²⁰ See Rev. Rul. 72-369, 1972-2 CB 245 (explaining, in the context of managerial and consulting services provided by an organization seeking exemption to unrelated exempt organizations, that

organization could sell its products or services at an amount at or above cost that would allow self-sustainability, potentially freeing it of the necessity of pursuing outside support in the form of grants or other contributions (aside, perhaps, from start-up funding). Further, it would not face IRS scrutiny over the substantiality of its net profits or the extent of its financial reserves, and it could consider providing products or services to other non-exempt entities in order to subsidize its provision of products or services to charitable entities.²¹

2. Freedom to compete with for-profit enterprises

A charitable organization must not be found to operate in competition with commercial enterprises.²² However, a non-exempt organization operating in an industry alongside traditional commercial enterprises would be free to compete with those commercial enterprises to expand its reach and maximize its impact. While the advertising and promotional expenses of an organization maintaining section 501(c)(3) compliance are subject to scrutiny, such expenses would be limited in the for-profit context only by an organization's resources.

3. No mandatory contributions to other organizations

While a charitable organization operating an exempt purpose-related trade or business is expected to conduct substantial educational, scientific, or charitable activities

“[f]urnishing services at cost lacks the donative element necessary to establish this activity as charitable”).

²¹ In *B.S.W. Group, Inc. v. Commissioner*, 70 TC 352 (1978), the court considered the substantiality of the organization's profits and the fact that it did not limit its clients to other section 501(c)(3) organizations in finding that it should not maintain its exemption.

²² See *Am. Inst. for Econ. Research v. United States*, 9 AFTR 2d 1426, 1430 (1962) (finding that the sale of economic periodicals in competition with commercial publications, even if in order to support educational activities, constitutes a substantial nonexempt purpose, defeating exemption); *Airlie Foundation v. IRS*, 283 F. Supp. 2d 58 (2003) (stating that “[a]mong the major factors courts have considered in assessing commerciality are competition with for-profit commercial entities; extent and degree of below cost services provided; pricing policies; and reasonableness of financial reserves,” and finding that the Foundation was operated for a nonexempt commercial purpose, rather than for a tax-exempt purpose, because of the commercial manner in which it conducted its activities), *aff'd per curiam* 2004 WL 287126 (DC Cir., 2004) (No. 03-5296).

in conjunction with its conduct of the related trade or business,²³ a non-exempt organization would not be obligated to fund additional, clearly charitable, activities in pursuit of its social goal. In other words, if a non-exempt organization were to pursue the development of an alternative energy resource, for example, it would be free to focus solely on those development activities and funnel 100% of its profits back into that development rather than to devote any portion of the profits to other charitable activities, such as the funding of research at a university.

4. Flexibility in executive and employee compensation and benefits

The expanded compensation options that would result from not being subject to self-dealing or excess benefit rules could help an organization attract, retain, and incentivize top talent. While many potential employees are attracted to the non-profit sector because they appreciate the intangible benefits of mission-related work, some also face financial pressures, such as student debt or family obligations, which lead them away from non-profit work.

One alternative we use is to have for-profit companies employ individuals under for-profit pay packages and then donate their services to a charity. While not the most tax-efficient model, this can sometimes be the answer to peculiar circumstances.

5. Political and greater than insubstantial lobbying activity

An organization that foregoes federal income tax exemption would be free of the limits placed on political and lobbying activities by section 501(c)(3).

III. Making Social Investments and Grants Through a Non-Exempt Entity

Traditionally a corporation or individual wishing to further charitable purposes would contribute to a section 501(c)(3) public charity or a private foundation and claim his, her, or its section 170 deduction. A public charity would then use the contribution to carry out its programs or to make further grants, as through a donor-

²³ See Edward Orton, Jr., 56 TC 147 (1971).

advised fund. A private foundation would make grants and/or program-related investments (“PRIs”) in non-profit or for-profit organizations furthering the charitable purposes of the foundation.

A. Contributions and Investments Utilizing a Non-Exempt Entity

1. Corporate hybrid

Many corporations pursue social goals with a combination of direct charitable giving and grant making through a corporate foundation. Google, Inc. has added the concept of investment in for-profit endeavors to that more traditional mix. The corporation pursues its philanthropic goals, which include supporting the development of renewable energy sources, rechargeable vehicles, and emerging small and medium-sized enterprises, through both grants to charitable organizations and investments in for-profit businesses. Some of these grants and investments come directly from Google, Inc., while others are made through the tax-exempt Google Foundation, with the philanthropic efforts of both organizations housed under the Google.org brand. Google, Inc. has foregone exemption with respect to some of its efforts in order to have greater freedom in its giving and investment strategies and maintain the ability to lobby the government.²⁴

2. Individual hybrid

There are also instances of individual philanthropists following a giving strategy similar to that followed by Google, Inc. Pierre Omidyar, founder of eBay, and his Omidyar Network represent one such example. The Network consists of both a non-exempt limited liability company and a section 501(c)(3) private foundation, with monies from the limited liability company being invested in for-profit enterprises that pursue “market-based solutions” to social challenges, such as Collaborative Drug Discovery and

²⁴ See Kate Hafner, *Philanthropy Google’s Way: Not the Usual*, N.Y. TIMES, Sept. 14, 2006; Google.org, About Us, <http://www.google.org/about.html> (last visited Oct. 6, 2008).

Ethos Water, and monies from the private foundation being invested in other charitable organizations.²⁵

3. Social investors

Some entities and individuals have been pursuing social good purely through social investment strategies, without attempting to structure investments through foundations in order to secure deductibility. The Wall Street Journal recently profiled Nicolas Berggruen, who built his fortune through financial investments, but whose wholly owned Berggruen Holdings is now pursuing social investments as well.²⁶ Berggruen's investments include rice farms in Cambodia, windmill farms in Turkey, grain fields in Australia, and an ethanol plant in Oregon, as well as buildings in neglected inner-city areas.²⁷ Joel C. Dobris provides an analysis of current thinking on and future development of socially responsible investing that highlights, among other things, the interest of younger wealthy individuals in this area²⁸ as well as increased participation by institutional investors.²⁹

4. The L3C

The L3C may provide an additional avenue for social investors. In April 2008 Vermont became the first state to recognize the Low-profit Limited Liability Company ("L3C") as a new for-profit corporate form.³⁰ Robert M. Lang, Jr., a pioneer of

²⁵ See Stephanie Strom, *What's Wrong with Profit?*, N.Y. TIMES, Nov. 13, 2006; Omidyar Network, About, <http://www.omidyar.net/about.php> (last visited Oct. 6, 2008); Omidyar Network, Portfolio, <http://www.omidyar.net/portfolio.php> (last visited Oct. 6, 2008).

²⁶ Robert Frank, *Putting His Money Where His Values Are*, WALL ST. J., May 19, 2008 at C1.

²⁷ See Press Release, Berggruen Holdings, Berggruen Holdings to Develop Global Agricultural Initiatives (Mar. 26, 2008), available at http://www.berggruenholdings.com/resources/resource_view.php?cid=2&rid=4. For a description of the interest of venture capital firm Kleiner Perkins Caufield & Byers, and others, in companies developing environmentally sound technologies, see Jon Gertner, *Capitalism to the Rescue*, N.Y. TIMES, Oct. 5, 2008.

²⁸ Dobris, *supra* note 7 at 765.

²⁹ *Id.* at 762, 768.

³⁰ See Debra E. Blum, *Vermont Governor Expected to Sign Bill on Charity-Business Hybrid*, CHRON. OF PHILANTHROPY, Apr. 21, 2008; VERMONT SECRETARY OF STATE: CORPORATIONS DIVISION, *Low-*

the new form, describes the L3C as “a for-profit entity organized to engage in socially beneficial activities.”³¹ Lang envisions L3Cs as vehicles for bringing nonprofit and for-profit investors together to invest in businesses with social potential, for instance a struggling factory in a blighted community or a developer of a socially beneficial technology in need of capital. The new form may increase the amount of capital traditional investors would place in such businesses because of the opportunity it would allow for co-investment alongside PRI money from nonprofits. Treasury Regulations require private foundations to invest on below-market terms to qualify their PRIs, which could allow L3Cs to accommodate for-profit investors who will likely expect greater returns and lower risk.³² The social motivation and PRI regulation compliance of each L3C is expected to be addressed through its operating agreement, the document that governs any limited liability company, including this variant.

5. Offshore organizations

A U.S. donor who wished to establish a private foundation without being burdened by IRC Chapter 42 reporting requirements could do so by establishing the foundation outside of the United States. Because the foundation would be governed by the laws of its country of formation, the Chapter 42 and Form 990-PF requirements would not apply to the foundation if it did not have U.S.-source income. This may be an attractive option to donors who are interested in preserving their anonymity, since the elimination of the Chapter 42 requirements may help keep the donor’s identity from being disclosed through IRS filings.

A pioneer in using the offshore foundation model is Charles Feeney, the founder of the Atlantic Philanthropies. In 1984, Mr. Feeney transferred his 38.75 percent interest in the Duty Free Shoppers chain to two Bermuda corporations, the Atlantic Foundation and the Atlantic Trust. Through the two Bermuda corporations and a related

Profit Limited Liability Company, http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited Oct. 6, 2008).

