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FOUNDATION REGULATION IN OUR AGE OF IMPACT

*Dana Brakman Reiser**

The Tax Reform Act of 1969¹ has had remarkable influence on American philanthropy in the past half century. Like most legislation—even watershed legislation—though, the Act was a product of its time.

Fifty years on the complexion of charity has changed. One hallmark of today's charitable sector is its preoccupation with impact. The act of giving alone is no longer enough to count as success. The problems society faces are too deep and too urgent. Charities, their donors, and even their regulators today are increasingly interested in what an individual charity, the charitable sector, or segments of it actually achieve with the resources they expend. These demands for impact also call into question the tools of traditional philanthropy and whether they are sufficient. For foundations, this means considering whether grant-making should be supplemented by investment practices designed to generate mission-aligned impact as well.

Although it did create the concept of a “program-related investment,”² the 1969 Act did not envision foundations pursuing charitable impact through their investments in a very substantial way. This meant its framers could not plan sufficiently for how other pieces of the Act might frustrate these activities. But they can. Some of the difficulties have been ameliorated by the Treasury Department and the IRS through regulatory changes and guidance. Still, foundation adoption of values-aligned investing is slower than might be expected, and some philanthropists are even turning to

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¹ Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969).

² I.R.C. § 4944(c).

alternative (and less transparent) giving technologies to free up investment flexibility.

This Article explores how the regulation of foundation investment might respond to our age of impact. Part I describes the Act's provisions limiting foundation business holdings and prohibiting jeopardizing investments. Part II explores values-aligned investing in the private foundation context, comparing the poles of program- and mission-related investment and their unique places in the increasingly crowded values-aligned investing sector. Part III identifies the remaining areas of mismatch between these impact-oriented tools and the Act's regulatory framework, even after Treasury's best updating efforts, and evaluates potential solutions. Part IV briefly concludes.

I. HOW THE 1969 ACT REGULATES FOUNDATION INVESTMENT

The key to the 1969 Act's provisions on exempt organizations was the distinction it created between public charities and private foundations,³ the latter of which are targeted by a series of new rules it enacted to more strictly regulate them.⁴ The distinction rests primarily on the source of an exempt organization's financial support.⁵ An organization is deemed a public charity if it can identify a significant class of small donors or consumers of their services. Those organizations supported primarily by a small group of large donors and without active charitable operations were instead deemed private foundations and ever since have been subject to a strict set of operational restrictions.

These private foundation rules drew heavily on recommendations from a 1965 Treasury Report pronouncing the foundation sector healthy overall but identifying several areas of concern.⁶ With only a few large donors heavily enmeshed in each foundation's operations, these organizations were

³ I.R.C. § 509.

⁴ I.R.C. §§ 4940–4946.

⁵ I.R.C. §§ 509(a)(1) & (2), and 170(b)(1)(A)(iv).

⁶ See S. COMM. ON FINANCE, 89TH CONG., TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS 5 (Comm. Print 1965) [hereinafter TREASURY REPORT] (describing Congress' request for the report studying critiques of foundations as delaying the receipt of donated assets by actual operating charities and their beneficiaries, diverting a large part of the economy to tax-exempt entities, and amassing "dangerous concentrations of economic and social power").

viewed as much more likely to become embroiled in transactions with their donors and managers and excessively entangled with businesses (both related and unrelated to their donors). Without active charitable programs, they would also be prone to retain their resources and engage in overly active trading and speculation. The Report concluded that abuses worthy of redress were confined to a minority of foundations, but public and congressional suspicion of foundations persisted.⁷ The congressional hearings on the 1969 Act included statements from vocal critics along with Treasury officials and foundation leaders, and ultimately generated a comprehensive legislative program to regulate private foundations.⁸

The private foundation regime covers a great deal of ground. It undermines foundation tax exemption by imposing a small tax on foundation investment income.⁹ It requires foundations to distribute 5% of their assets annually¹⁰ and imposes steep penalties on most transactions with donors and insiders, political expenditures, and grants to non-public charities.¹¹ It also significantly impacts foundation investment decisions by limiting the stakes foundations may hold in business entities¹² and by penalizing investments that might “jeopardize the carrying out” of a foundation’s charitable functions.¹³ The rest of this Part focuses attention on these investment restrictions and their evolution over the last five decades.

⁷ See generally Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspective on its Origins and Underpinnings*, 27 EXEMPT ORGS. TAX REV. 52 (2000).

⁸ See *id.* at 58–62.

⁹ I.R.C. § 4940. Originally, this tax was set at 4%. It was reduced in 1978 to 2%. See MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS* 264–65 (2004). Tax legislation in 2017 reduced it further to 1.39%. See I.R.C. § 4940(a) (2019).

¹⁰ I.R.C. § 4942(e)(1). The 1969 statute originally required foundations to payout all of their adjusted net income or a minimum of 6%. See Comment, *Internal Revenue Code Section 4942: Its Impact on Private Foundations*, 3 U. HAW. L. REV. 67, 82 (1981). The figure bounced around a bit before settling at 5% in 1976. See *id.* at 82–83.

¹¹ See *id.* §§ 4941, 4945.

¹² See *id.* § 4943.

¹³ *Id.* § 4944.

A. Excess Business Holdings

Like many other provisions of the 1969 Act, the excess business holdings section levies a two-tiered penalty tax on foundations that engage in disfavored behavior.¹⁴ The 1965 Treasury Report provided several reasons to disfavor excessive entanglements by foundations with business. In addition to concerns that businesses affiliated with private foundations would be advantaged over their competitors, they worried about mission drift.¹⁵ Concerns about a foundation's business holdings could unduly distract their managers from their proper charitable focus, and Treasury worried that "[b]usiness may become the end of the organization; charity, an insufficiently considered and mechanically accomplished afterthought."¹⁶ It also warned that self-dealing problems and delays in distributing assets for actual charitable programs intensified in foundations with considerable business involvements, and particularly in those foundations with investments in businesses linked to their donors.¹⁷ To combat these issues, Treasury recommended a cap on the size of foundation holdings in any particular business and a new rule disallowing deductions for gifts of interests in controlled businesses until disposition of the asset, use of it by the foundation in its charitable programs, or cessation of donor control.¹⁸

Congress ultimately took up only the first of these recommendations, enacting excise penalties on foundation business holdings above a bright-line cap. Foundations that exceed the limits imposed by the statute initially must pay a tax set at 10% of the value of the excess holdings.¹⁹ If a recalcitrant foundation fails to divest its excess holdings even after the application of the initial tax, it must pay an additional tax of 200% of the holdings.²⁰ This confiscatory tax is so high that no rational private foundation would ever pay it. When faced with divesting their holdings, presumably for some value, or

¹⁴ *Id.* § 4943(a)–(b).

¹⁵ *See* TREASURY REPORT, *supra* note 6, at 31–35.

¹⁶ *Id.* at 35.

¹⁷ *See id.* at 39–41.

¹⁸ *See id.* at 36–37, 41–42.

¹⁹ *See* I.R.C. § 4943(a)(1).

²⁰ *See id.* § 4943(b).

retaining them and paying twice their value in penalty taxes, the choice is clear.

