I. Introduction

Charitable funders, typically but not always private foundations, are increasingly engaging in historically non-traditional activities and with non-charitable entities, often in their efforts to make progress toward achievement of their charitable missions. This phenomenon is occurring for a variety of reasons. For some, social impact is taking them to countries or regions in which the enabling legal environment for public charity equivalents does not exist or is too nascent to be usable. They must then work with social change entities that are either non-charity nonprofits of some kind or investor-owned businesses. For others, seeking change at large scale, the best available charitable option for reaching a large number of people or making a visible impact on a problem will be entities which can raise scale capital far more easily than grant-seeking nonprofits. For still others, achieving the mission involves impact in a sector or with respect to a problem not clearly within the well-trod path of traditional charitable activity—such as mitigating climate change, preserving investigative or local journalism or financial inclusion through mobile telephone applications. These funders are finding that the actors in those sectors also often do not fit well into easily recognizable public charity forms.

Funders are thus being called upon to enter transactions or otherwise work with ventures with or from other than charitable-oriented businesses and investors, including combined public-private fund arrangements, pay-for-success bond placements, impact investing limited partnership funds, opportunity zone investments, micro-lending or off grid energy access platforms for businesses and consumers, and other transactions with significant financial components.

Further, charitable funders are being asked to invest in “social impact benefit” transactions alongside an array of personal investment vehicles that has proliferated over the past decade. We are also witnessing an erosion in the primacy of tax optimizing strategies by social change actors. Instead, surveying the opportunities for change at scale in the sectors that are important to them, these actors have determined that charitable pools of money such as foundations can only conduct some of their work. These actors
are engaging in historically non-traditional activities through vehicles such as 501(c)(4) social welfare organizations or targeted blended return investment funds, neither of which uses tax-deductible money or faces charitable purpose constraints. The opportunities that they identify can present a real chance for impact at scale for charitable co-funders—if the activity is sufficiently charitable.

One thing that these transactions all have in common is that they raise concerns regarding impermissible private benefit for the charitable funder participants. Or, put another way, they are pushing the boundaries of what could be broadly considered to be readily recognizable as activity that is more about a charitable impact than it is about anything else. For funders which have seldom had to pause long to identify the plainly charitable nature of their activities and reputations, this world is very new, unfamiliar and uncomfortably ambiguous. Formal legal guidance is very limited, and precedents are often scarce. Addressing this dynamic can require a serious and detailed effort for which an organization might be unprepared.

Before generally discussing each of the above topics through the private benefit lens, we provide a short primer on private benefit. In doing so, we include its relationship to “exclusively” charitable purposes under the Code and the permissibility of “incidental” private benefit.

II. Summarizing Intersections Between Mandatory “Exclusively” Charitable Purposes and Permissible “Incidental” Private Benefit

IRC § 501(c)(3) generally allows organizations recognized thereunder to be exempt from paying income taxes.1 IRC § 170(c) allows such organizations to receive donations for which donors may take charitable deductions.2 Many states provide similarly and extend tax exemptions to property, sales, and other taxes. Under both Code sections and accompanying federal regulations, recognized organizations must be organized and operated exclusively or primarily for one or more specified exempt purposes.3 In addition, no part of the net earnings of such an organization may inure to the benefit of any private shareholder or individuals,4 or stated slightly differently the organization must be organized and operated to serve public interests rather than private ones.5

Thus, tax exemptions and charitable deductions are available for/from organizations (1) that are organized and operated exclusively or primarily for exempt purposes and (2) that do not serve private interests. These two requirements might be

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1 26 USC 501(c)(3). Exemption does not extend to unrelated business taxable income, 26 USC § 511. Also, private foundations pay an excise tax under 26 USC § 4940 on net investment income, and the tax reform of 2017 imposed an excise tax on net investment income of certain college and university endowments.
2 26 USC § 170(c)(2)(B) – organized and operated exclusively . . . (C) – no part of net earnings inure to benefit of private shareholder or individual
3 26 USC §§ 501(c)(3) and 170(c)(2)(B); CFR § 1.501(c)(3)-1(a)(1).
4 26 USC §§ 501(c)(3) and 170(c)(2)(C); CFR § 1.501(c)(3)-1(c)(2).
5 CFR § 1.501(c)(3)-1(d)(1)(ii).
interpreted such that the second is rendered superfluous because an organization arguably cannot be exclusively or primarily devoted to exempt purposes while simultaneously serving private interests. As a functional matter, though, the private benefit prohibition helps mitigate arguments about the relative weight or merit of the respective possible exempt or public purposes.\textsuperscript{6} As such, the second component appropriately complements the first mandate while also having independent merit, relevance and application.