³¹ Robert M. Lang, Jr., *Overview* (of L3C concept), *attached at Appendix C*.

³² *See id.*

for-profit corporation based in New York City, Mr. Feeney made anonymous contributions of over \$600 million to a wide range of charitable organizations. It was only in 1997, when a lawsuit stemming from the sale of the Duty Free Shoppers stock would have resulted in the disclosure of his identity, that Mr. Feeney agreed to discuss his giving with the press.³³

The clear disadvantage of using an offshore foundation as a charitable giving vehicle is that a U.S. donor would not be entitled to claim a section 170 deduction for contributions to the foundation, since section 170 deductibility is limited to organizations created in the United States.³⁴ In addition, a donor's anonymity might be lost if the offshore foundation were to conduct extensive non-grant-making activities in the United States, such that it would be considered to be "doing business" in one or more states. The organization might then be required to register with state corporation or charity regulators, and might even find it desirable to file for federal and state tax exemption to avoid being taxed on its U.S.-source income, which would necessarily lead to disclosure of the names of directors, officers, and contributors.

B. Burdens of Giving and Investing Through a Non-Exempt Entity

1. Foregoing Code section 170 deductibility

The obvious burden for donors not using a section 501(c)(3) donee for social investments and certain gifts is the inability to claim an income tax deduction for any part of such contributions. However, because of annual percentage-of-income caps on

³³ See Conor O'Clery, *The Billionaire Who Wasn't* (2007); Marty Michaels, *Secretive Philanthropist Breaks Long Silence*, CHRON. OF PHILANTHROPY, Oct. 18, 2007; Stephen G. Greene, Jennifer Moore, and Grant Williams, *A Donor's Obsession With Secrecy*, CHRON. OF PHILANTHROPY, Feb. 6, 1997, available at <http://philanthropy.com/premium/articles/v11/i23/99092001.htm>; Stephen G. Greene, Jennifer Moore, and Grant Williams, *For Anonymous Donors, Offshore Philanthropy Can Be Appealing*, CHRON. OF PHILANTHROPY, Feb. 6, 1997, available at <http://philanthropy.com/premium/articles/v11/i23/99092002.htm>; Judith Miller, *He Gave Away \$600 Million and No One Knew*, N.Y. TIMES, Jan. 23, 1997.

³⁴ 26 U.S.C. § 170(c)(2).

deductibility for both individuals and corporations, the significance of deductibility can decline for a donor or investor depending on the scale of his giving.

C. Benefits of Giving and Investing Through a Non-Exempt Entity

In addition to the benefits of more flexible employee compensation and the opportunity to lobby and become politically active, discussed in the operational context above, several other benefits from foregoing section 501(c)(3) exemption and section 170 deductibility emerge in the grant making and social investment context.

1. Flexibility in investment strategy

Freedom from the jeopardizing investment, program-related investment, and excess business holdings rules that are applicable to 501(c)(3) private foundations would give increased flexibility to a social investor, allowing the investor to, for instance, unilaterally evaluate the social value of a product or service in which he would like to invest. In addition, the manner in which an investor funds his investments or grows his social-investment capital would be free from regulatory control.

2. Option of exercising control

The ability to hold a sizeable interest in a company, discussed above, also means that a social investor would be free to obtain and exercise a controlling interest in a for-profit enterprise, something an investor might consider in order to influence the environmental practices of a company, for instance, or otherwise to pursue a social mission.

3. No mandatory payout requirement

A tax-exempt private foundation is subject to the section 4942 tax on failure to distribute income. Free of section 4942 tax liability, a non-exempt entity could accumulate or distribute income according to whatever strategy its managers considered most advantageous for accomplishing its social goals.

4. Facilitation of anonymous giving

As mentioned above in the context of Atlantic Philanthropies, foregoing section 501(c)(3) exemption and section 170 deductibility can allow donors to operate with greater anonymity. A non-exempt or foreign entity would not be required to submit the publicly available Form 990 or Form 990-PF filing to the Service, which discloses donors, grant recipients, and investments. But it would, of course, need to comply with other applicable reporting requirements which might reveal significant information to the public as well (e.g., SEC filings).

Appendix A

February 2, 2002

9/11 Tie-Ins Blur Lines of Charity and Profit

By DAVID BARSTOW AND DIANA B. HENRIQUES

For months women have been lining up for one of Steve Madden's latest creations, sneakers emblazoned with an American flag of imitation gemstones.

Retailing for \$49.95, the sneakers were christened the Bravest by Mr. Madden, founder of a national shoe company bearing his name. The sneakers were promoted across the country as a joint endeavor with a charity run by Denis Leary, star of "The Job" on ABC, to "raise money for New York City's fallen firefighters." Nearly 35,000 pairs have been sold. Yet none of the company's \$515,783 in profits from the Bravest have yet reached the families of New York's 343 dead firefighters. And in truth, none of the promotional material about the sneakers ever indicated how much would go to the families. Until Jan. 15, in fact, when Mr. Madden's company finally pledged 10 percent of the profits from the Bravest to Mr. Leary's charity, there wasn't even a contract spelling out the most basic terms of the arrangement.

The problems with the Bravest deal -- lack of a formal contract, imprecise disclosures to consumers and profits far exceeding the amounts donated to the involved charity -- have cropped up with other products being sold to raise money for the victims of the Sept. 11 attack, from best-selling books to chart-climbing compact discs.

"This is perfect evidence of why those who want to give to charity should do it directly," said Eliot L. Spitzer, who regulates charities as attorney general of New York. "Don't buy a shoe or a book or a CD. Just write the check."

In the remarkable flood of giving since Sept. 11, millions of Americans have responded with a single-minded desire to help. Charities have sprung from nowhere, nearly \$2 billion was raised and, not surprisingly, problems arose. Aid was bogged down in bureaucracy. Charities were poorly coordinated. Some rules were simply ignored, often in the name of getting help to those who needed it in extraordinary times.

Now, a similar pattern has emerged with the hundreds of products being sold in the name of Sept. 11 charities. Companies, interested in doing good and capitalizing on patriotic fervor, scrambled to form marketing alliances with charities and then rushed merchandise into stores. Some charities, aware of past problems with these relationships, worked with their corporate partners to get it right, insisting on contracts and other formal commitments.

But many other charities and companies did not. Often, nothing was in writing. Frequently, no audits were required. Contrary to New York law, many product labels have promised donations to a specific charity without the charity's knowledge or consent. In one Manhattan record store, for example, labels on six compact discs invoke the name of the American Red Cross. The Red Cross had approved only one.

In another pitfall that charity regulators worry about, many products fail to disclose exactly how much of the purchase price will be given away, and some labels are misleading. A large sticker on the front cover of the best-selling book "Brotherhood," states: "All profits donated to FDNY charities." In fact, substantial profits from the book are going to booksellers, who typically receive about half the \$29.95 cover price, which also pays for their overhead. Only the book's publisher, American Express, has agreed to donate its portion of the cover price to firefighter-related charities.

Already, product sales tied to Sept. 11 charities far exceed \$100 million. But with many items, barely a dime out of every dollar goes to charity, and regulators -- troubled by these deals -- warn of other consequences. In the absence of elementary safeguards, they say, consumers who bought a product to help victims have no assurance it will; charities cannot in the end guarantee that they will get anything, and the enforcement of accountability is seriously compromised.

Charity regulators like Mr. Spitzer are careful to say they have not seen any examples of fraud involving these deals. At the same time, corporate executives and charity officials are admitting that they have never felt more concerned about the potential appearance of capitalizing on a national catastrophe.

"I told my guys, 'I don't want anybody making any money on this,'" said Jimmy Iovine, co-founder of Interscope Records and executive producer of the compact disc from the telethon, "America: A Tribute to Heroes."

He added, "Even if, after all is said and done, money fell in our pocket, I'm going to give it back."

A Hit CD, but No Contract

Within days of the attacks, executives at Sony Music were anticipating the strong commercial appeal of songs rooted in themes of God and country. Searching their library of master recordings, they quickly assembled songs by everyone from Sinatra to Springsteen onto a

compact disc. "God Bless America" was rushed to stores by mid October. "We were putting it out for profit," Patricia Kiel, senior vice president for communications at Sony Music, said when first asked about the album. "But," she added, "we were also going to give a huge amount to charity."

Prominent on the disc's cover are the words, "For the benefit of the Twin Towers Fund," the charity established by former Mayor Rudolph W. Giuliani for the families of uniformed rescuers killed in the World Trade Center collapse. In small print on the back, the disc also says that a "substantial portion" of Sony Music's profits will be donated to the fund.

Already, "God Bless America" has sold nearly 1.2 million copies worldwide, generating millions of dollars in profits. As well, the label on the disc urges customers to visit the Web site -- www.sonymusic.com/godblessamerica -- which again mentions the Twin Towers Fund and steers customers to other Sony recordings. The site does not mention that these recordings are strictly for profit.

Ms. Kiel acknowledged that Sony claimed an association with the Twin Towers Fund without first securing either written or oral approval from Mr. Giuliani or his aides. She described it as an innocent oversight. Officials with the fund -- all new to the world of charity -- were "fairly overwhelmed," she said. "I had a very hard time getting through."

Officials with Mr. Giuliani's fund, which has yet to receive any proceeds from Sony, were only vaguely aware of the compact disc last fall. "It's only in the last week that we have had a full-time staff," Carolyn Cavicchio, acting deputy director of the fund, said in a recent interview. "Over the next month we will be developing a list of these things."

