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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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
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.