Current Complex Investment Issues: Part II of Outline

Speaker:
Michael Durham, Kirton McConkie PC

American Bar Association
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Committee on Exempt Organizations
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I. Program-Related Investments in Impact Funds

a. Background

Over the last decade, we have seen a real expansion in the number of investors interested in “impact investing”: investment focused not only on earning a financial return, but hoping to accomplish some charitable impact as well. The law has long recognized that such investments can be a valid way for an exempt organization to further its charitable purposes, and for certain impact investments qualifying as “program-related investments,” there are additional tax benefits for private foundations. If an investment qualifies as a “program related investment,” then:

- it will not be subject to penalties under section 4944 for unduly risky investments\(^1\);
- the investment will not be subject to the excess business holdings limits of section 4943\(^2\);
- the entire amount of the investment will be treated as excluded from the private foundation’s assets for purposes of the 5% payout requirement\(^3\);
- the entire amount of the investment is temporarily treated as paid out for charitable purposes, but added back to undistributed income as the investment capital is returned.\(^4\)

For these purposes, a “program related investment” (or “PRI”) is one that has no significant purpose of producing income (usually demonstrated by showing that its expected returns are less favorable than profit-maximizing investors would accept in the market), that is made primarily to accomplish one or more exempt purposes (this prong is satisfied if the investment “significantly furthers the accomplishment of the private foundation’s exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation’s exempt activities), and that is not used for prohibited electoral or lobbying conduct. Some of the same benefits are extended to a “functionally related business” under section 4942(j)(5) of the Code, i.e. a business that is not an unrelated business, or is a business carried on as part of a larger aggregate of activities that is not an unrelated business. The IRS has in recent years finalized regulations confirming that a variety of international development, environmental protection, and medical relief activities are appropriate

\(^1\) Treas. Reg. § 53.4944-3(a)(1).
\(^2\) Treas. Reg. § 53.4943-10(b).
\(^3\) Treas. Reg. § 53.4942(a)-2(c)(3)(ii)(d); I.R.C. § 4942(d)(1), (f)(2)(C).
\(^4\) Treas. Reg. § 53.4942-3(a)(2)(i),
targets for program related investment.\textsuperscript{5} While the new examples do not mark any radical shifts in the IRS interpretation of these rules, they do indicate the Service’s willingness to confirm that program-related investments abroad are an appropriate use of charitable assets.

Note that for purposes of section 4945, a program-related investment is treated as a grant.\textsuperscript{6} Thus, if the investment target is not a public charity or equivalent, a private foundation may need to exercise expenditure responsibility over the program-related investment over the life of the investment; the regulations under section 4945 have rules tailoring the expenditure responsibility requirements to the investment context.\textsuperscript{7}

Donor advised funds are not subject to the prudent investment requirements of section 4944 that originally gave rise to the program related investment exception. However, they are subject to excess business holdings limits, and thus could potentially use the program related investment exception to hold more than they would otherwise be permitted to hold in a foreign company. It is a possible reading of the rules, as yet unconfirmed, that program-related investments out of DAFs may also require expenditure responsibility.

The Treasury Department has indicated that it does not believe that program-related investments should count toward payout requirements for Type III non-functionally-integrated supporting organizations.\textsuperscript{8}

Of course, a variety of investments may still have the accomplishment of charitable purposes through the activity of the target company as a significant purpose of the investment, even if all of the standards for PRI treatment are not met. Such investments are generally referred to as “mission-related investments” or MRIs. In Notice 2015-62, 2015-39 I.R.B. 411, the IRS affirmed that trading off some prospect of financial return for greater impact is permissible for private foundations, even where the foundation is subject to general fiduciary duties to use its assets to promote charitable purposes and subject to excise taxes if it jeopardizes its charitable mission through unduly risky investments:

\begin{quote}
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
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\textsuperscript{5} T.D. 9762 (Apr. 25, 2016).

\textsuperscript{6} Treas. Reg. § 53.4945-4(a)(2).

\textsuperscript{7} Treas. Reg. § 53.4945-5 (separately treating expenditure responsibility grants and expenditure responsibility program related investments for certain purposes).