New York State law has long required for-profit ventures to execute contracts with charities before selling a product on their behalf. The purpose of the law is twofold -- to protect charities from being unwittingly used as marketing bait, and to ensure a measure of accountability for consumers. Ms. Kiel, however, said that Sony's lawyers were unaware of the state's requirement.

Yet Sony executives signed contracts to market two other charity-related compact discs, one for the Sept. 11 Fund and the other for the Robin Hood Relief Fund, the beneficiary of a televised Madison Square Garden concert. Both contracts require Sony to donate 100 percent of its proceeds. And the Robin Hood contract, a 24-page document, also required Sony to pay a \$1 million advance and submit to audits.

"We didn't enter into anything where anybody was profiting," said Laurie Fabiano, director of marketing for Robin Hood. "We would never want that to happen."

It is unclear how much the Twin Towers Fund will get from "God Bless America." Without a contract, charity experts say, the word "substantial" can mean almost anything. When first interviewed, Ms. Kiel said that the Twin Towers Fund would certainly receive more than half of the profits. She said that while some cynics might view this as Sony cashing in on Sept. 11, a fairer interpretation would be that regardless of what Sony makes that "doesn't mean they're not also being hugely generous."

Days later, Ms. Kiel called to clarify her remarks. She said that she had misspoken in saying that Sony meant to make money off "God Bless America." In fact, she said, Sony intended all along to donate 100 percent of its profits -- currently estimated at \$8.5 million -- just as it will for its other two charity-related discs. As for the use of the word "substantial," she said, "I don't know why that language was chosen."

Partnerships and Profits

It would be difficult to overstate the number of marketing proposals made to charities after Sept. 11. The United Way of New York City, which established the Sept. 11th Fund with the New York Community Trust, has alone recorded 1,540 such offers.

United Way officials were leery of these partnerships, which they knew could easily spiral into unseemly profiteering. "This isn't our business," said Bertina Ceccarelli, senior vice president of marketing and communications at the United Way in Manhattan. "We're not accountants. We're not auditors."

At the same time, she said, the agency was reluctant to turn away well-meaning, reputable companies offering, in effect, millions of dollars. So the United Way decided to consider offers, but only if the company would give it final say over promotions and, more important, turn over all profits.

"If they were going to use our brand, that was going to be important to us -- that they weren't profiting from this," Ms. Ceccarelli said. About a dozen deals were negotiated on these terms. But most companies said no, offering only a portion of their profits, Ms. Ceccarelli said.

Some firms unwilling to donate all profits were urged to state in general terms that a portion of proceeds would go to victims of the attacks, without naming the Sept. 11 Fund, Ms. Ceccarelli said. The companies were told that they could then make a donation directly to the fund.

"This became good middle ground," Ms. Ceccarelli said, adding, "We're not going to be in a position of discouraging donations."

Retailers Join In

Retail chains, which are not generally party to the deals that produce these products, have nonetheless aggressively promoted their sale -- in part because they have become a lucrative source of revenue. As a result, at least some charity-linked Sept. 11 products were conceived

mainly to satisfy retailers' desire to tap the nation's surging patriotism. One such product is "God Bless America United We Stand," a boxed set of compact discs from St. Clair Entertainment Group in Montreal.

The set was not St. Clair Entertainment's idea, said Morey Richman, a company vice president. "We were approached after the attacks by our customers -- big chains like Wal-Mart and Best Buy," Mr. Richman said. "They were saying that other companies they deal with were coming through with products that were patriotic in nature."

The company's managers agonized over the request, he said. They did not want to do anything that would smack of exploiting the tragedy, he said, but they were also worried about disappointing big customers like Wal-Mart. "So," Mr. Richman said, "we asked ourselves, 'How can we do this in a way that is respectful?'"

Their solution was a label stating that a donation would be made to the American Red Cross from each sale. Mr. Richman said St. Clair is contributing \$3 per set -- \$45,000 so far -- to the Red Cross in Plattsburgh, N.Y., the chapter closest to Montreal.

But St. Clair's wholesale price is roughly \$7 for the set. The retail price is about double that, and, in the case of Wal-Mart, none of that markup is being donated to charity. "They are handled like all our other products," a company spokeswoman said of the St. Clair set and its other charity-related products.

Rules Go by the Wayside

Not long after Sept. 11, Steve Madden, the shoe designer who was awaiting sentencing after pleading guilty to stock-fraud charges, saw Denis Leary on television talking about his charity, the Leary Firefighters Foundation, established after his cousin and a close friend, both firefighters, died battling a 1999 blaze in Massachusetts.

A spokeswoman for Mr. Madden said that he was impressed by Mr. Leary's passion, and an introduction was arranged on the set of "The Job," where Mr. Madden pitched the idea of the Bravest shoe line. Then, on Nov. 14, at a New York Rangers hockey game, he handed a \$50,000 check to Mr. Leary as an advance against future sales. He said he wanted the money to be split among fire departments in cities where his company had stores, according to a spokesman for Mr. Leary.

Mr. Leary's charity had rules requiring third parties raising money for it to get written approval in advance, document expenses and state on all promotional materials the "exact percentage of the proceeds" the charity would receive. But impressed by the \$50,000, Mr. Leary ignored these rules and quickly agreed to lend his charity's name to the Bravest.

Jim Serpico, co-chairman of Mr. Leary's charity, said it was "understood" that Mr. Madden's company would produce a signed contract that conformed with the foundation's rules. Yet after two months, Mr. Serpico still had no contract, no idea how many sneakers had been sold and no information about how profits would be split. What's more, the company's Web site and promotional material were claiming that the money was being raised "for New York City's fallen firefighters."

"Absolutely not the original intent," Mr. Serpico said.

Days after being contacted by reporters, Mr. Madden's company drafted a letter promising Mr. Leary's charity at least 10 percent of the profits from the Bravest. The money, \$100,000 at minimum, will be donated to improve fire training in the New York Fire Department.

"Ten percent is a great number," Mr. Serpico said.

Jamie Karson, the Madden chief executive, defended the company's decision to retain more than \$400,000 in profits from the Bravest. "We have stockholders, so we walk the line between doing what is good for the stockholder and the company and doing these good deeds," he said.

Profits, Mr. Karson noted, are what allow companies to make donations in the first place. "The most patriotic thing we can do," he said, "is make money."

Appendix B

DRAFT EXAMPLES OF PROGRAM-RELATED INVESTMENTS (“PRIs”) (FOR
ADDITION TO TREAS. REG. SEC. 53.4944-3(b)) AND ANALYSIS OF EACH

The following Examples and Analysis represent the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Examples and Analysis were prepared by individual members of the Committee on Exempt Organizations and its Task Force on Program Related Investments. Principal responsibility was exercised by Victoria B. Bjorklund and David S. Chernoff. Substantive contributions were made by Betsy Buchalter Adler, John A. Edie, Rosemary Fei, Paul Feinberg, Jennifer L. Franklin, Eileen Hershenov, Lisa Johnsen, Kirstin Keel, Barbara Lindsay, and Julia Caputo Stift. The Examples and Analysis were reviewed by Alfred C. Groff and James F. Warren of the Section’s Committee on Government Submissions and by Douglas M. Mancino, Council Director for the Committee on Exempt Organizations.

Although many members of the Section of Taxation who participated in preparing these Examples and Analysis have clients who would be affected by the federal tax principles addressed by these Examples and Analysis or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matters of these Examples and Analysis.

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EXECUTIVE SUMMARY

Section 53.4944-3(b) of the Treasury Regulations, adopted in 1972, contains nine *Examples* describing loans and other investments which, under the facts and circumstances described, qualify as program-related investments, and one that does not so qualify. While those ten *Examples* are useful and give some guidance to private foundations' staff and attorneys, they have become stale. The Task Force believes that the *Examples* should be supplemented to reflect grantmaking philosophy and practices, international social and economic realities, and forms of doing business emerging in the 21st Century.

The program-related investment Task Force generated the attached draft of 19 suggested additional program-related investment *Examples*. The suggested *Examples* will not change existing law; we believe they merely reflect existing law.

Some of the significant points made by the 19 suggested additional *Examples* which are not expressly made by the 10 existing *Examples*, but are supported by existing law, include the following:

1. If an activity is charitable when conducted in the U.S., it is likewise charitable if conducted in a foreign country.
2. Efforts to preserve and protect the natural environment and endangered species serve a charitable purpose.
3. Raising the living standards of needy families in underdeveloped or developing countries serves a charitable purpose.
4. The recipients of loans and working capital need not themselves qualify for charitable assistance as such; they are "merely the instruments" by which the charitable purposes are served. (This language will be much clearer to non-tax specialists than the present language in Treas. Reg. 53.4944-3(a)(2)(i), which says "the term 'purposes described in section 170(c)(2)(B)' shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c).")
5. Not just the presence of a "significant" financial return, but the presence of a seemingly high projected rate of return should not, by itself, prevent a foreign investment from qualifying as a program-related investment.
6. Program-related investments may be properly accomplished by or through the mechanisms of loans to or investments in for-profit domestic or foreign financial intermediaries.
7. Providing credit enhancement for a borrowing by a third-party which accomplishes a charitable purpose may qualify as a program-related investment.