But in deference to reality, the private benefit prohibition is not absolute. For example, the prohibition does not mean that organizations exempt under 501(c)(3) cannot pay for goods, services, facilities, or other transactions from which they benefit, or that the individual members of the charitable class it targets cannot improve their lot. Quite the contrary, even payments that might (or even are likely to) include a profit margin for the provider are allowed, even though intentionally engaged and technically a private benefit to an outsider and private inurement to an insider. But such payments are generally permissible private benefits/inurement as long as they are not unreasonable or a substantial purpose for establishing and/or operating the 501(c)(3) entity.\textsuperscript{7} Additionally, the law recognizes that such entities may have limited non-exempt purposes as long as they are not “substantial in nature.”\textsuperscript{8}

The challenges come when the non-charitable impacts or purposes are inseparably integrated with the engagement or activities. Those private benefits lose their insubstantial (“incidental”) status if they are intended outcomes and substantive reasons for the underlying engagement, or in context are so substantial that they outweigh the desired charitable purposes. They do not even need to be financial or even tangible. They just must be, under the facts and circumstances, qualitatively and quantitatively relatively trivial or beside the point compared to the intended charitable impact or outcome. Each fact pattern must be analyzed separately—facts from one situation cannot determine the analytical outcome in a highly similar yet distinct situation.

The way in which the practitioner must conduct both analyses explains why each is so dependent upon the specific facts of the situation and why one template or model does not automatically preclude an intensive factual review in another similar application of that template or model. The quantitative analysis evaluates the relative amounts of money, people, time, or other resources dedicated to or served by the various underlying activities. With such weighting, however, the amounts allocated to non-charitable activities must be both secondary to the amounts allocated to the charitable activities and insubstantial relative to those amounts. The qualitative analysis evaluates whether the respective benefits can be separated from each other or whether they are inextricably


\textsuperscript{7} See CFR § 1.501(c)(3)-1(d)(1)(ii). Private foundations operate under a different rubric for disqualified persons under 26 USC § 4941 pursuant to which certain transactions with disqualified persons are forbidden whether reasonable or not and even if the terms substantially favor the foundation and disfavor the disqualified person.

integrated as a necessary byproduct such that pursuing the charitable purpose(s) necessarily and unavoidably within reason includes pursuing the non-exempt purpose(s).

We will now turn to applying these rules to some of the circumstances that charitable funders are now facing.

III. Finance-Oriented Transactions and Private Benefit

The growth in interest in strategies that claim to combine financial returns with social benefit impact has yielded an entire industry of investment vehicles seeking to address the demand. These entities travel under any of a number of labels, including impact investing and mission-related investing. Using these special purpose entities, charitable and social change organizations, as well as investment fund managers, consultants and others, are seeking to marshal assets and make investments pursuant to a model that speaks to the social change or charitable impact that investors desire. Funds can be found in a wide variety of sectors—financial inclusion, climate change mitigation, housing, economic development, education access and renewable energy, to name just some.

Action by regulators such as the Department of Labor and Treasury to clarify when/how pension funds and charitable endowments may or may not invest their assets has contributed to that attention. Policymaker interest in social impact bonds, other pay-for-success models, and newly designated opportunity zones seeks to exploit similar leveraging opportunities. The still novel social purpose business structures like benefit corporations and low profit limited liability companies have been confusingly identified as attractive ways for charitable organizations to deploy innovative finance for “social” (not charitable) purposes.