The regime, therefore, turns on the definition of “excess” business holdings. These are defined as the holdings a foundation must divest to retain only “permitted holdings.”²¹ Permitted holdings in a corporation are generally any amount up to 20% of the voting stock, when combined with holdings of substantial contributors, foundation managers, members of their families, and related parties (including related foundations).²² Members of these groups are categorized as “disqualified persons.”²³

Refinements on this proscription deal with variations in the control of foundations’ investee companies. If disqualified persons themselves do not hold greater than 20% of the voting stock, the foundation can count any nonvoting stock it holds as permitted holdings.²⁴ And if a private foundation can establish “that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation,” the permitted holdings ceiling rises to 35%.²⁵ There is also a *de minimis* rule, whereby foundation holdings of 2% or less of a corporation are *per se* not excess holdings.²⁶

Because many foundations held substantial stakes in businesses, both related and unrelated, at the time of the 1969 Act, the legislation initially applied largely on a prospective basis. Foundations that already had holdings in excess of the limit were temporarily grandfathered, and the law included

²¹ *Id.* § 4943(c)(1).

²² *See id.* § 4943(c)(2). The Act also includes provisions that apply similar restrictions on the holdings of unincorporated businesses. *See id.* § 4943(c)(3).

²³ I.R.C. §§ 4946(a), 4943(f)(4).

²⁴ *Id.* § 4943(c)(2)(A).

²⁵ *See id.* § 4943(c)(2)(B). Otherwise, blocks of nonvoting stock are not permitted holdings. This language likely responds to the practice discussed in the 1965 Treasury report of using nonvoting stock transactions to allow foundations to retain or transfer control of family businesses while also obtaining valuable tax deductions. *See* TREASURY REPORT, *supra* note 6, at 37–39.

²⁶ I.R.C. § 4943(c)(2)(C).

generous extensions and phase-in schedules.²⁷ Perhaps this generosity is what has allowed the excess business holdings regime as enacted in 1969 to remain largely intact. Only one significant exception has been attached, when, in 2018, the Newman's Own Foundation finally obtained a long-pursued exception.²⁸ The new language excepts from the regime's limitations and penalties foundation holdings of 100% ownership stakes in a business enterprise a foundation obtains other than by purchase (as did Newman's Own Foundation), so long as the wholly-controlled business operates independently of the foundation and donates all profits to charity.²⁹ While important for Newman's Own, this exception is extremely narrow and will impact investment decisions for very few foundations. If anything, the original Act's idea of limiting philanthropic organizations' involvement in business has been extended. The 2006 Pension Protection Act applied business holding restrictions patterned on the 1969 Act to donor-advised funds and supporting organizations.³⁰

B. Jeopardizing Investments

The 1969 Act's jeopardizing investment rule expanded a previous prohibition on jeopardizing investments of accumulated income only.³¹ The Treasury Report expressed a worry that foundations did not confine risky investment practices to investments of accumulated income.³² It recommended a very broad prohibition on what it considered jeopardizing

²⁷ See *id.* § 4943(c)(4)–(7). Treasury regulations further elaborate these matters and provide examples. See, e.g., Treas. Reg. §§ 53.4943-2 to -7 and 53.4943-11 (as amended in 1986).

²⁸ See Ana Radelat, *Tax Bill Glitch Endangers Future of Newman's Own and Actor's Foundation*, CONN. MIRROR (Dec. 21, 2017), <https://ctmirror.org/2017/12/21/tax-bill-glitch-endangers-future-of-newmans-own-and-actors-foundation/> (describing Newman's Own Foundation's failure to obtain an exemption from the excess business holdings regime in the negotiations over the 2017 Tax Cut and Jobs Act). See also Ana Radelat, *Budget Deal Has Plenty for Connecticut*, CONN. MIRROR (Feb. 9, 2018), <https://ctmirror.org/2018/02/09/senate-stumbles-on-way-to-vote-on-budget-bill-with-plenty-for-ct/> (explaining the foundation's successful advocacy for such an exemption early the following year allowed it to avoid the 200% confiscatory tax).

²⁹ I.R.C. § 4943(g).

³⁰ Pension Protection Act, Pub. L. No. 109–280, §§ 1231–33, 1241–43, 120 Stat. 1094 (2006).

³¹ TREASURY REPORT, *supra* note 6, at 24–25.

³² *Id.* at 25.

investments, but Congress in the end enacted something a bit less extensive. Treasury sought both the expansion Congress enacted as well as a complete ban on “devices ordinarily deemed inherently speculative—as, for example, the purchase of ‘puts,’ ‘calls,’ ‘straddles,’ ‘spreads,’ ‘strips,’ ‘straps,’ and ‘special options,’ selling short, and trading commodity futures.”³³ These practices, it opined, not only subjected charitable assets to inappropriate levels of risk and distracted foundation managers from their charitable missions, but raised the specter of “financial empire building.”³⁴

The ultimate jeopardizing investment rules Congress enacted swept broadly but stopped short of banning specific types of investment activity. Penalty taxes apply “[i]f a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes.”³⁵ Unlike in the excess business holdings regime, which penalizes only the offending organization, the jeopardizing investment regime imposes excise taxes on both the organization (of 10% of the investment initially,³⁶ with a potential additional 25% tax if the “investment is not removed from jeopardy”)³⁷ and on foundation managers who knowingly make such investments. Managers face an initial tax of 10% of the offending investment, with an additional 5% penalty on failure to cure.³⁸

Some language from the original Treasury Report proposal survives in Treasury regulations defining jeopardizing investments. These rules generally impose a standard of ordinary care and prudence, which is applied on an investment-by-investment basis, but takes into account the foundation’s overall investment portfolio.³⁹ Still, the regulations call out “[t]rading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of ‘puts,’ ‘calls,’ and ‘straddles,’ the purchase of warrants, and selling short” as “types or methods

³³ *Id.* at 54.

³⁴ *Id.* at 53.

³⁵ I.R.C. § 4944(a). *See generally* I.R.C. § 4944(b).

³⁶ *See* I.R.C. § 4944(a)(1), (b)(1).

³⁷ *Id.* § 4944(b)(1).

³⁸ *See id.* § 4944(a)(2), (b)(2).

³⁹ *See* Treas. Reg. § 53.4944(a)(2)(i).

of investment which will be closely scrutinized” to determine compliance with this standard.⁴⁰

Although both individual and aggregate taxes on managers are capped⁴¹ and they apply only to knowing violations, the prospect of personal liability could loom large. Foundations with counsel or otherwise aware of its provisions can be comforted by the fact that enforcement is light⁴² and the risk of personal liability can be avoided if the manager’s participation in the investment “is not willful and is due to reasonable cause.”⁴³ This exculpatory standard can often be met by relying on written advice of counsel that determines the investment will not violate the jeopardizing investment rules.⁴⁴ Foundations do take advantage of this option and sometimes even seek private letter rulings to ensure proper classification.⁴⁵

1. The Exception for Program Related Investments

The single exception to the jeopardizing investment proscription blesses “program-related investments” (PRIs).⁴⁶ Prominent members of the foundation community began developing this idea around the time of the Act. The Ford Foundation created a \$10 million program it called the “Program Related Investment Account” in 1968, and first used it that year to make loans to businesses and other entities in undercapitalized communities.⁴⁷

⁴⁰ *Id.*

⁴¹ Treas. Reg. § 53.4944-4(b).

⁴² See Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 TAX L. REV. 59, 108 (2004) (describing the provisions as “close to being deadwood”); see also Richard Schmalbeck, *The Lesser Foundation Excise Taxes: What Are They Good For? (Not Quite) Absolutely Nothing*, at 28–30 (2019 conference draft on file with author) (detailing a lack of enforcement breeding a lack of concern among most foundations).

⁴³ I.R.C. § 4944(a)(2).

⁴⁴ See Treas. Reg. § 53.4944-1(b)(2)(v).

⁴⁵ See, e.g., Paul Brest, *Investing for Impact with Program-Related Investments*, STAN. SOC. INNOVATION REV. 19, 22–23 (2016) (describing the Gates Foundation’s practice of seeking legal opinions for every PRI). See also BENABENTOS ET AL., STRATEGIES TO MAXIMIZE YOUR PHILANTHROPIC CAPITAL: A GUIDE TO PROGRAM RELATED INVESTMENTS 17 (2012).