8. Given the proper facts and a charitable purpose, a loan or investment with an “equity kicker”, or an investment in a limited liability company, may qualify as a program-related investment.

The addition of the suggested new *Examples* would give guidance on these matters all in one place. Practitioners would not have to search various portions of the Code, Regulations, Revenue Rulings, case law and elsewhere for authority to support more current forms of permissible program-related investments.

Attachment

DRAFT EXAMPLES OF PROGRAM-RELATED INVESTMENTS (“PRIs”) (FOR ADDITION TO TREAS. REG. SEC. 53.4944-3(b)) AND ANALYSIS OF EACH

Example 1
Development of New Drug

C is a major, publicly-traded pharmaceutical company with a substantial research and development budget. P is a private foundation whose exempt purposes include improving public health worldwide. P has consulted experts who have advised P that, with enough financial support, a drug D might be developed within 10 years to effectively treat a debilitating disease affecting millions of people in poor third-world countries. C does not have a research program directed at developing drug D, and P has concluded that commercial drug companies like C are unlikely to devote the resources required because the potential market for drug D is not as certain or as immediately profitable as others C can pursue. If drug D can be successfully developed and marketed, it could substantially improve public health in the affected countries as well as producing a very large profit for C. P has agreed to provide a loan to C at a below market rate of interest, if C will devote the loan and a stated percentage of its own research and development funds to developing drug D over the next 10 years, and agrees to either manufacture and market or license drug D if developed in that time. C would not be willing to engage in such research activities absent P’s loan. P’s primary purpose in making the loan is to increase the likelihood and speed of development and marketing of drug D, in order to improve public health. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers P’s exempt purpose and would not have been made but for the relationship between the loan and that exempt purpose. The loan is a program-related investment.

*Analysis: The possibility that the pharmaceutical company (C) might make a profit on the sale of the new drug (D) to be developed is secondary; this hasn’t been seen as a problem since Plumstead Theatre Society v. Comm’r., 74 T.C. 1324 (1980), *aff’d*, 675 F.2d 244 (9thCir. 1982). But for P’s below-market rate loan, C would not do the research and development necessary to bring D to the market. P’s purpose in making the loan is to facilitate the development and marketing of D, which will, likely, substantially improve the health of millions of people in poor third-world countries. While it is clear that if an activity is charitable when conducted in the U.S., it is likewise charitable if conducted in a foreign country, none of the existing Examples make this point.*

Example 2
Development of New Drug

Assume the facts as stated in Example 1, except that instead of a loan, C wants P to take an equity position in C in exchange for C’s commitment to work on drug D. C has not been able to secure any venture capitalist investors because of the high risk involved in

developing a new drug. Although, if successful, P's equity holding in C is likely to increase in value greatly, the investment has no significant purpose involving the production of income or appreciation of property. The investment significantly furthers P's exempt purpose and would not have been made but for the relationship between the loan and that exempt purpose. P's investment in shares of C is a program-related investment.

Analysis: This proposed Example ties together an equity investment in a for-profit company -- which is already a permitted form of PRI, even though there is a possibility of a large return -- with accomplishing a charitable purpose in a foreign country -- which is also clearly permitted. None of the existing Examples in the Regulations contain both features.

Example 3 Development of New Drug

Assume the facts as stated in Example 1, except that drug D has already been developed and tested, and is now ready to bring to market. However, due to cash constraints, C is currently unwilling to incur the substantial expenditures required to market, manufacture and distribute drug D and train health-care providers in its use unless P agrees to make the loan. The loan significantly furthers P's exempt purpose and would not have been made but for the relationship between the loan and that exempt purpose. The loan has no significant purpose involving the production of income or appreciation of property. P's loan is a program-related investment.

Analysis: The same as Example 1. C does not have the capital to bring the drug to market. P's below-market rate loan will provide funds necessary for P to manufacture, market and distribute drug D, and train health-care providers in its use, thereby benefiting potentially millions of persons in poor third-world countries. The fact that C will make a profit on the manufacture and sale of D is secondary to the accomplishment of a clear charitable purpose. Although this hasn't been a problem since the Plumstead Theatre case, the point should still be made clear.

Example 4 Development of New Organic-Farming Process

C is a start-up company that has been actively seeking venture capital financing, so far unsuccessfully. C's "product" is a new process that would greatly reduce the losses of certain crops to pests without the use of pesticides, thereby making organic farming of such crops cheaper, more profitable, and more widespread. P is a private foundation whose exempt purposes include fostering and promoting a cleaner environment. P has concluded that if C's process is widely adopted, it will result in greater use of organic farming and a substantial reduction in the world's total pesticide burden. C has approached P to invest in shares of C. As with all venture-capital investments, the risk of

loss is extremely high, but, if successful, potential returns on investment are also extremely high. C has obtained commitments from several venture-capitalist investors, but not enough to move forward. C is offering shares to P on terms less favorable than those offered to the venture-capitalist investors. P's purpose in investing in C is to allow C to successfully market its new process, causing it to be widely adopted, and thereby reducing pesticide use, resulting in a cleaner environment. The investment significantly furthers P's exempt purposes and would not have been made but for the relationship between the loan and that exempt purpose. The investment has no significant purpose involving the production of income or the appreciation of property, although if C is successful, the value of P's shares could increase significantly. P's equity investment in C is a program-related investment.

Analysis: The possibility that the company (C), other investors or P might make a substantial amount of money if the new "product" is successful is secondary; this has been clear since the Plumstead Theatre case. But for P's investment the new "product" would not be developed and made available. C does not have the capital to bring the new "product" to market. P's purpose in investing in C is to allow the development of an organic farming process whose use will result in significant environmental benefits, not financial returns. While there are Revenue Rulings, PLRs, cases and federal legislation favoring efforts to preserve and protect the environment, none of the existing Examples in the Regulations address this important charitable endeavor.

Note that P is putting in the last dollars, which were otherwise unavailable. Query whether or not it would be permissible in such a situation for P to invest on the same terms as the for-profit investors?

Example 5 Loan with Equity Kicker

Assume the facts as stated in Example 4, except that P's investment will take the form of a loan with a below-market interest rate, and C has also offered P pre-initial public offering shares in C as an inducement to make the loan. If C is unsuccessful, the shares will be worthless, but if successful, the value of the shares could increase enough so that P would receive an extremely high rate of return on its investment. C has made the same offer to a series of venture capitalist investors, but was unable to obtain financing on these terms. P's loan to C, and investment in shares of C, are both program-related investments.

Analysis: The addition of pre-IPO shares to P's potential return should not have any effect on the loan and equity investment qualifying as a PRI. The existing Regulations provide generally that the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or appreciation of property. This Example provides a look at some of the "other factors" to be considered. The existing Regulations further provide that it is relevant whether the hypothetical investor solely

engaged in investment for profit would be likely to make the investment on the same terms as the private foundation. In this Example, it was clear that venture capitalists would not make the same investment on the same terms. This is a second reason why the inclusion of an equity “kicker” should not prevent the investment from being a PRI.

Example 6

(Based on PLRs 9551005 and 9014063 (grant/loan)
& Rev. Rul. 74-587)

Loans to Media in Former Communist Block Countries

X is a newspaper, Y is a television station and Z is a radio station, all located in former communist block countries. In those countries, there is no effective banking system and the rates of return demanded by non-bank lenders are not financially feasible for the borrowers. P is a private foundation whose exempt purposes include promoting the development of independent, non-governmental, non-partisan, tolerant and non-extremist media in countries that have historically been "closed" (or non-democratic). P makes loans to X, Y and Z, on terms more favorable than would be available (if at all) from local commercial lenders, to promote independent, fair, honest and responsible media in those countries. The loans significantly further the accomplishment of P's exempt activities and would not have been made but for such relationship between the loans and P's exempt activities. The loans have no significant purpose involving the production of income or appreciation of property. Although X, Y and Z are for-profit businesses, they are merely the instruments by which P seeks to accomplish its exempt purposes. Accordingly, the investment is a program-related investment.

Analysis: First, this Example addresses development of “free” news media in former communist block countries. This is a clear charitable purpose, and was the subject of a PLR. Second, the investment is being made outside of the U.S., which, as discussed above, should not change the analysis. Third, the loans are being made to for-profit entities. The existing Regulations (Sec. 53.4944-3(a)(2)(i)) already provide that the “purposes described in section 170(c)(2)(B)” shall be treated as including such purposes irrespective of whether or not they are actually carried out by organizations described in section 170(c). The “merely the instruments ...” language from Rev. Ruling 74-587 is clearer. Inclusion of that language in one or more new Examples would be helpful. Lastly, P is making the loans in countries where there is no effective banking system or where the rates of return demanded are not financially feasible, and on more favorable terms than otherwise available, if at all. There is no profit motive, only a charitable purpose being served.