These funds and special purpose business entities opportunities present enormous private benefit challenges for private foundation funders/investors. The challenges result generally from the scope and scale of the commercial, or noncommercial yet also non-charitable (probably social welfare), impacts embedded alongside the charitable ones. We will discuss each category of challenges and suggest approaches for the funder’s counsel to consider when examining the potential for private benefit to make any investment problematic.

First, these investment entities can have overly broad social impact theses. Permissible charitable purposes are a subset of all social purposes, a point all too often missed by non-lawyers. Investment funds thus are all too often established to attain a generally described social benefit impact and not an impact that is clearly charitable by nature. For example, sometimes entities tout an impact focus upon a generally stated goal that is not inherently charitable, such as “economic development” or “job creation” in a certain geography. In other situations, funds propose an investment model promising

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financial returns and/or a scale of activities that relies upon a target market that includes, but inherently is not limited to, an identifiably charitable class of people. These social impact purposes are not synonymous with exempt purposes as required under §501(c)(3), and so many social enterprises are not charitable in purpose. Therefore, making concessionary investments in or committing charitable resources (e.g., personnel) or assets (e.g., intellectual property) to such social enterprises cannot be presumed to qualify as a charitable distribution (for a private foundation) or a charitable operating activity as contemplated by §501(c)(3), even if the enterprise achieves a goal that generally worthwhile or even desirable in service to public welfare.

This point matters because, while some funds promise market rate financial returns with tangible social benefit impact (though very seldom charitable benefit impact), and so might be eligible for endowment investment based upon an asset allocation, most such funds do not promise market rate returns. Consequently, interested charitable funders seek to invest in these opportunities through program-related investments of some kind—since the opportunities are disqualified from endowment investment. In this situation, the potential for private benefit must be determined through a close analysis of the facts, as described above.

Second, discussions within “social” enterprises often emphasize the organizational goal of attaining both a stated social and financial impact, without any specificity about the relative priorities for those intentions or the permanence of that ordering or relationship. This is especially important considering the life span of many of these investments—often at least seven years, if not ten or more. If there is a conflict and a choice must be made, what is more important: social impact or financial returns? If decisions must be made about allocating resources, equipment, or staff in ways that contribute to social impact while simultaneously detracting from financial returns, how will each purpose weigh against the other in practice and not merely as a reflection of “best intentions”?10 And, what is the process for making these decisions and who is involved in it?

Laudatory yet ambiguous declarations of “intent” will seldom suffice as the basis for a reasoned public benefit analysis. More will be needed and be articulated in the deal documents in significant detail. For example, impact measurements will need to be specifically articulated and be designed to show a beneficial outcome upon an identifiable group that constitutes a charitable class under the law (not just outputs such as number of subscribers, customers or people reached). Many social enterprises are not set up to conduct this kind of disciplined, extended impact inquiry—and many lack any capacity to gather the necessary data. Absent this systematic tracking of charitable impact

information, the charitable organization funder/investor will face a formidable task to show, often upon review some time later, the fundamentally charitable nature of the funding. Consequently, charitable organization board members, managers and attorneys need to scrutinize their involvements with social enterprises for impermissible private benefit exposure prior to any commitment.

Given the general uncertainty of charitable impact and its related tracking by social enterprises and funds, there are ways in which the charitable organization funder’s board members, managers and legal counsel can try to protect the organization (and themselves) against impermissible private benefit in this regard by designing oversight and remedial controls through contract, veto rights, governance vehicles, mandatory exit strategies and otherwise. These contractual provisions are often critical to establishing and maintaining a showing of the ongoing primacy of charitable intent. Ultimately, others’ intentions are less relevant if the charitable funder has control over the decision-making and, thus, can ensure the proper ordering and weighting of priorities. However, if that control or substantive involvement does not exist, then knowing others’ intentions matters more.

Third, private foundations and other charitable funders cannot rely upon the use of the still nascent social purpose business forms as any kind of proof that an investment fund or other social enterprise has a primarily charitable purpose—so no private benefit exposure is likely. Advocates too often laud these legal entities as establishing via state corporate law the primacy of broader social or narrower charitable purposes and/or related accountability. Upon closer examination of the structures, however, the benefit corporation and social purpose corporation structures by statute do no such things. In fact, they exterminate legal accountability to such purposes that might conceivably exist.