⁴⁶ I.R.C. § 4944(c).

⁴⁷ See Rachel Wimpee, *The Economics of Empowerment: The Civil Rights Origins of Program-Related Investments* 6–7 (2019), https://cppp.usc.edu/wp-content/uploads/2019/03/Wimpee-Rachel-Wimpee_Civil-Rights-Origins-of-PRIs.pdf.

Despite the potential that such efforts might violate existing legal commands that foundations invest prudently, the Ford Foundation board approved its program as a cost-effective route to achieving its community development goals.⁴⁸

The paper advocating the PRI approach to the Ford board suggested at least two ways such investments could achieve a multiplier effect. First, they would generate some returns—as opposed to outright grants that returned nothing—which could be recycled into future philanthropic efforts.⁴⁹ Second, foundation support could attract additional capital from sources otherwise unwilling to lend into financially distressed communities.⁵⁰ John Simon, of the Taconic Foundation and Yale Law School, had also been advocating for foundations to use investments in addition to grants as a tool for achieving their charitable objectives.⁵¹ Simon recognized not only PRIs’ financial value, but also the expressive vote of confidence the use of investments, rather than grants, could give marginalized communities.⁵² Although not addressed in the initial Treasury Report or the House bill, language supporting PRIs found its way into the Act through the Senate Committee on Finance.⁵³ Under the Act, program-related investments are “investments, the primary purpose of which is to accomplish one or more [charitable purposes], and no significant purpose of which is the production of income or the appreciation of property.”⁵⁴

Program-related investments receive special treatment in three different ways, each of which has affected the trajectory of this tool. First, PRIs are *per se* not jeopardizing investments.⁵⁵ This is important, as many PRIs will

⁴⁸ *Id.* at 7–8.

⁴⁹ *See id.* at 8.

⁵⁰ *Id.*

⁵¹ *See id.*

⁵² *See id.* (citing a 1968 speech by Simon to the Council on Foundations).

⁵³ S. COMM. ON FIN., 91ST CONG., TAX REFORM ACT OF 1969, COMPILATION OF DECISIONS REACHED IN EXECUTIVE SESSION 50, 57–58 (Comm. Print 1969).

⁵⁴ I.R.C. § 4944(c). Regulations add that investments for lobbying and electioneering purposes cannot qualify as PRIs. *See* Treas. Reg. § 53.4944-3(a)(iii).

⁵⁵ *See* I.R.C. § 4944(c).

offer higher risk and lower financial return than could be justified under a prudent investor standard. From the earliest, pre-statute Ford Foundation loans in financially depressed neighborhoods, to today's PRIs in high-risk social-enterprise startups, PRIs are structured as investments because equity, debt, revenue-based financing, or a loan guarantee is a superior device for achieving charitable objectives, not because they offer an attractive financial return. Consider that early Ford loan portfolio. It self-reported that these investments generated a more than 35% default rate, a shockingly high rate for foundation debt investments normally.⁵⁶ By 1991, it had a mature PRI program staffed by professional loan officers and still targeted only an 85% recovery of funds.⁵⁷ A category of investments in which one expects negative 15% return certainly courts the imprudent label.

But PRIs were doing something quite different from the typical foundation investing for which the jeopardizing investment prohibition was conceived. Early on, according to a Ford Staffer, Ford's losses were greatest when they "were making substantial loans to small enterprises run by inexperienced entrepreneurs in the poorest neighborhoods."⁵⁸ They did so not for financial return, but to pursue charitable objectives of economic and community development in those neighborhoods.⁵⁹ As Ford's program matured and it and others began to use the PRI technique as legislatively-prescribed, the idea that PRIs were a substitute not for other investments, but for grants, remained strong.⁶⁰

The second special statutory provision for PRIs makes this equivalency explicit. A major prong of the 1969 Act is its mandatory distribution regime. Under it, each private foundation must generally make "qualifying

⁵⁶ See FORD FOUND., *INVESTING FOR SOCIAL GAIN: REFLECTIONS ON TWO DECADES OF PROGRAM-RELATED INVESTMENTS* 14 (1991).

⁵⁷ *Id.* at 10–11.

⁵⁸ *Id.* at 8 (quoting a Ford staffer).

⁵⁹ See *id.* at 4 ("[T]he medium of support fits the message of the Foundation's program goals," including "develop[ing] capacity within individuals and organizations") (quoting in part former Ford trustee and PRI committee chair, Donald S. Perkins).

⁶⁰ See, e.g., *id.* at 15 ("Certainly recovering 85% of a PRI from a project that accomplished an important program goal is less costly than if the total project had been supported with non-recoverable grant funds") (quoting Ford's PRI Director at the time).

distributions” of 5% of its assets each year.⁶¹ Failure to do so will trigger yet another set of two-tiered penalty and confiscatory taxes on the organization.⁶² Qualifying distributions include “any amount paid to accomplish one or more [exempt] purposes” of the foundation or “to acquire an asset used” in carrying them out, so long as payments are not made to related entities or other private foundations.⁶³ Treasury regulations clarify that program-related investments fall within this definition.⁶⁴ To summarize, meeting the requirements of the PRI exception not only eliminates any risk of penalty taxes on jeopardizing investments, but also allows a foundation to count the PRI toward its mandatory 5% payout.⁶⁵

The final regulatory consequence of qualifying as a program-related investment relates to the excess business holdings restrictions addressed above. Treasury regulations specifically exclude PRIs from the definition of a “business enterprise,” holdings of which are limited by the regime.⁶⁶ Unlike all other businesses, related or unrelated, foundations may hold large stakes, majority stakes, even the entire equity of a business in which it makes a program-related investment.

The exceptional treatment PRIs receive means a great deal can hinge on the Act’s one-sentence definition. Treasury regulations in 1972 provided useful elaboration.⁶⁷ For an investment’s primary purpose to be considered as accomplishing the charitable purposes of the foundation, the regulations consider both how much the investment contributes to those purposes and a question of but-for cause: whether the investment would have been made

⁶¹ I.R.C. § 4942(e).

⁶² *Id.* § 4942(a)–(b).

⁶³ *Id.* § 4942(g)(1).

⁶⁴ Treas. Reg. § 53.4942(a)-3(a)(2). Of course, if a PRI generates returns, those assets will increase the foundation’s overall assets and its future required 5% distributions. Notably, however, if the principal of a PRI loan is returned or a PRI equity investment is liquidated for a gain, these amounts are added directly to the foundation’s minimum distribution amount for the year. *See* I.R.C. § 4942(d), (f)(2)(C).

⁶⁵ For a discussion challenging the Act’s treatment of grants and PRIs as equivalent, see Ray D. Madoff, *The Five Percent Fig Leaf*, 17 PITT. TAX REV. 341 (2020).

⁶⁶ *See* Treas. Reg. § 53.4943-10(b).

⁶⁷ They also clarify that PRIs cannot be made to influence legislation or participate or intervene in elections. Treas. Reg. § 53.4944-3(a)(1)(iii).

without this contribution.⁶⁸ They also clarify that the mere fact that an investment ultimately produces a high return does not preclude its qualification as a PRI.⁶⁹ But whether investors concerned solely with financial return would make the same investment is “relevant” in determining if a proposed PRI appropriately lacks an income-seeking or property-appreciation purpose.⁷⁰

These initial regulations also provided ten examples illustrating Treasury’s understanding of PRIs at the time. Six of the nine examples that successfully meet the PRI requirements involve loans with below-market rates or other below-market terms made to low-income individuals or firms that are either owned by members of economically depressed or disadvantaged communities or the operation of which is important to such communities.⁷¹ Two more involve equity or unspecified “investment” in similar entities or projects,⁷² and the last simply allows a PRI’s terms to be changed over time to protect the foundation’s investment without losing its classification.⁷³ The examples could not be more clear. At the time of enactment, and for decades following, PRIs were investments traditional investors would avoid, ones made in businesses or individuals lacking access to capital, and ones generally involving marginalized communities or geographies.