Example 7

Based on PLR 199910066
Investment in LLC

B and C are private foundations, located in D, an economically depressed city. The exempt purposes of B and C include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. Both B and C make significant grants for economic development activity in D. B and C propose the formation of a Limited Liability Company (LLC X) with E, a for-profit entity well-experienced in technology transfer and business development. E will be the 51% owner and manager of LLC X. The purposes of LLC X will be to supplement and enhance technology transfer in D's universities; assist in the creation of new technology businesses in D; help finance technology businesses that agree to locate their operations in economically depressed areas of D; and to encourage, support and supplement the technology businesses by offering access to competent business advice and services. In addition, each of the technology businesses agrees to repay the investment in the event they leave D. If LLC X is unsuccessful, the investments by B and C will be worthless. The investments by B and C significantly further the accomplishment of their exempt activities and would not have been made but for such relationship between the investments and the exempt activities of B and C, respectively. No significant purpose of the investments is the production of income or the appreciation of property. Accordingly, the investments by B and C in LLC X are program-related investments even though B and C may both realize a substantial profit if LLC X is successful.

Analysis: None of the present Examples in the Regulations contemplate investments in LLCs. Although that form of business organization did not exist when the Regulations on PRIs were being written, it has become a commonly used investment vehicle and should be so recognized, and take its place along with corporations and limited partnerships. The Service issued a PLR on facts similar to these. There is the possibility that foundations B and C may both realize a substantial profit on their interests in LLC X if it is successful; but that is not the reason they made their investments. This Example illustrates that investments in 21st Century high technology are within the scope of section 170(c)(2)(B), notwithstanding the antiquity of that section, and may be made in the form of a PRI in appropriate circumstances.

Example 8 Terrorist Attack

X, Y and Z are small to mid-sized for-profit business enterprises located in N, an urban area. On date S, a terrorist attack occurs in N, and results in significant damage to the business district of N where the offices of X, Y and Z are located. The business operations of X, Y and Z are affected because much of the infrastructure and many of the buildings in the business district have been damaged, and customers do not have easy access to the business district as a result of the attack. X, Y and Z are having difficulty meeting the financial needs of their respective businesses. Conventional sources of funds are unwilling or unable to provide funds to X, Y or Z on terms those businesses consider economically feasible. P is a private foundation whose exempt purposes include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. P makes loans to X, Y and Z bearing rates of interest somewhat reflecting

the credit risk of the businesses and circumstances, but financially acceptable to X, Y and Z. P's primary purpose for making such loans is to assist those businesses located in the business district of N affected by the terrorist attack. The loans significantly further the accomplishment of P's exempt activities and would not have been made but for such relationship between the loan and P's exempt activities. The loans made by P have no significant purpose involving the production of income or the appreciation of property. Accordingly, the loans to X, Y and Z are all program-related investments.

Analysis: This Example addresses a traditional charitable purpose, namely, economic redevelopment of a physically "blighted" area, in starkly modern 21st Century clothes. The fact that the blight and accompanying economic distress were caused by the acts of terrorists, rather than urban decay, does not change the fact that their elimination serves a very traditional charitable purpose. While urban redevelopment is reflected in several Examples in the existing Regulations, it would be helpful to have a new Example should the need ever again arise and the private foundation community wanted to act quickly, without having to seek rulings. No further discussion is necessary with respect to either (a) no significant purpose of a below-market rate loan is the production of income or (b) the "instruments" through which the foundation seeks to accomplish its charitable purposes are not themselves tax-exempt entities.

Example 9 National Disaster

Assume the same facts as stated in Example 8, but, instead of a terrorist attack, the damage to the business district in N was caused by a natural disaster (such as a hurricane, flood, earthquake or wildfire). P, a private foundation, makes loans to X, Y and Z bearing rates of interest somewhat reflecting the credit risk of the business circumstances, but financially acceptable to X, Y and Z. P's primary purpose for making such loans is to assist those businesses located in the business district of N affected by the disaster. The loans significantly further the accomplishment of P's exempt activities and would not have been made but for such relationship between the loan and P's exempt activities. The loans made by P have no significant purpose involving the production of income or the appreciation of property. Accordingly, the loans to X, Y and Z are all program-related investments.

Analysis: The same as Example 8, except that natural disasters are not new. Nonetheless, it would be helpful to have an Example covering a disaster. Perhaps it should address extensive damage to the business community caused by either a terrorist attack or a natural disaster.

Example 10
 (Based on PLR 200136026
 & Rev. Rul. 74-587)
 Environmental Investments in Third-World Countries

F is a foreign, for-profit financial intermediary formed for the purpose of financing and promoting the expansion of environmentally oriented businesses that will contribute to conservation and economic development in areas of third-world countries that are economically or environmentally sensitive. F will make direct investments in businesses in third-world countries that involve the sustainable use of natural resources, foster the preservation of biological diversity, or engage in organic agriculture with biodiversity linkages. P, a private foundation which is a strong supporter of biodiversity and environmental sustainability, as well as development in economically undeveloped or underdeveloped countries or regions, makes a capital investment in F. The investment significantly furthers the accomplishment of P's exempt activities and would not have been made but for such relationship between the investment and P's exempt activities. The investment by P has no significant purpose involving the production of income or the appreciation of property. Although F is a for-profit business, it is merely the instrument by which P seeks to accomplish its exempt purposes. Accordingly, P's investment is a program-related investment.

Analysis: Proposed Examples 10 and 11, based on a recent PLR, deal with environmental purposes and economic development in poor third-world countries, plus several important but heretofore ignored issues. In our world economy, it is important to be able to use foreign, for-profit financial intermediaries to accomplish 21st Century philanthropic goals. This is not much of a "stretch" from the non-tax exempt entities described in Rev. Ruling 74-587 which were "merely the instruments" by which the intended charitable purposes were accomplished.

Example 11
 Projected Rate of Return on Investment in Third-World Countries

Assume the facts as stated in Example 10 and that F has a goal of an 18% to 22% rate of return for its investors. Although seemingly high on its face for domestic investments, the projected rate of return is significantly less than the acceptable rate of return on international venture capital fund investments of comparable risk in third-world countries. The targeted rate of return, taken as a factor by itself by P, in a normal investment strategy (and not in conjunction with a program-related investment), would not compensate P for the speculative nature of the investment and overall risk associated with F's unique investment characteristics. The investment has no significant purpose involving the production of income or appreciation of property. . Although F is a for-profit business, it is merely the instrument by which P seeks to accomplish its exempt purposes. Accordingly, the investment is a program-related investment even though P may earn income from the investment in an amount comparable to or higher than earnings from conventional domestic portfolio investments.

Analysis: Initially, the same as Example 10. In addition, this Example makes it clear that although the projected rate of return appears high on its face, it is, in fact, significantly less than an acceptable rate of return on international venture capital fund investments of comparable risk in third-world countries. This Example gives clear meaning to the provision in the existing Regulations that one has to look beyond the mere fact that the investment "produces significant income or capital appreciation" to the "presence or absence of other factors" to determine whether or not a significant purpose of the investment is the production of income or appreciation of property. Even with a projected return of 18% to 22%, the hypothetical investor solely engaged in investment for profit would not make this investment in a third-world financial intermediary. The rate was high, but not high enough. Therefore, P can make the investment as a PRI.

Example 12

(Based on PLR 9826048 & Rev. Rul. 74-587)
Economic Development in Depressed Countries

W and X are commercial banks, Y is a small agricultural business, and Z is a small manufacturing business, all located in countries that are economically depressed, largely because most commercial enterprises in those countries had in the past been controlled by the government. Businesses in those countries are either unable to obtain financing from local commercial sources or are unable to obtain such financing on economically feasible terms. P is a private foundation whose exempt purposes include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. P did the following (collectively, the "Foreign Investments"):

- (i) provided financial assistance to W, in the form of deposit insurance (to encourage deposits), and required W to make loans to local small businesses at below market interest rates and following standardized lending practices developed by P;
- (ii) guaranteed a loan by X to Y; and
- (iii) made an unsecured, below market rate loan to Z (or otherwise on less favorable terms than customarily required by commercial lenders or investors for profit).

The Foreign Investments all significantly further the accomplishment of P's exempt activities and would not have been made but for such relationship between the Foreign Investments and P's exempt activities. The Foreign Investments have no significant purpose involving the production of income or appreciation of property. Although W, X, Y and Z are for-profit businesses, they are merely the instruments by which P seeks to accomplish its exempt purposes. Accordingly, all of the Foreign Investments constitute program-related investments.

Analysis: There is no question but that that if an activity is charitable when conducted in the U.S., it is likewise charitable if conducted in a foreign country; that is not the main point to be made by this Example. Nor that loans to for-profit entities may be PRIs. One of the two significant features of this Example, which is based on a PLR, is that P is

providing credit enhancement, not money, in two of the three Foreign Investments. The effect is the same, however; W is able to attract deposits from its customers, and Y is able to obtain a loan from X. Of no less importance, if P is ever called upon to make good on its deposit insurance or loan guaranty, those payments will constitute PRIs and, as such, will be considered "qualifying distributions". The second significant feature of this Example is that the loan from P to company Z may not necessarily be at an interest rate which is "below market". The interest rate may be at "market", but some other term or terms of the loan will be below or not as attractive as those in loans made by commercial lenders or investors for profit under like circumstances.

