August 8, 2012

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on New Examples of Program-Related Investments in Proposed Regulations Section 53.4944-3(b)

Dear Commissioner Shulman:

Enclosed are comments on new examples of program-related investments in Proposed Regulations section 53.4944-3(b). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Rudolph R. Ramelli  
Chair, Section of Taxation

Enclosure

cc: Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury  
William J. Wilkins, Chief Counsel, Internal Revenue Service
These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by David S. Chernoff and Robert A. Wexler of the Committee on Exempt Organizations of the Section of Taxation. Substantive contributions were made by Cassady V. Brewer, Milton Cerny, Paul Feinberg, Jennifer L. Franklin, Lisa Johnsen, David Levitt, Ken Monteiro, Drew Porter, and Richard Sevcik. The Comments were reviewed by Suzanne McDowell, Committee Chair. The Comments were further reviewed by Victoria Bjorklund of the Section’s Committee on Government Submissions and by Michael Clark, Council Director for the Committee on Exempt Organizations.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, 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 matter of these Comments.

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Date:  August 8, 2012
Proposed regulations providing additional examples of “program-related investments” (“PRIs”) under section 4944(c)\(^1\) were published on April 19, 2012 (the “Proposed Regulations”).\(^2\) The Proposed Regulations are intended to provide additional examples of PRIs “that reflect current investment practices.”\(^3\)

First, we want to express our sincere appreciation for these Proposed Regulations. The Proposed Regulations will go a long way towards adding clarity to the types of PRIs that may be made by private foundations. Many grantmaking public charities will also look to the PRI examples for guidance. Furthermore, the preamble to the Proposed Regulations provides a helpful articulation of the principles governing PRIs.

By way of background, section 4944(a) imposes an excise tax on a private foundation that makes an investment that jeopardizes the carrying out of any of the private foundation’s exempt purposes. Section 4944(c) excepts PRIs from treatment as jeopardizing investments. The regulations under section 4944(c) define a PRI as an investment: (1) the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B); (2) no significant purpose of which is the production of income or the appreciation of property; and (3) no purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(D) (attempting to influence legislation or participating in or intervening in any political campaign).

Regulations section 53.4944-3(b) contains nine examples illustrating investments that qualify as PRIs and one example of an investment that does not qualify as a PRI. The existing examples focus on domestic situations principally involving economically disadvantaged individuals and deteriorated urban areas. The Proposed Regulations would add additional PRI examples that reflect current investment practices and illustrate certain principles.

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\(^1\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.


\(^4\) ABA Section of Taxation Comments, “Draft Examples of Program-Related Investments For Addition to Treasury Reg. Sec. 53.4944-3(b) and Analysis of Each,” available at http://www.abanet.org/tax/pubpolicy/2002/020515pri.pdf.

Our specific recommendations are as follows:

1. The preamble to the Proposed Regulations contains the following articulation of the principles governing PRIs:

   The Treasury Department and the IRS are aware that the private foundation community would find it helpful if the regulations could include additional PRI examples that reflect current investment practices and illustrate certain principles, including that: (1) an activity conducted in a foreign country furthers a charitable purpose if the same activity would further a charitable purpose if conducted in the United States; (2) the charitable purposes served by a PRI are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas; (3) the recipients of PRIs need not be within a charitable class if they are the instruments for furthering a charitable purpose; (4) a potentially high rate of return does not automatically prevent an investment from qualifying as program-related; (5) PRIs can be achieved through a variety of investments, including loans to individuals, tax-exempt organizations and for-profit organizations, and equity investments in for-profit organizations; (6) a credit enhancement arrangement may qualify as a PRI; and (7) a private foundation’s acceptance of an equity position in conjunction with making a loan does not necessarily prevent the investment from qualifying as a PRI. 6

   This statement of principles is extremely helpful guidance. Consequently, we recommend that it be included in the text of the final regulations so that the principles are readily accessible to grantmaking organizations. Alternatively, although it is less preferable, we suggest that the principles be preserved in another readily accessible place, such as on www.irs.gov as part of the Life Cycle of a Private Foundation.

2. We understand that some of the examples that we had previously proposed address whether particular charitable purposes, such as mixed-income housing, certain environmental activities, newspapers, and lessening the burdens of government, are appropriate for PRIs. We also understand that these charitable activities were not included in the Proposed Regulations because the new examples are designed to illustrate section 4944 issues rather than what qualifies under section 170(c). We do want to suggest, however, that more guidance, perhaps in some other format such as one or more revenue rulings, on substantive areas such as mixed-income housing and nonprofit newspapers, would be helpful to the nonprofit sector and to foundation funders.