As creative vehicles for social investments flourished, pressure grew for Treasury to update these examples. In 2016, after nearly fifteen years of

⁶⁸ Treas. Reg. § 53.4944-3(a)(2)(i) (explaining an investment will have the required primary purpose “if it significantly furthers the accomplishment of the private foundation’s exempt activities and if the investment would not have made but for such relationship between the investment and the accomplishment of the foundation’s exempt activities”).

⁶⁹ *Id.* § 53.4944-3(a)(2)(iii).

⁷⁰ *Id.*

⁷¹ *Id.* § 53.4944-3(b), ex. (1), (2), (4), (5), (6), (9), (10). The final, negative example underscored that equity investments in firms unrelated to the foundation’s exempt purposes would not qualify, even if the proceeds were applied to fund foundation’s exempt activities. *See id.* § 53.4943-3(b), ex. (7).

⁷² *Id.* § 53.4944-3(b), ex. (3), (10).

⁷³ *Id.* § 53.4944-3(b), ex. (8).

advocacy by the nonprofit legal community,⁷⁴ it added nine new and more wide-ranging examples.⁷⁵ These examples bring within the PRI definition not only traditional debt or equity investments, but hybrid models and loan guarantees, and expressly approve a PRI with a potentially high rate of return.⁷⁶ They also focus more than the original ten on hypothetical investments' *risk-adjusted* rate of return as the relevant inquiry. Still, the core idea of PRIs as investments only worth making for their social or charitable value remains. Like their predecessors, the new examples continually mention—so often it becomes almost a mantra—that qualifying PRIs are made on below-market terms and lack appeal to conventional investors.⁷⁷

II. VALUES-ALIGNED INVESTING

The idea of aligning one's investments with one's values has purchase today far beyond the confines of private foundations. ESG investing, in which investments are selected not only for financial risk and return profiles but also based on environmental, social, and governance (ESG) factors, is growing at a staggering rate globally. Estimates pegged the share of assets under management using ESG factors in 2019 at nearly \$30 trillion.⁷⁸ For many investors today, the turn to consider ESG factors is in part motivated by a desire for long-term investment growth or stability that appears associated with firms that outpace their peers on these factors.⁷⁹ Negative

⁷⁴ See I.R.S. Pub. No. 4344, Advisory Committee on Tax Exempt and Government Entities (ACT): Report of Recommendations 8 (2009) (referencing the work of the PRI Task Force, and its recommendation that new examples be added in 2002).

⁷⁵ See T.D. 9762, 2016-19 I.R.B. 718.

⁷⁶ See Treas. Reg. § 53.4944-3(b), ex. (11)–(19).

⁷⁷ See *id.*

⁷⁸ See Pippa Stevens, *Your Complete Guide to Investing with a Conscience, a \$30 Trillion Market Just Getting Started*, CNBC (Dec. 14, 2019), <https://www.cnbc.com/2019/12/14/yourcomplete-guide-to-socially-responsible-investing.html> [<https://perma.cc/4HZC-FLJ5>]; see Gregory Elders et al., *Sustainable Investing Grows on Pensions, Millennials*, BLOOMBERG INTELLIGENCE (Apr. 4, 2018), <https://www.bloomberg.com/professional/blog/sustainable-investing-grows-pensions-millennials/> (noting that global estimates include investments “labeled as sustainable, responsible or ethical investing” and amounted to \$23 trillion in prior years and citing to estimates provided by the Global Sustainable Investment Alliance).

⁷⁹ See Dana Brakman Reiser & Anne M. Tucker, *Buyer Beware: Variation and Opacity in ESG and EDG Index Funds*, 41 CARDOZO L. REV. 1921 (2020).

investment screens that eschew or divest from “sin” or “vice” stocks or fossil fuels have been on the scene for some time, as niche investment vehicles.⁸⁰ The field today, though, includes a panoply of additional techniques to incorporate ESG factors, including various positive screening mechanisms to identify best-in-class or improving ESG firms, themed ESG investment vehicles composed of green tech or woman-led firms, and both active and passive mutual fund and ETF options.⁸¹ The ability to feel good about one’s investment portfolio is a psychic bonus and can be a powerful marketing tool for investment companies designing ESG products.⁸²

Private foundations were some of the first to identify the appeal of this type of investment—though for different reasons. As philanthropic entities legally and practically devoted to pursuing charitable purposes, but which also often manage considerable investment portfolios, early adopters saw values-aligned investing as a natural fit. It is still, however, far from the standard investment strategy for private foundations.⁸³ This relatively low level of penetration can be traced to many factors, but the regulatory framework for foundations staked out in the 1969 Act is surely one of them.

The legal framework outlined above has led foundations’ values-aligned investment activity to be cleaved into two separate camps: program-related investments and mission-related investments. As the 1969 Act and its accompanying regulations envisioned, program-related investments are viewed as part of the grant-making side of the foundation. Like grants, PRIs are made to generate gains for the foundation’s charitable objectives. They effectively substitute for grant-making but involve a possible financial return as opposed to the 100% financial loss expected from traditional grants. That said, expected risk-adjusted financial returns from PRIs are typically low.⁸⁴ Their expected returns are so low, in fact, that they would frequently be intolerable under the jeopardy investment rules—even as part of a diversified

⁸⁰ See Casey C. Clark & Andy Kirkpatrick, *Impact Investing Under the Uniform Prudent Investor Act*, 32 PROBATE & PROP. 32, 33 (2018).

⁸¹ See Brakman Reiser & Tucker, *supra* note 79, at 1930–34.

⁸² See *id.* at 1992–98.

⁸³ See Heng Qu & Una Osili, *Beyond Grantmaking: An Investigation of Program-Related Investments by U.S. Foundations*, 46 NONPROFIT & VOLUNTARY SECTOR Q. 305, 308 (2017) (noting the use of PRIs by “only a handful of foundations” each year).

⁸⁴ See Brest, *supra* note 45, at 19 (“[F]oundations do not expect PRIs to produce market-rate returns”).

endowment portfolio. PRIs would also sometimes run afoul of the excess business holdings rules, as the investment needed to seed a small business in a struggling neighborhood or scale a startup social enterprise developing environmentally- or socially-focused products will sometimes represent more than a minority stake. Thus, the special exceptions provide cover.

While the 1969 Act literally coined the term PRI, it did not contemplate mission-related investments, which substitute for other investments—not grants. Mission-related investments fall within the purview of the endowment side of the foundation and are intended to generate financial returns for the foundation, though not financial returns alone. A mission-related investment will also provide returns aligned with the foundation’s mission—or in the view of some MRI adopters, at least not conflict with or frustrate those objectives. A foundation with a health-related charitable mission might invest in a biotech fund or purchase bonds issued by a fitness company, but it might also avoid investments in major packaged food companies or heavy polluters.