Example 13

(Based on PLRs 199943058 and 200036050

& Rev. Rul. 74-587)

Foreign Economic Development

M is a poor country with a shortage of energy, natural resources, food and housing, and where local bank loans to businesses, if available, are at rates which are not economically feasible. W and X are commercial banks, and Y is a struggling small business, all located in M. Z is a financially secure business located elsewhere and unwilling to locate any operations in M without some financial inducements. P is a private foundation whose exempt purposes include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. P did the following (collectively, the "Foreign Investments"):

(a) made a loan to the government of M at a below market rate, the terms of which required the money to be reloaned to W and X (who both joined in the loan agreement) at a below market rate, and that W and X reloan those proceeds to local small businesses at below market rates following standardized lending practices developed by P;

(b) made a below market rate loan to Y (or otherwise on less favorable terms than customarily required by commercial lenders or investors for profit); and

(c) made a below market rate loan to Z (or otherwise on less favorable terms than customarily required by commercial lenders or investors for profit) on the condition that Z locate operations in M.

The Foreign Investments all significantly further the accomplishment of P's exempt activities and would not have been made but for such relationship between the Foreign Investments and P's exempt activities. The Foreign Investments have no significant purpose involving the production of income or appreciation of property. Although W, X, Y and Z are for-profit businesses, they are merely the instruments by which P seeks to accomplish its exempt purposes. Accordingly, all of the Foreign Investments constitute program-related investments.

Analysis: The below-market rate loan to Y shows how an investment in a foreign for-profit business can accomplish a charitable purpose. The below-market rate loan to the government of M, the proceeds of which must be reloaned to commercial banks in M, who must then reloan those proceeds at below market rates following standardized lending practices developed by P, shows that there can be some considerable distance between the private foundation and the organization (the "instrument") actually accomplishing the charitable purpose, while still qualifying as a PRI. The point of the below-market rate loan to induce Z to locate operations in M is that a foundation is no longer limited to inducing companies to locate (and thereby provide jobs) in blighted inner-city neighborhoods in the U.S., as envisioned by the Examples in the existing Regulations. Another significant feature of this Example is that the loans by P to companies Y and Z may not necessarily be at an interest rate which is "below market". The interest rates may be at "market", but some other term or terms of the loans will be below or not as attractive as those in loans made by commercial lenders or investors for profit under like circumstances.

Example 14

(Based on PLR 8301110)

Rate of Return on Investment in Deteriorated Downtown

X is a limited partnership which will construct and own a large hotel in the presently blighted and deteriorated downtown area of Y. The land on which the hotel will be constructed is owned by the City of Y, which acquired it by eminent domain as part of a downtown redevelopment plan. Y will lease the land to X for 99 years. Long-term financing for the new hotel is being provided by a group of local banks, corporations and foundations. The foundations will receive interest on their loans at a rate considerably over the current "prime" rate and normal return on their portfolio investments, and the other lenders will receive the same rate plus a percentage of total room rentals over a set amount. P is a private foundation whose exempt purposes include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. P makes an investment in the form of a loan to X to help finance the new hotel, whose financial success is far from certain. The investment significantly furthers the accomplishment of P's exempt activities and would not have been made but for such relationship between the investment and P's exempt activities. The fact that P will receive a return on its investment which is considerably over the then current "prime" rate and normal return on portfolio investments does not, by itself, necessarily indicate a profit motive; all factors must be considered. The investment has no significant purpose involving the production of income or appreciation of property. Accordingly, the investment is a program-related investment even though P may earn income from the investment at a rate considerably above that available from conventional portfolio investments by foundations.

Analysis: This Example, which is based on a PLR, illustrates a very traditional charitable endeavor, namely, revitalizing a deteriorated downtown area in a U.S. city. What is of particular interest is that the interest rate (15.0 % in the actual PLR) was

considerably over the then-current "prime" rate and normal return on foundations' portfolio investments. This helps to show that even though the rate of return for a domestic investment may appear high on its face, "other factors" are relevant in determining whether a significant purpose of the investment is the production of income or appreciation of property.

Example 15
(Based on PLRs 9033063 and 200043050)
Credit Enhancement & Fees

X, a tax-exempt science museum, owns land on which it wants to construct a larger, more modern museum building, but does not have a sufficient credit rating to obtain long-term financing at an affordable rate. The specific use for which the new museum will be constructed reduces its value as collateral. P is a private foundation whose purposes include charitable, scientific and educational purposes. P makes the following investments:

(a) P issues a letter of credit in favor of the bond trustee to guaranty payment of the first 20% of the principal amount of 20-year museum construction bonds to be issued by X and sold to investors, which bonds will be secured by the land and new museum building and bear a market interest rate; or

(b) Instead of issuing a letter of credit, P purchases from its bank (and guarantees to the bank) a letter of credit in favor of an insurance company to guaranty payment of the first 20% of the principal amount of a 20-year mortgage loan to be made to the museum by the insurance company, which loan will be secured by the land and new museum building and bear a market interest rate; or

(c) Instead of issuing or purchasing a letter of credit, P signs a guaranty of payment of the first 20% of the principal amount of a 20-year mortgage loan to be made to the museum by a commercial bank, which loan will be secured by the land and new museum building and bear a market interest rate;

In each instance, P receives from X an initial fee in the amount of 1.0% of the amount of the total borrowing, plus an additional annual fee of 1.0% of the loan amount outstanding from time to time.

In all three instances, the investments significantly further the accomplishment of P's exempt activities and would not have been made but for such relationship between the investments and P's exempt activities. The investments have no significant purpose involving the production of income or appreciation of property. Accordingly, the investments are all program-related investments.

Analysis: In the three scenarios in this Example (which combines two PLRs) a foundation provides three different forms of credit enhancement to allow a science museum with a sagging credit rating to construct a larger, more modern building. In connection with the issuance of P's own L/C, P's purchase of an L/C from a local bank, and P's directly guarantying the museum's borrowing, P charged both initial and annual fees. Such fees, which are common in commercial lending and credit transactions, were approved in the two PLRs cited. No significant purpose of any of the three forms of credit enhancement furnished by P involves the production of income or appreciation of property, and all three transactions constitute PRIs. Further, if P is ever called upon to fund its L/C or guaranty, or repay the bank if the bank's L/C is drawn upon, such payments by P will constitute qualifying distributions.

Example 16 Equity Investment with Equity Kicker

X is a small business enterprise located in Z, a country that is economically depressed. Because X has generated little or no net income since its inception, conventional lenders are unwilling to provide funds to X at reasonable interest rates unless it increases the amount of its equity capital. Consequently, P, a private foundation, as well as two for-profit investors purchase shares of two new classes of X's common stock. P's exempt purposes include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. The two for-profit investors will be entitled to an annual dividend equal to 5% of X's net income, while P will be entitled to no such preferential annual dividend. However, to compensate P for the increased risk of holding an equity investment in X, P will be entitled to receive an "equity kicker" in the form of a special dividend (to be paid annually) in any year in which X's net income is in excess of a stated dollar amount. The dividend will be 10% of that amount. P's primary purpose in purchasing the stock is to encourage economic development in Z, and no significant purpose involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of P's exempt activities and would not have been made but for such relationship between the investment and P's exempt activities. Accordingly, the purchase of X's common stock by P is a program-related investment, even though P may realize a sizeable profit if X is successful and (i) the common stock appreciates in value and (ii) P is entitled to a special dividend in any year.

Analysis: While this Example validates a foundation's investment in a foreign country to accomplish some traditional charitable purposes, such as economic development and providing new jobs, the main feature is the form of that investment. It is important to note that although P may receive something more than an ordinary investor would in an ordinary investment situation, namely, the "equity kicker", what P will receive is not the same as what the investors for profit are receiving. Presumably, those investors would not make their investment in X on the same terms as offered to P; they are getting the first 5.0% of X's annual profits, starting with the first dollar, as opposed to 10% over a stated level. This Example, too, shows that although P's investment may produce significant

income or capital appreciation, that fact, in the absence of other factors, is not conclusive evidence of a significant profit motive.

Example 17
Loan with Equity Kicker

The facts are the same as in Example 16, except that P makes a loan to X bearing interest below the market rate for commercial loans of comparable risk (or otherwise on less favorable terms than customarily required by commercial lenders or investors for profit). To induce P to make the loan to X, P will be entitled to receive an “equity kicker” in the form of the opportunity to purchase up to 100,000 shares of the common stock of X for \$.01 per share in the event that the stock of X is sold in an initial public offering. The loan significantly furthers the accomplishment of P’s exempt activities and would not have been made but for such relationship between the investment and P’s exempt activities. P’s primary purpose in making the loan is to encourage economic development in Z, and no significant purpose involves the production of income or the appreciation of property. Accordingly, the loan by P to X is a program-related investment, even though P may realize income from this investment in an amount higher than earnings from conventional portfolio investments due to the “equity kicker” feature of this investment.

Analysis: The same as in Example 16, except this one involves a loan (rather than a stock purchase) with an “equity kicker”. In both instances, P is getting something different (and less valuable) than what the company must offer to attract investors for profit. Even though the possibility exists for P to realize a sizeable return on its investment, P’s primary purpose in making the investment is to encourage economic development in Z and no “significant purpose” of the investment in either Example involves the production of income or appreciation of property. Another important feature of this Example is that the loan by P to X may not necessarily be at an interest rate which is “below market”. The interest rate may be at “market”, but some other term or terms of the loan will be below or not as attractive as those in loans made by commercial lenders or investors for profit under like circumstances.