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3. Example 11 permits a private foundation to make a PRI in a for-profit subsidiary of a for-profit drug company for the development of a vaccine, provided that the agreement between the foundation and the subsidiary requires the subsidiary to make the vaccine available to the poor at affordable rates and provided that the subsidiary publishes its research. We recommend that the example be modified in two ways: first, to make it clear that the subsidiary can also sell the vaccine to those who can afford it at fair market value prices, and second to remove the publication requirement, since providing the vaccine to the poor at affordable prices without more furthers the accomplishment of exempt purposes. Similarly, a publication requirement, without a concurrent requirement to sell the vaccines to the poor, would also further the accomplishment of exempt purposes. Our suggested modification of the example follows:

Example (11). X is a business enterprise that researches and develops new drugs. X’s research demonstrates that a vaccine can be developed within ten years to prevent a disease that predominantly affects poor individuals in developing countries. However, neither X nor other commercial enterprises like X will devote its resources to develop the vaccine because the potential return on investment is significantly less than required by X or other commercial enterprises to undertake a project to develop new drugs. Y, a private foundation, enters into an investment agreement with X in order to induce X to develop the vaccine. Pursuant to the investment agreement, Y purchases shares of the common stock of S, a subsidiary corporation that X establishes to research and develop the vaccine. The agreement requires S to distribute the vaccine to poor individuals in developing countries at a price that is affordable to the affected population; however, the agreement does not preclude S from selling the vaccine to other individuals at a market rate. The agreement also requires S to publish the research results, disclosing substantially all information about the results that would be useful to the interested public. S agrees that the publication of its research results will be made as promptly after the completion of the research as is reasonably possible without jeopardizing S’s right to secure patents necessary to protect its ownership or control of the results of the research. The expected rate of return on Y’s investment in S is less than the expected market rate of return for an investment of similar risk. Y’s primary purpose in making the investment is to advance science. No significant purpose of the investment involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y’s exempt activities and would not have been made but for such relationship between the investment and Y’s exempt activities. Accordingly, the purchase of the common stock of S is a program-related investment.

4. Example 15 involves a PRI for disaster relief in a developing country. We believe it would be helpful, particularly in the context of disaster relief (e.g., relief following the earthquake in Japan), to have an example that indicates that providing PRI disaster relief to a foreign country, whether or not it is a developing country, would
further the accomplishment of exempt purposes. Accordingly, we suggest the following change to example 15:

Example (15). A natural disaster occurs in W, a developing foreign country, causing significant damage to W’s infrastructure. Y, a private foundation, makes loans bearing interest below the market rate for commercial loans of comparable risk to H and K, poor individuals who live in the region within W where the natural disaster occurred, to enable each of them to start a small business. H will open a roadside fruit stand. K will start a weaving business. Conventional sources of funds were unwilling or unable to provide loans to H or K on terms they consider economically feasible. Y’s primary purpose in making the loans is to provide relief to the poor and distressed. No significant purpose of the loans involves the production of income or the appreciation of property. The loans significantly further the accomplishment of Y’s exempt activities and would not have been made but for such relationship between the loans and Y’s exempt activities. Accordingly, the loans to H and K are program-related investments.

Example (16) involves a PRI loan to a limited liability company. We understand that a decision was made not to include an equity investment in a limited liability company because of the complexity of the issues around investments in pass-through entities. We respectfully note, however, that private foundations do make equity investments in pass-through entities on a regular basis, and where these investments otherwise qualify as PRIs, we believe that the fact that the recipient is organized as a pass-through entity should not be an issue. We recommend, therefore, that example 16 be modified to describe an equity investment in a limited liability company, as follows:

Example (16). X is a limited liability company treated as a partnership for federal income tax purposes. X purchases coffee from poor farmers residing in a developing country, either directly or through farmer-owned cooperatives. To fund the provision of efficient water management, crop cultivation, pest management, and farm management training to the poor farmers by X, Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. X purchases membership interests in X. X and Y enter into an investment agreement, pursuant to which Y agrees to use the proceeds from the loan to provide the training to the poor farmers. X would not provide such training to the poor farmers absent the loan additional investment by Y. Y’s primary purpose in making the loan investment is to educate poor farmers about advanced agricultural methods. No significant purpose of the loan investment involves the production of income or the appreciation of property. The loan investment significantly furthers the accomplishment of Y’s exempt activities and would not have been made but for such relationship between the loan investment and Y’s exempt activities. Accordingly, the loan investment is a program related investment.
Thank you for your consideration of our comments. Please feel free to contact the authors of these comments if you would like to discuss anything further or if we can provide any additional information.