Mission-related investments can occur across industries and asset classes and require a foundation to identify its mission and how it desires to pursue that mission through its investment activities. As socially responsible investing has matured, new strategies have emerged for which risk adjusted returns will match or even exceed traditional investments.⁸⁵ Some investing choices made to align a portfolio with a foundation’s values, however, will involve tradeoffs in terms of risk and financial return, and any decision to impose a mission-related screen on investments can impact diversification. As such, federal tax law’s jeopardizing investment prohibition is relevant when considering individual MRIs and—even more so—adopting an MRI policy for all or part of a foundation’s endowment.⁸⁶ Recall that the 1969 Act imposes penalties on foundations and their managers if the foundation

⁸⁵ See Brakman Reiser & Tucker, *supra* note 79, at 1934–35; Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. COLO. L. REV. 731, 747–63 (2019).

⁸⁶ Such decisions also raise questions of compliance with state law fiduciary obligations to invest foundation assets prudently. See Gary, *supra* note 85, at 784–94 (arguing ESG integration investment strategies will comply with charitable trustees’ state law fiduciary obligations); Susan N. Gary, *Is It Prudent to Be Responsible? The Legal Rules for Charities that Engage in Socially Responsible Investing and Mission Investing*, 6 NW. J. L. & SOC. POL’Y 106 (2011) (discussing these state law compliance issues in socially responsible and mission investing).

“invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes.”⁸⁷ Although the regulations embrace portfolio theory and diversification, the penalties are still assessed based on investment-by-investment review. Mission-related investments that take on greater risk or contemplate lower return than alternative investment choices once appeared almost a facial violation of these rules.

True-believing early adopters of MRI, like the like the \$270M Heron Foundation, which began moving its endowment to MRI in the mid-1990s and started 2017 with an endowment 100% committed to mission,⁸⁸ had shown it is possible. But for more foundations to jump in, reassurance was necessary. It came in the form of a 2015 Treasury Bulletin, which clarified that:

When exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation’s charitable purposes. Foundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity so long as the foundation managers exercise the requisite ordinary business care and prudence under the facts and circumstances prevailing at the time of the investment in making investment decisions that support, and do not jeopardize, the furtherance of the private foundation’s charitable purposes.⁸⁹

Endowments must shift slowly, and it is too early to draw conclusions about the fate of mission-related investment, but highly public moves by a few large foundations in the wake of this guidance are encouraging. In 2017, the Ford Foundation announced that over the next ten years it would shift of up to one billion of its \$12 billion endowment to MRI,⁹⁰ in part in response

⁸⁷ I.R.C. § 4944(a)(1).

⁸⁸ See *The Evolution of Heron*, HERON FOUND., <https://www.heron.org/enterprise> (last visited Jan. 26, 2020).

⁸⁹ I.R.S. Notice 2015-62, 2015-39 I.R.B. 411 [hereinafter *Treasury Guidance*]. Although this article focuses on federal tax law regulation of foundations, it is worth noting that similar trends appear in state law addressing charitable fiduciaries’ responsibility to invest prudently. See generally UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT §§ 3(a), (e)(1)(H) (Nat’l Conference of Comm’rs on Unif. State Laws 2006).

⁹⁰ Darren Walker, *Unleashing the Power of Endowments: The Next Great Challenge for Philanthropy*, FORD FOUND.: EQUALS CHANGE BLOG (Apr. 5, 2017), <https://www.fordfoundation.org/ideas/equals-change-blog/posts/unleashing-the-power-of-endowments-the-next-great-challenge-for-philanthropy/>.

to the guidance's resolution of the "legal uncertainty" that been an obstacle before.⁹¹ The following year Nathan Cummings Foundation "committed to align all of [its nearly half-billion endowment] assets for impact."⁹²

III. UNFINISHED IMPACT BUSINESS

New regulatory examples and guidance have done a great deal to update the 1969 Act and make foundations more comfortable exploring ways to invest for impact. But more could be done. This Part explores the advantages and disadvantages of additional changes that could increase the use of PRIs and mission-related investing, as well as other means to introduce more impact thinking into foundation regulation.

A. Increasing PRI Uptake

Only a small number of foundations regularly engage in PRIs, and together these foundations allocate a very small amount of total funds to such investments.⁹³ At least two explanations for this lack of uptake are plausible. On the one hand, it may be due to uncertainty: that it is still too hard or too risky to make PRIs. On the other hand, the lack of PRIs may instead be the result instead of good decision-making. Perhaps PRIs are not a good use of more foundation assets.

1. Uncertainty

Despite the new 2016 examples, reports of foundation managers' reticence surrounding program-related investing and that of their counsel persist. The practice of seeking written opinions of counsel to ensure a PRI's

⁹¹ *Id.*

⁹² See NATHAN CUMMINGS FOUND., *Nathan Cummings Foundation Announces Move to 100 Percent Mission-Aligned Investing* (Mar. 12, 2018), <http://www.nathancummings.org/ncf-commits-100-percent> (quoting Board Chair Ruth Cummings).

⁹³ See, e.g., Brian Galle, *Pay It Forward? Law and the Problem of Restricted-Spending Philanthropy*, 93 WASH. U. L. REV. 1143, 1148, 1198 (2016) (finding that in a data set of thousands of foundations over 25 years "barely one tenth of 1% of foundation assets is given over to" PRIs); Marc Gunther, *Doing Good and Doing Well*, CHRON. PHILANTHROPY (Jan. 8, 2019), <https://www.philanthropy.com/article/Impact-Investing-Struggles-to/245390> (summing up its findings about slow uptake of impact investing with: "[t]he bottom line is that less than three-tenths of 1 percent of the endowments of those 15 big foundations are invested in ways designed to align with mission").

charitability continues,⁹⁴ in part because the world of creative investment vehicles simply moves far more swiftly than do regulatory changes. Recommendations along the lines of the new 2016 examples were first submitted by a special task force in 2002.⁹⁵ Although the legal community welcomed the eventual updates, the new examples described transactions that, by the time of their release, no longer represented the cutting edge. The additional examples did make the important point that credit enhancements could qualify as PRIs,⁹⁶ but other scenarios they describe are similar to those addressed by existing private letter rulings.⁹⁷ Foundations wishing to make the most novel and potentially transformative PRIs thus still face regulatory risk when doing so, as do their managers. The costs associated with reducing this risk are particularly trenchant because of the small deal sizes PRIs typically involve.⁹⁸ Foundations understandably reel at spending tens of thousands of dollars to “paper” a deal whose investment size is only \$100,000, and PRIs often involve far smaller amounts.

If this explanation is accepted, how might the Act and its accompanying regulations be changed or interpreted to resolve the problem? Tax law commonly utilizes safe harbors to mitigate risk and uncertainty in transactions that have the potential to be both valuable and problematic. For example, the regime regulating transactions between public charities and related persons relies on a safe harbor.⁹⁹ In that context, the law’s objective is to screen out self-dealing transactions that harm public charities, particularly by taking advantage of insiders’ access to or control over them.

⁹⁴ See PROGRAM-RELATED INVESTING: SKILLS & STRATEGIES FOR NEW PRI FUNDERS, GRANTCRAFT 4 (2018) [hereinafter PROGRAM-RELATED INVESTING].

⁹⁵ See I.R.S. Pub. No. 4344, *supra* note 74, at 8.

⁹⁶ See Treas. Reg. § 53.4944-3(b), ex. (18) & (19).

⁹⁷ Compare, e.g., Treas. Reg. § 53.4944-3(b), ex. (11) with I.R.S. Priv. Ltr. Rul. 200603031 (Oct. 25, 2005) (addressing qualifying distributions to commercial enterprise developing health innovations). See also Sharon Schneider & Page Snow, *Program Related Investments: An Overview*, FOUND. SOURCE 6 (2012), <https://static1.squarespace.com/static/577434ede4fcb5f238e9b8b3/t/586eaa3a1b631b755fe0925f/1483647546917/PRI+Overview+-+Foundation+Source.pdf> (describing the new examples when initially proposed as “based on private letter rulings published over the last several decades”).