The low profit limited liability company (L3C) shows more promise for this purpose because it at least clearly prioritizes charitable purposes under §501(c)(3) over financial returns. Going further, L3C statutes explicitly deprioritize the latter such that it cannot be a substantial purpose.11 Even so, charitable funder board members, managers, and lawyers should not neglect additional means by which to protect against private benefit inuring from their organization’s involvement. Further, these entities have not been used to attract capital for impact at scale, suggesting their limited business utility. Additionally, these entities do not fit well for use by investment funds, which typically use limited partnerships. So, this approach will not provide a private benefit solution, either.

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Fourth is the potential for charitable funders to be asked to invest in some way that is concessionary compared to comparably situated commercial, governmental or family office investors. This occurs frequently with the promise that the concessions will provide the extra financial returns and/or reduced financial risks necessary to attract into the fund/deal/transaction investment from non-charitable entities on the sidelines which need their investments to meet minimum financial return and/or risk profiles. The result of this strategy is that a social enterprise is structured so that financial returns are allocated differently among otherwise similarly situated investors based on the concessions. For example, non-charitable investors interested in financial returns may get preferred distributions either at a higher rate or in an earlier waterfall than the charitable purpose investors, or else the charitable funders function as absorbers of first losses or expenses.

For business, replicability, scaling and, for private foundations, qualifying distribution purposes, the default pattern should be that charitable funders invest on the same terms and conditions as that of other comparably situated investors/participants, with the additional demand of the impact measurement and reporting effort described above and other terms aligning the investment with a demonstrably charitable desired impact. In other words, if an informed private investor would not enter the deal on the terms proposed to the charitable funder, then neither should the charitable funder. Otherwise the risk of impermissible private benefit is very high—and counsel for the charitable funder can find it very challenging to collect the evidence of funding leverage so frequently cited by investment advocates.

However, it may be that the endeavor’s exempt purposes can only be pursued with involvement of the charitable funder at concessionary levels – that is, on other than market terms -- and that but for those concessions, the exempt purposes could not or would not be pursued. If the charitable funder can document those legitimate circumstances, then it increases the likelihood that accompanying private benefit is incidental to pursuing the exempt purposes and, therefore, permissible.12

Certainly, the charitable funder’s counsel will need to be very wary in these situations and gather every fact available to support the charitable purpose primacy of any investment. The challenge is all to often that few such facts can be found at the time that the transaction is coming together—and the charitable funder faces push back when it tries to build in the right to gather information later with which to build an evidentiary trail.

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12 Private foundations must undertake further analyses and documentation to protect against self-dealing under 26 USC § 4941. Disqualified persons co-investing alongside or in addition to the private foundation with which they are associated is not per se self-dealing; after all, the excess business holdings rules under § 4943 presume some degree of permissible co-investment. However, even though permissible, the foundation and its disqualified persons should document their analysis that the disqualified person has not received special treatment that might be attributable to their connections to the foundation, such as exceptions to investor threshold requirements, favorable distribution rights, fees, etc. Other than to identify the issues, the details are beyond the scope of this paper.
IV. The Charitable Entity’s Brand

Like other enterprises and people, charitable organizations have reputations, recognition and credibility that aggregate to an overall brand. Many private foundations spend significant time and energy nurturing a brand, for the real and significant programmatic impact leverage that judicious brand deployment can yield. These brands also can yield identifiable yet intangible association benefits for endowment investment (such as access to an otherwise closed manager) and for investment with noncharitable actors as discussed above. These investors seek collaboration with the charitable investors for an array of business, personal and reputational reasons of their own. These reasons generally are rooted in a view that these investors will benefit in some manner from association with the charitable investor. Thus, the prospect of private benefit is again a very real concern for the charitable investor’s counsel and leadership. Of course, the noncharitable entities also contribute their own reputations and goodwill to the venture, including brand halos. It may even be that their glow is stronger and more valuable than that of the charitable investor, in which case reputational benefits may flow to the 501(c)(3) rather than the other direction. This should also be a part of the private benefit calculus as part of determining whether the private benefit is incidental or more substantial.