Example 18
(Based on PLR 200124022/public charity)
Lessening the Burdens of Government

The downtown area of the City of M is old and deteriorated; further, it is located next to the area’s most distressed low-income community. The City, together with its local community, civic and business leaders, wants to regenerate the downtown area into a center of commerce, housing, transportation, governmental services, cultural activities, and higher educational opportunities. The redevelopment will also result in the creation of many new jobs. As a result of existing renewal projects, there is a significant shortage of parking in the downtown area. The existing developments have both eliminated prior

open air parking lots and created an ever-increasing demand for parking. A study commissioned by the City of M determined that there is a desperate need for substantially more parking in the downtown area, which will get worse as redevelopment continues and more employees, persons using municipal services and the courthouse, shoppers, diners and visitors come to the downtown area.

Through its powers of eminent domain, the City of M acquired a large tract of land in the downtown area which is ideally suited for a parking garage. The City has agreed to lease the land to LLC X for development as a parking garage. LLC X is majority-owned and controlled by D, a for-profit real estate developer, who will operate and manage the new parking garage and receive a management fee. The other members of LLC X will include local businesses, community organizations and civic-minded investors. LLC X will borrow some of the necessary construction funds from a group of local banks, at market interest rates, and mortgage the improvements as security for the loan.

P is a private foundation whose exempt purposes include alleviating poverty, providing relief to the poor and distressed, combating community deterioration and lessening the burdens of government. P has agreed to loan the remainder of the necessary funds to the LLC at a below-market interest rate, without collateral (or otherwise on less favorable terms than customarily required by commercial lenders or investors for profit).

The provision of additional parking is essential to serve the needs of the stores, restaurants, municipal buildings, courthouse, and cultural and educational facilities being developed, as well as job creation, and, therefore, will “lessen the burdens of government” within the meaning of section 1.501(c)(3)-(1)(d)(2) of the Income Tax Regulations. P’s loan to LLC X has no significant purpose involving the production of income or appreciation of property. The loan significantly furthers P’s exempt purposes and would not have been made but for the relationship between the loan and those exempt purposes. P’s loan is a program-related investment.

Analysis: Urban renewal and economic redevelopment of physically blighted and economically depressed neighborhoods are very traditional charitable purposes and are already captured in the Examples contained in the existing Regulations. However, none of those Examples deal with such activities in terms of “lessening the burdens of government”, as did the PLR on which this situation is based. It would be helpful to have a new Example of a PRI made for that explicit purpose. Here, too, P’s loan to LLC X may not necessarily be at an interest rate which is “below market”. The interest rate may be at “market”, but some other term or terms of the loan will be below or not as attractive as those in loans made by commercial lenders or investors for profit under like circumstances.

Example 19
(Based on PLR 200124022/public charity)
Single-Member LLC Owned by Foundation

The facts are the same as in Example 18, except that (a) foundation P is the sole owner and single member of LLC X, (b) the City of M sells the land for the parking garage to LLC X, (c) LLC X borrows 80% of the necessary construction funds from local banks at a market interest rate, with full recourse and secured by a mortgage on the land and new improvements, and (d) P invests an amount equal to the remaining 20% of the necessary construction funds in LLC X, from its own assets. Using LLC X to own and operate the parking garage insulates P's charitable assets from potential judgments in favor of lenders, owners of damaged or stolen vehicles, or persons who might suffer injuries while on the garage premises.

The separate existence of single-member LLC X, which is wholly-owned and managed by P, will be disregarded for tax purposes. Even though funds for construction of the parking garage will be borrowed from local banks, this will not result in P having any "debt-financed income". Further, neither P's ownership and management of LLC X nor LLC X's ownership and management of the parking garage will result in P having any "excess business holdings".

The provision of additional parking is essential to serve the needs of the stores, restaurants, municipal buildings, courthouse, and cultural and educational facilities being developed, as well as for job creation, and, therefore, will "lessen the burdens of government" within the meaning of section 1.501(c)(3)-(1)(d)(2) of the Income Tax Regulations. P's investment in LLC X has no significant purpose involving the production of income or appreciation of property. The investment significantly furthers P's exempt purposes and would not have been made but for the relationship between the loan and those exempt purposes. P's investment in LLC X is a program-related investment.

Analysis: In Example 19, the "burdens of government" are lessened through construction of a new parking garage in the city's blighted downtown district by an LLC which is wholly-owned by a private foundation. This raises many interesting and important 21st Century issues, including disregarding the single-member LLC for tax purposes (and instead looking solely at P); the wholly-owned LLC's borrowing of funds to construct the parking garage not generating any "debt-financed income" for P; and the LLC's 100% ownership of the parking garage not constituting an "excess business holding" by P. As private foundations move forward with more contemporary forms of grantmaking, and encounter more contemporary forms of doing business, these will be important considerations.

Appendix C



AMERICANS FOR COMMUNITY DEVELOPMENT

Overview

Author – Robert M. Lang Jr. - CEO of The Mary Elizabeth & Gordon B. Mannweiler Foundation Inc.

Contributors - When we first started this project we had a few wonderful contributors and we listed them. However, as this project has evolved we have received help from many quarters. This page always contained this statement: "The following represents some thoughts regarding the concept of the L³C. They are by no means complete or final. The parties receiving copies are asked to respond with their ideas and comments." We received many suggestions, and as we hired law firms and advisors and appeared on panels in different places in the world we got more suggestions. So if you in any way helped with the project consider yourself thanked and acknowledged. To even attempt a list would be to insult those who added to it over the years and whom I have forgotten. Be assured that the L³C has been and remains a work in progress so as they used to say, "keep those cards and letters coming" and thanks for all your hard work.

Conventional wisdom in this country usually divides private resources into two pools – the for profit sector and the nonprofit sector. While the for profit sector tends to focus on making money and building wealth, the nonprofit sector focuses on those areas where the market incentive is inadequate.

The Mannweiler Foundation, like so many nonprofits across the country, was established in order to help address those areas lacking free market solutions. The challenge is that while there are innumerable good causes for us to focus on, there are never enough dollars to adequately fund them all.

The challenge is to access the vast pools of market driven wealth to make socially responsible investments in so called nonprofit areas.

The key insight of the L³C is that it is not a two-part world but a three-part world and that many worthy causes are capable of being self sufficient; they simply do not offer enough of a return in order to attract for profit investors—particularly at their inception. These causes fall into the gap between the nonprofit and for profit worlds. The L³C would bridge that gap. It is the integration of business and mission organized to operate in what we might call the low-profit zone (L³C = Low Profit Limited Liability Company).

The L³C's investment structure is designed to bring vast new pools of funds such as private

investors, banking, insurance, pension and endowment investments to bear on problems normally only addressed by the non profit community and its limited resources.

PROGRAM RELATED INVESTMENT

A key element in many L³Cs is Program Related Investment (PRIs). By law, the IRS requires foundations to make annual grants and/or have operating expenditures equal to at least 5 percent of their net asset value. One of the few exceptions to this 5 percent grant rule is the Program Related Investment.

The PRI is an investment made by a foundation to support a charitable project or activity. The PRI counts as a grant for the purposes of the 5% rule and while income and appreciation are acceptable in a PRI, they cannot be the intended or required outcome. In other words, it is an investment that would be unacceptable (imprudent) for the main endowment of the foundation. Section 4944c of the tax code applies some basic tests to a PRI. To qualify as a PRI an investment must:

- Further Charitable Purpose - has primary purposes that are those of a normally charitable organization, i.e. educational, preservation, jobs creation, economic development etc. and involves no lobbying or political campaigning;
- Significantly further the foundation's exempt purposes;
- Not have production of income or appreciation of property as a significant purpose;
- Be such that a foundation would not normally be likely to invest because risk/return profile would likely be classified as a jeopardizing investment and;
- Influencing legislation (lobbying) or taking part in political campaigns on behalf of candidates is not a purpose.

Actual PRI-qualified investments can take many forms:

- Purchase of stock or other equity security such as an LLC membership;
- Interest free or ultra low-interest loan;
- Loan guaranty or letter of credit;
- Low cost leases, etc.

Although there are numerous ways to make a Program Related Investment, three things have slowed the wider use of PRI as a tool for socially beneficial purposes:

- First, there was no vehicle specifically targeted to receive the PRI. Absent a vehicle specifically designed to attract the disparity of investors needed for our low profit gap between nonprofit and for profit, it is difficult to organize a successful PRI.
- Second, there was a lack of uniformity of process that would otherwise give investors confidence that the entity and its operation comply with IRS rules. This lack of uniformity results in foundations and other potential PRI investors seeking guidance from the IRS in the form of Private Letter Rulings.

Private Letter Rulings take months or years to attain and can cost tens of thousands in legal

fees. They also require an \$8,700 payment to the IRS. These are resources that could be better used furthering a foundation's mission. Since the operating agreement of an L³C specifically spells out the operational requirements necessary to meet PRI regulations, it standardizes the process of making a PRI with no need for prior IRS involvement.

By definition, the L³C is a variant form of an LLC (Limited Liability Company) organized under state law – that complies with IRS regulations regarding PRIs, so there is little need for the IRS private letter or similar assurance that the investment complies with IRS rules. There was no method of marketing PRI investments for small and large outside investors. The L³C will standardize PRI investments, so that smaller and less sophisticated foundations, trusts and investors can become part of a specific PRI without being forced to invest time and resources they simply do not have.