⁹⁸ See, e.g., THE PRI PULSE, VENN FOUNDATION 20 (2016) (reporting that over half of PRIs issued by Minnesota foundations from 1998–2016 were for amounts of \$100,000 or less).

⁹⁹ See Treas. Reg. § 53.4958-6(a).

At the same time, the law desires to allow transactions that will provide public charities with valuable services or property on market or better terms despite (and often by virtue of) insiders' involvement. To balance the risks and benefits, tax law provides arrangements involving insiders with a rebuttable presumption of reasonableness (and therefore acceptability under the regulatory scheme) so long as they are approved by a disinterested body, in reliance on information indicating comparable terms in the marketplace, and are thoroughly and contemporaneously documented.¹⁰⁰

A similar, process-based approach could be used to create a safe harbor that would give skittish foundations more comfort in making PRIs. New Treasury regulations could design a rebuttable presumption that an investment meets the PRI requirements if a foundation's board or investment committee determined it met the PRI standard, relying on information from a disinterested outsider indicating its terms would not be accepted by conventional investors, and documenting both this and the investment's contribution to achieving the foundation's charitable objectives. This process-based approach would have the advantage of removing the need to constantly update the terms of the statute or regulations to address new investment structures.

It would also inject the objectivity of a disinterested third party into the mix, calling on this entity to confirm a foundation's potentially self-serving claim that an investment had no purpose to generate income or property appreciation. But whether this system could be trusted by tax authorities would depend on the gatekeepers. Like all regulatory approaches that rely on third-party certification, they introduce a new set of regulation-relevant parties, whose independence and expertise is crucial. In the PRI context, however, there is a perhaps even more fundamental problem with introducing such parties. They already exist in the form of attorneys offering written opinions, and the cost of these parties is precisely the problem that a safe harbor reform would be intending to solve. Indeed, the self-dealing regulations provide a special rule for small organizations precisely to respond to concerns about the cost a process-based safe harbor can impose.¹⁰¹ If the

¹⁰⁰ *Id.*

¹⁰¹ *Id.* § 53.4958-6(c)(2)(ii).

obstacle to foundation PRI uptake is its expense, it is hard to see how a safe harbor approach on this model would eliminate it.

Would the government accept a PRI safe harbor without an appeal to third parties for certification or confirmation that an investment met the standard—one that relied on foundation findings alone? It is hard to see how the government would tolerate such an alternative. After all, the public charity self-dealing safe harbor itself was consciously limited in application to public charities. The government could easily have applied it to private foundations but chose not to—a decision unsurprising in light of the government’s persistent (and reasonable) concerns about foundations’ lack of accountability mechanisms.

Targeted rulemaking more specific than a safe harbor, but more generalizable than new examples, is a helpful—and likely more feasible—alternative. Future Treasury regulations should address types and qualities of transactions rather than specific hypotheticals. For example, regulations could outline the qualities of permissible loan guarantees, rather than particular allowable structures. A provision also could detail the circumstances under which the existence of non-impact-oriented co-investors would preclude PRI designation, rather than discussing a specific compliant or non-compliant deal. Direct discussion of whether below-market rates are always required would likewise be extremely welcome guidance.

Whether such clarifications will be forthcoming is highly uncertain because the PRI designation is uniquely powerful. It not only prevents a foundation investment from triggering jeopardizing investment and excess business holding penalties, but also allows the investment to serve as a qualifying distribution toward the annual 5% payout requirement. These rules—rules PRIs flout—are key pillars of the 1969 Act. They work together to cabin foundations within their societally acceptable limits. Relying on foundations themselves to police them goes against the very core of the 1969 Act, creating a loophole that could undo much of the progress it seeded. Indeed, understanding the regulatory potency of PRIs suggests the government might see foundations’ limited uptake of the tool as a feature of the regulatory regime it has created for them, rather than a bug.

Alternatively, a self-regulatory option can also offer great potential to increase PRI uptake. Foundations that make significant use of PRIs, many of which are the very largest foundations, may feel comfortable taking the risk of investing without a letter ruling. If they, however, begin as a matter of course and field-building to seek such rulings and disseminate then, they

could make great strides in providing education, guidance, and comfort to risk-averse foundations or those new to the PRI scene. There are foundations that already have taken this costly but worthwhile approach.¹⁰² Greater coordination amongst them, and more publicity surrounding the results of the rulings they obtain and their significance, could bring other foundations off the proverbial bench.

2. Good Decision-Making

The possible solutions addressed above assume that uncertainty is to blame for low PRI uptake. If more PRIs would instead be an inferior use of foundation assets, these solutions would be counterproductive. As much as it is in vogue, investing for impact is neither simple nor cheap. Investments that generate social returns can rely upon innovative structures, novice managers (either at the investee or fund level or both), limited liquidity, and multiple types or tranches of investors.¹⁰³ Small foundations may well be making wise decisions when they forego PRIs in favor of standard grants and traditional investment portfolios to focus on charitable impact and avoid adding to their already overwhelming obligations.¹⁰⁴

PRIs may be too burdensome a prospect even for many larger foundations with staffs. They generally employ individuals with expertise in charitable grantmaking and investment management for pure financial return. These employees will have neither the experience nor the capacity to evaluate new structures, incentivize and monitor managers, and vet co-investors who may or may not share an impact orientation.¹⁰⁵ Taking on a

¹⁰² See, e.g., I.R.S. Priv. Ltr. Rul. 20-06-100-20 (Dec. 13, 2005) (ruling that a foundation's acquisition of a membership interest in a fund "organized for the purpose of investing in businesses in low-income communities owned or controlled by members of a minority or other disadvantaged group that have not been able to obtain conventional financing on reasonable terms, and that will provide community benefits" would qualify as a PRI).

¹⁰³ Cf. Benjamin Leff, *Preventing Private Inurement in Tranched Social Enterprises*, 45 SETON HALL L. REV. 1 (2015); Elaine Waterhouse Wilson, *Is Consistency the Hobgoblin of Little Minds: Co-Investment under Code Section 4941*, 85 UMKC L. REV. 393 (2017).

¹⁰⁴ See Dan Parks, *Many Small Foundations Wary of Impact Investing*, CHRON. PHILANTHROPY, Mar. 2, 2020, <https://www.philanthropy.com/article/Many-Small-Foundations-Wary-of/248163> (describing a new study showing small foundations do not have sufficient interest, capacity and/or risk tolerance to engage in impact investing).

¹⁰⁵ PROGRAM-RELATED INVESTING, *supra* note 94, at 5 (discussing the need for foundation staff with financial expertise to make successful PRIs); *Program Related Investments*, THE CENTER FOR HIGH

new and complex form of investing may require so many administrative resources that it is simply a poor fit.¹⁰⁶

There are some, too, who would argue there is simply very little charitable advantage to be gained from replacing grantmaking with investment. Larry Kramer, a rare public skeptic of impact investing among foundation leaders, has argued that “[t]hose impact investments that promise to deliver market returns ‘will attract the capital they need with or without investors for whom social impact is an additional consideration. So we decrease our grant-making power while adding no additional social impact.’”¹⁰⁷ PRIs do allow for foundation assets to be (at least partially) recycled and pursue charitable objectives multiple times, while grants involve a certain 100% loss every time. Yet if there are in fact very few real opportunities to primarily achieve charitable objectives while generating an incidental financial return and many traps for the unwary, even large foundations with dedicated staffs should rarely make PRIs.

After all, for those who seek access to a broad spectrum of impact investments without the administrative costs and regulatory headaches of squeezing them into the PRI category, alternatives exist. The founding of the Chan Zuckerberg Initiative in 2015¹⁰⁸ shed light on the pre-existing practice of elite philanthropists using limited liability companies to coordinate all or part of their philanthropic activities.¹⁰⁹ This practice has many advantages, but one significant one is the regulatory freedom it offers for engaging in a range of investment practices. Laurene Powell Jobs’ LLC, the Emerson Collective, purchased a “significant minority stake” in a firm called

IMPACT PHILANTHROPY, 10–11 (2016). *See also* Qu & Osili, *supra* note 83, at 315–20 (finding that larger foundations with more staff invested more in PRIs and made more such individual investments).

¹⁰⁶ *See* Paul Brest & Kelly Born, *When Can Impact Investing Create Real Impact?*, 11 STAN. SOC. INNOV. REV. 22, 26 (2013).

¹⁰⁷ *See* Marc Gunther, *Hewlett Foundation’s Leader Makes a Case Against Impact Investing*, CHRON. PHILANTHROPY (Jan. 8, 2019), <https://www.philanthropy.com/article/Hewlett-Foundation-s-Leader/245394?cid=RCPACKAGE> (quoting Kramer).

¹⁰⁸ *See* Mark Zuckerberg, *A Letter to Our Daughter*, FACEBOOK (Dec. 1, 2015), <https://www.facebook.com/notes/mark-zuckerberg/a-letter-to-our-daughter/10153375081581634/>.

¹⁰⁹ *See* PAUL BREST, MONEY WELL SPENT 298 (2018); Dana Brakman Reiser, *Disruptive Philanthropy: Chan-Zuckerberg, the Limited Liability Company, and the Millionaire Next Door*, 70 FLA. L. REV. 921 (2018).

Anonymous Content, which produced the film *Spotlight*.¹¹⁰ This investment fits poorly into the PRI category as conventional investors would and do make similar investments. Such an investment might qualify as non-jeopardizing under the *Treasury Guidance*, but the size of the stake could still present problems as an excessive holding. Philanthropic entities operating as LLCs rather than as private foundations—not only Emerson, but CZI, one half of the Omidyar Network, or the LLC that John and Laura Arnold recently transitioned to using to manage their philanthropy¹¹¹—need not concern themselves with ensuring their investments comply with these rigid regulatory frameworks.

B. Mission-Related Investment Uptake

Fewer and lower barriers remain for foundations seeking to engage in mission-related investing, especially if one defines this term broadly to include any investment tool aligning investment strategy with a foundation's values and charitable objectives. After the 2015 *Treasury Guidance*'s explicit statement that “[w]hen exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes,”¹¹² any foundation should be able to find at least some investment vehicles that will enhance value alignment. Even Kramer generally approves of foundations investing in ESG mutual funds “as long as they don't sacrifice returns.”¹¹³

That said, *Treasury Guidance* lacks the permanence of law. To express the acceptance and value of mission-related investment even more strongly, the statute should be amended to parallel the *Guidance* position. If legislative

¹¹⁰ Matthew Belloni, *Laurene Powell Jobs Goes Hollywood, Buys Minority Stake in 'Spotlight' Producer Anonymous Content*, HOLLYWOOD REP. (Sept. 30, 2016, 7:37 AM), <http://www.hollywoodreporter.com/news/laurene-powell-jobs-takes-minority-934139>.

¹¹¹ See Ben Steverman, *Two Texas Billionaires Think They Can Fix Philanthropy*, BLOOMBERG.COM (Dec. 12, 2019), <https://www.bloomberg.com/news/articles/2019-12-12/billionaires-john-and-laura-arnold-s-data-driven-philanthropy>; see also Ben Gose, *John and Laura Arnold Join Other Billionaires in Move Away from Traditional Philanthropy*, CHRON. PHILANTHROPY (Jan. 28, 2019), <https://www.philanthropy.com/article/JohnLaura-Arnold-Join/245557>.

¹¹² *Treasury Guidance*, *supra* note 89, at 3.

¹¹³ See Gunther, *supra* note 107.

amendment is not politically feasible, at least the accompanying regulations should be amended to conform with the 2015 *Guidance*.

Foundations could be moved more squarely into the impact camp in the mission-related investment context by embracing even more fundamental changes. For example, the limitation on excess business holdings could be removed for mission-related investments, as it was for PRIs all the way back in 1969. The policy concerns behind the excess business holdings caps map quite poorly onto the terrain of mission-related investments. Concerns that substantial business holdings would distract foundation managers from their proper spheres of charitable concern or displace the production of charitable benefits are muted if pursuit of an investment aligns with charitable mission. The inclination to self-dealing the *Treasury Report* identified in excessive holdings in related businesses could be addressed by retaining limits on even mission-related investments if controlled by a foundation's own donors, managers, or their relatives or controlled entities. Similarly, concerns about the poor investment quality of substantial holdings in mission-related investments could be dealt with through retained requirements for prudence, diversification, and monitoring. Unfair competition issues might remain, but considering the UBIT regime's comfort with excepting investment income from even wholly unrelated businesses from taxation¹¹⁴ despite the significant potential competitive effects thereof, it is hard to be overly exercised about them.

Line-drawing is the real problem with creating an exception to the excess business holdings rules for mission-related investment. In today's business world, where every firm seems to tout its corporate social responsibility and every fund manager is rushing a new ESG fund to market, what kind of investment could not be treated as mission-related? Drafting language to except mission-related investments from the excess business holdings regime without gutting its remaining provisions in the process would be extremely difficult. The difficulty faced by Newman's Own Foundation in obtaining a statutory exception only for wholly owned, independently-run businesses that donate all of their profits to charity

¹¹⁴ See I.R.C. § 512(b)(1) (excluding from the definition of unrelated business taxable income "all dividends, interest, payments with respect to securities loans . . . amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income").

demonstrates the uphill battle such an exception would face in seeking congressional approval.

One possible way to thread this needle would be to impose an additional regulatory burden on foundations seeking to use a potential MRI exception. For example, statutory or regulatory language could impose monitoring and documentation obligations on those seeking to use a mission-related investment exception added to the excess business holdings regime. The “expenditure responsibility” rules for foundation grants to non-public charities offer one potential model.¹¹⁵ They require a private foundation to exert reasonable efforts and to establish adequate procedures to ensure the grant is spent solely for the exempt purposes for which it was made, to obtain documentation of how the funds were spent, and “to make full and detailed reports” on such grants.¹¹⁶

To maintain holdings in a business beyond the statutory maxima on grounds the investment was mission-related, a foundation could likewise be required not only to meet an MRI definition but also to track and document the investment’s achievements of its charitable objectives (or at least its greater alignment with them relative to non-mission-related alternatives). The challenge of this drafting exercise should not be underestimated. Setting the hurdle high enough could address concerns about the potential breadth of a mission-related investment definition. Yet, setting it too high would remove its ability to spur greater uptake of mission-related investment in the first place. The example of expenditure responsibility should give us pause. Despite the seeming simplicity of its requirements, many entities subject to it prefer not to trigger its application.¹¹⁷

An evaluation and documentation requirement of this type would be independently valuable in updating the 1969 Act to adopt more impact-focused orientation. Much of the impact movement within philanthropy is consumed with how to ensure and therefore measure impact. This metrics

¹¹⁵ *Id.* § 4945(h).