THE LLC & THE L³C

The elegance of an L³C is that it is nothing more than a variation of an LLC (Limited Liability Company). The LLC is the extremely successful business form that combines the best features of a partnership – with the best features of a corporation – liability protection and ability to sell itself in pieces.

To this mix of positive attributes, the L³C adds the idea of socially responsible investment. It is a for profit entity organized to engage in socially beneficial activities or as The Mannweiler Foundation likes to call it “the for profit with the nonprofit soul.”

LLCs are not corporations and the owners of an LLC are not shareholders. The LLC is a form of partnership and its investors are called members. Instead of a charter or bylaws, they create a contract amongst themselves called an operating agreement.

These operating agreements are of particular important to the L³C structure, because they can include provisions that fundamentally guarantee the charitable or public benefit orientation of the enterprise. Essentially, we are taking an LLC and writing its “rules” in such a way as to further one or more social purposes:

- LLCs are already legally recognized in all 50 states, DC and territories, so once one state amends the definition section of their LLC laws to include the L³C variant, it is legal in the entire country.
- LLCs can be pass-through entities for tax purposes, which means no double taxation of net revenues, and profits are applied to each investor according to his own tax situation.
- LLCs are structured by their operating agreements so each member can have an arrangement tailored to meet his own particular needs. Each member can enjoy different powers and privileges.
- LLCs offer tremendous flexibility in how they are managed; members may participate in managing the LLC or may be completely passive. Management powers in an LLC can be

distributed and delegated quite freely.

- LLC profits may be allocated to members in proportions that are different from capital contributions. For example, a charity could be a member entitled to a fixed percentage of profit, guaranteeing the charity a source of revenue. Or a particular class of members can have preferential treatment regarding distributions so that their risk is less and their income higher than it is for members of another class.

The same flexible rules that have made the LLC the most popular form of business today would help ensure that the L³C succeeds in making socially beneficial investment more prevalent among the for profit business community.

In other words, the foundation can leverage its ability to make a PRI as a means of increasing the rate of return and lowering the overall risk to other investors.

For the market driven investor, the benefits are obvious: a low risk investment with market rates of return. For the nonprofit, the benefits are two-fold. First, it furthers a particular mission. Second, the nonprofit's investment in the L³C counts towards the foundation's five percent requirement yet, unlike a grant, it possibly remains available to the foundation to be used for future grants and/or investments and may result in capital gains and significant income over the long run.

The flexible structure of the L³C's ownership allows organizers the ability to tailor ownership shares to meet the specific needs of each investor. The L³C's ability to structure tranchéd –or layered – investments will allow foundations to market the L³C to larger market driven investors not typically associated with charitable investments, increasing the pool of resources available for foundations to pursue their missions. This is possible because the tranchéd structure will make it feasible for the market driven investors to make their investment decisions based on cold hard investment criteria, not social benefit.

THE LLC AND SOCIALLY RESPONSIBLE INVESTING

The L³C is more than just a better way to utilize PRI regulations. It is a way to leverage limited foundation dollars to access trillions of dollars of market driven investment funds.

Until now, foundations have faced a limited choice in meeting their 5 percent annual requirement. They could make the traditional grants or they could go through the arduous process of making a PRI under the old model. The L³C offers a better alternative.

The L³C is a profit-making entity with a social mission as its primary goal. As such, it has the ability to operate in a territory with a profit/risk profile that would scare off normal investors.

Under the PRI structure, the foundation member of the L³C may agree to make an investment based on the premise of a less than market rate of return and take first risk. The ability of the foundation to invest at less than the market rate at higher risk lowers the risk to other investors while increasing their potential rate of return.

For example, a for profit business may decide to close a furniture factory in a small town where it is the major employer. Closing the factory would put 200 people out of work.

The business bases its decision on the ultimate cost of keeping the factory open compared to the other uses for that money. In this example, say the factory requires \$10 million in capital investment but only promises a 3 percent annual rate of return (\$300,000). Alternative investments with similar risks promise a 6 percent annual rate of return (\$600,000). The company invests elsewhere.

But that decision fails to take into account the costs to the community from the loss of that factory – costs like the dislocation of workers, the loss of economic activity to remaining businesses, etc. – that do not show up on the company's balance sheet.

With the L³C, a foundation dedicated to serving the local community could organize an L³C specifically dedicated to buy the factory, make the investment and keep the jobs. The L³C would be structured so that the foundation's ownership stake includes a very low rate of return, while allowing its ownership interest to be subordinate to the other investors. If the investment is sold, the foundation's interests would be paid last.

The remaining L³C ownership shares could then be marketed at rates of return and risk levels necessary to attract market driven investors.

Using the example above, the foundation might assume the equity ownership tranche of the L³C for \$5 million and agree that its ownership share would be both subordinate and receive no return. It could then offer the senior ownership tranche for the remaining \$5 million, offering investors the full return available based on the factory's output \$300,000 or 6% on \$5,000,000. To be sure the L³C fulfills its mission, the foundations might insist on say 60% of the voting rights which would result in their control of a management board.

FINANCING

So far, we have just discussed nonprofits and pure market-driven investors. What about philanthropically minded institutions and individuals who could assume a level of ownership in between the two ownership examples – a mezzanine position at or below market rates?

If you have read Brian Dunn's white paper, *Modern Portfolio Theory – with a Twist, the New Efficient Frontier* (See <http://americansforcommunitydevelopment.org/publications.asp> for download) you are familiar with a three dimensional frontier with impact as the third axis. We are now dealing with a graph which is a paraboloid instead of a parabola and target zone on the surface rather than points on a line. This justifies adding individual philanthropy into our mix and allows for involved, enthusiastic individuals, along with institutions.

For many firms and individuals, an investment with a reasonable level of risk and a moderate return is attractive because they are willing to trade some income and security for philanthropic satisfaction. This mezzanine tranche is attractive to banks wishing to fulfill their community reinvestment requirements or for investors who want to make a recoverable charitable investment.

They could invest in an L³C to get it up and running and then wait until it has been pooled or otherwise turned into a more marketable security so that they can be bought out.

The widespread use of CDOs (Collateralized Debt Obligations) and other asset backed securities opens the door to widespread development of the L³C to address particular social needs like developing low-income housing or making low-interest loans for education or business startups since it would allow the senior ownership shares of these enterprises to be packaged together and sold as securities.

Moreover, by using the program related investment, the foundation allows the L³C to turn the normal tranching investment structure on its head. Usually, the investor who assumes the highest risk also enjoys the highest return. With the L³C, the ownership portions with the lowest risk can also enjoy the highest reward, making them particularly attractive to market driven investors.

Finally, we have only discussed using the L³C to help foundations meet their 5 percent requirement. But what about their endowments? A foundation could put a lot more of its portfolio into an L³C by not only making a PRI investment but by making a prudent portfolio investment into the mezzanine or senior tranches of an L³C. If the senior tranches of L³C ownership are secure enough for banks and other commercial investors, they should be secure enough for foundations as well.

GOVERNANCE

One reason for basing the proposed L³C on the existing LLC is to give the organization flexibility that LLC rules allow. Another is to give the L³C the governance and discipline that a for profit enterprise demands.

As a for profit, we designed the L³C to operate as a private business. We believe the for profit aspect of the LLC helps to make the business self-regulating. The managers of the L³C will have the freedom and flexibility of a for profit but with marching orders that ensure they maintain their nonprofit souls. The organizational structure of the LLC, with a board, officers, and members, will help ensure that the L³C will comply with the goals set out by its founders.

At the same time, the L³C actually encourages the involved parties to act in a manner consistent with nonprofit law. For example, the model state law providing for the establishment of the L³C actually states:

The entity (i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of section 170(c)(2)(B) of the Internal Revenue Code of 1986, as amended, and (ii) would not have been formed but for the entity's relationship to the accomplishment of charitable or educational purposes;

This language is taken from the code defining the Program Related Investment that every foundation making a PRI must follow.

Organizational effectiveness and accountability are, of course, a major issue for the nonprofit sector. Unlike the government, most foundation boards are self-perpetuating and not “governed” by an electorate. Unlike the for-profit sector, nonprofits have no owners to rein in managers. The L³C would make available market tools for organizational control that could have profound impact on the measurement of effectiveness for social purpose organizations.

The L³C structure helps reduce the possibility that the entity will be run by a self-perpetuating board which loses sight of its main goals. It further means that the investors cannot claim, as some donors do, that they would not have given the money if they had known what direction the entity was going to take. If an investor wants an ongoing say in the way an L³C is managed, they may insist the operating agreement give them an active role in its governance.

CONCLUSION

The potential for the L³C is huge. The L³C is especially designed so that its members can be any assortment of individuals, government agencies, foundations, nonprofits, and for profit corporate entities that have made different types of contributions in exchange for their membership. It is particularly suited to have different classes of investors with different levels of risk.

With the L³C, foundations will have the opportunity to make widespread investments that meet their 5 percent requirement and can do so without the complexities of being involved in the structuring and management of an operating corporation.

For profit investors, on the other hand, will be saved the restrictions and burdens of nonprofit status while being offered an infinite number of risk and reward combinations to meet their particular needs.

The layering of L³C ownership – using the flexible LLC ownership rules as their basis – allows for any combination of ownership risk and reward. Set on a PRI base, there really is almost no limit to how the L³C can be structured to further the missions of foundations and other nonprofits.