¹¹⁶ *See id.*

¹¹⁷ *See* Elaine Waterhouse Wilson, *Cooperatives: The First Social Enterprise*, 66 DEPAUL L. REV. 1013, 1062 (2017) (noting that “[t]he expenditure responsibility requirements are extremely technical; as a result, many private foundations will not make expenditure responsibility grants” and citing examples of foundation statements refusing to do so).

debate is heated, introducing questions about how to quantify impact and compare incommensurables.¹¹⁸ Addressing it comprehensively here is not possible within the scope of this symposium contribution. Still, it is worth noting that impact evaluation requirements are worthy of consideration for possible adoption in the grantmaking context as well.

An even more ambitious change might not merely permit or encourage mission-related investment but mandate it. The arguments for mission-related investing are strong and cut to the core of the concerns to which the 1969 Act responded. Foundations are given significant advantages—tax and otherwise—in recognition of their contributions to society. But if managed as required to comply with the law, a foundation needs to spend only 5% of its assets per year to support actual charitable activity. The data show that on average, most foundations do act in precisely this way. U.S. foundations’ grantmaking and PRIs hover right around the mandatory 5% floor.¹¹⁹

Could they not be doing more? The 5% number envisioned foundations being able to roughly replace their spent assets though investment gains, therefore allowing them to be sustainable in perpetuity. Even if one does not seek to shake the potentially perpetual lifespan of foundations, could we not ask foundations to do some good, something mission related, with their remaining 95%? Mission-related investment is a way to do this. Demanding that foundations align their investments—at least some of them—with their values and their charitable missions would hardly be drastic. If the Treasury is convinced such investments can be made without endangering foundations’ ability to carry on their charitable activities, mandating that foundations enter this area is far from radical.

Requiring some charitable gains from the use of the remaining 95% would also resonate with the spirit of the 1969 Act. Many at the time sought even greater demands be put on foundation assets. The *Treasury Report*

¹¹⁸ See DANA BRAKMAN REISER & STEVEN A. DEAN, SOCIAL ENTERPRISE LAW: TRUST, PUBLIC BENEFIT & CAPITAL MARKETS 124–42 (2017).

¹¹⁹ See Alex Daniels, *What’s So Special About 5%?*, CHRON. PHILANTHROPY (Mar. 7, 2017), <https://www.philanthropy.com/article/Big-Foundations-Give-Little/239383> (reporting results of “a Chronicle analysis of Internal Revenue Service data compiled by the Foundation Center” showing big foundations generally pay out almost exactly the 5% required by law).

argued for a requirement to distribute all income.¹²⁰ Senator Gore advocated limiting foundation lifetimes altogether,¹²¹ encouraging foundations to spend down in terms quite familiar to critics who argue against the perpetual life charitable gift restrictions enjoy today.¹²² But one need not go any further than the terms of the statute as enacted to find justification for demanding more charitable impact from foundations. Its centerpiece imposed a payout requirement, designed to ensure that private foundation assets reached charitable programs.

Any attempt to draft legislation or regulations to mandate that foundations engage in mission-related investing would need to contend with two sets of objections. The first set is theoretical. Private foundations are private, state-created organizations.¹²³ The benefits received by foundations and their donors are the means through which federal law can regulate them. Critics already argue federal forays into nonprofit governance strain the boundaries of this jurisdictional reach.¹²⁴ Mandating how foundations choose their investments, not to safeguard assets for future exempt use but instead to conform to congressional or Treasury views on how to achieve a foundation's charitable goals would indeed be a heavy hand on foundation autonomy. Moreover, it would be federal interference with private state law organizations, raising federalism concerns as well.

In addition to these more abstract concerns are practical ones. Imposing a new mandate on foundations might further encourage donors to use foundation alternatives, like donor-advised funds that are treated as public

¹²⁰ See TREASURY REPORT, *supra* note 6, at 26.

¹²¹ Troyer, *supra* note 7, at 22.

¹²² See, e.g., Linda Sugin, *Competitive Philanthropy: Charitable Naming Rights, Inequality, and Social Norms*, 79 OHIO ST. L.J. 121, 148–50 (2018); Melanie Leslie, *Time to Sever the Dead Hand: Fisk University and the Cost of the Cy Pres Doctrine*, 31 CARDOZO ARTS & ENT. L.J. 1, 16 (2012); see also JOEL FLEISHMAN, PUTTING WEALTH TO WORK 139–70 (2017) (canvassing rationales supporting “giving while living”).

¹²³ See EVELYN BRODY & JOHN TYLER, *HOW PUBLIC IS PRIVATE PHILANTHROPY? SEPARATING REALITY FROM MYTH* (2d ed. 2012).

¹²⁴ See, e.g., James J. Fishman, *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545, 586–91 (2009); Lloyd Hitoshi Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479, 539 (2010).

charities and the philanthropy LLC vehicles that escape the web of tax-exempt legislation altogether. An MRI mandate would also be devilishly difficult to draft. The *Treasury Guidance* is a good place to start. Legislation or regulation could require, rather than simply permit “foundation managers [to] consider all relevant facts and circumstances, *including the relationship between a particular investment and the foundation’s charitable purposes*.”¹²⁵ Such a broad statement, standing alone, would have significant expressive value in recognizing the value of mission-related investment. Without more, and particularly some kind of standard for accountability and enforcement, it is hard to see how such language would spur greater mission-related investments than would the current permissive language. Process requirements could be added, demanding documentation that foundations engaged in such considerations, but it is hard to see how the IRS would meaningfully enforce them.

The breadth of the mission-related investment umbrella, at least on some definitions, is also a confounding factor. If a foundation could comply with an MRI mandate simply by investing in ESG-focused mutual funds or instructing its financial advisors to take such concerns to heart, the mandate would devolve into a box-checking exercise scarcely worth the political capital to enact. Mission-related investment could instead be defined to require finding individual direct investments or funds that match precisely with a foundation’s mission, while still presenting a tolerable risk-return profile in terms of safeguarding the foundation’s assets. Conceived this way, mandated MRI would be a costly and time-consuming process that would take time away from other charitable pursuits (read—grantmaking) to which many foundations and their staff would be far better suited. A mandate on these terms would appropriately be confined to foundations with quite large endowments,¹²⁶ and would still raise significant enforcement challenges.

However an MRI mandate might be structured and its terms defined, it also could not be created by regulation alone. Legislation is necessary, and whether Congress has an appetite for taking up the challenges of drafting and implementing a mandate remains to be seen. The permissive stance taken in the 2015 *Treasury Guidance* seems to be moving the needle already. Perhaps

¹²⁵ See *Treasury Guidance*, *supra* note 89, at 3 (emphasis added).

¹²⁶ But see Gunther, *supra* note 107 (reporting Kramer’s view that, conversely, big foundations with the capacity to earn above-market returns should reject potentially return-damaging impact investment and use their gains for increased grantmaking).

no more will be required to spur the foundation community over time to accept mission-related investment as a best practice.

IV. CONCLUSION

In a philanthropic world obsessed with impact, the question of how foundations can align their investments with their values is fundamental. The 1969 Act's original PRI exception, as retrofitted with regulatory examples over time, guides the use of investment as a substitute for grantmaking. Recent *Treasury Guidance* on mission-related investment now also allows foundations keen to engage in mission-related investment with their endowments to keep better pace with innovations in the field.

Identifying these components of the 1969 Act that remain generative or have been interpreted to allow them to continue to be useful also reveals potentially beneficial additional updates. Some of this unfinished impact business could be attended with incremental regulatory changes. Other changes, particularly those that might increase the uptake of mission-related investment, would likely require congressional intervention. The reform proposals outlined here are only preliminary steps designed to spur further research and lively debate. To design foundation regulations for today's age of impact as influential and enduring as the 1969 Act will require both careful study and deliberative and inclusive legislative and agency processes.