\textsuperscript{8} Notice of Proposed Rulemaking, Requirements for Type I and Type III Supporting Organizations, 81 Fed. Reg. 8,446 (Feb. 19, 2016).
furtherance of the private foundation’s charitable purposes. For example, a private foundation will not be subject to tax under section 4944 if foundation managers who have exercised ordinary business care and prudence make an investment that furthers the foundation’s charitable purposes at an expected rate of return that is less than what the foundation might obtain from an investment that is unrelated to its charitable purposes.

While this guidance is directed at private foundations, it would seem to support other charitable entities in making mission-related investments as well.

b. Investment Funds

Part of the promise of impact investment is that it could enable an overall shift in how capital is deployed toward investments that are more likely to advance charitable purposes in fields such as poverty relief, environmental protection, medical research, and many other fields. However, so long as impact investing remains the province of large private foundations and similar institutional investors willing to design bespoke investment terms, the capital of many smaller investors will remain on the sidelines. A focus in the impact investment world has therefore been the creation of market structures and intermediaries who can centralize some of this work and make it easier for retail investors and small-dollar investors to make impact investments. Some of this work has been in trying to develop more uniform metrics for measuring impact, so that investors can be more certain what they are “getting” from a given impact investment in terms of actual social benefit. Some has been creating benefit corporations and other corporate structures that provide mechanisms for ongoing corporate accountability for impact produced. An increasingly important part of the development of the impact investment space has been the creation of impact investment funds that aim to find a portfolio of companies meeting certain impact criteria as well as risk-reward criteria and allow investors to invest indirectly in those companies by investing in the impact investment fund. In some cases these funds have been developed by individuals or groups primarily interested in increasing capital investment in important charitable causes, seeing impact investment as a way to deploy capital to solve social problems in ways that are self-sustaining and thus more easily scalable. As interest in impact investment has expanded, however, a growing number of traditional fund managers and investment banks have responded to market demand by adding social impact investment funds to their menu of offerings. These funds fall at various points along the spectrum from an ordinary investment fund with some kind of social screening in place, to funds that have a mix of investments including some allocation of funds to companies with loosely-defined positive social impacts, to funds that are designed to have all or most of their portfolio company investments meet the PRI standards and qualify as charitable acts. These funds sometimes seek out charitable investors willing to be anchor investors to encourage secondary investors to take the additional risk associated with their impact investment focus.

Such funds, like many investment funds, are frequently but not always structured as partnerships for U.S. tax purposes. This means that in addition to the normal rules for program-related
investments, impact investment funds may also be subject to the rules applicable to exempt organization participation in partnerships. It is not clear how these two bodies of law interact in the impact fund space, and indeed it appears that even the IRS’s expanded set of PRI examples added to the regulations under section 4944 avoid any mention of investments in partnerships. In rejecting a request to modify one of the recently added examples to clarify that a program-related investment could be made in a partnership, or in an LLC taxed as a partnership, the Treasury provided this explanation:

> When a private foundation makes an equity investment in an LLC (or other entity) treated as a partnership for federal tax purposes, the activities of the LLC are attributed to the foundation for purposes of determining both whether the foundation operates exclusively for exempt purposes (and therefore continues to qualify for exemption under section 501(c)(3)) and whether the foundation has engaged in an unrelated trade or business described in section 511. See Rev. Rul. 2004-51 (2004-1 CB 974). As a result, investments in partnership interests by section 501(c)(3) organizations raise a host of issues that are not raised by loans or by investments in stock of corporations. These issues necessitate consideration and analysis of a variety of facts and circumstances that are difficult to summarize in examples in regulations, and hence investments by section 501(c)(3) organizations in partnership interests have been addressed primarily through revenue rulings. See Rev. Rul. 2004-51, Rev. Rul. 98-15 (1998-1 CB 718).

However, this hesitance has not prevented the IRS from ruling privately that investments in partnerships can qualify as program related investments. c. Exempt Organization Investment in Partnerships

It has long been recognized that exempt organizations may in some circumstances conduct activities indirectly through a partnership with other exempt or taxable entities. Perhaps the clearest authority addressing this issue is in the unrelated business context, where section 512(c)(1) provides as follows:

> If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its

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9 See Treas. Reg. § 53.4944-3(b).
unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Thus, an exempt organization cannot avoid UBIT through the simple expedient of conducting the unrelated business through a partnership; if “its share” of the partnership’s income is from an unrelated trade or business, it will be taxed as if it had conducted that unrelated business directly.

The Service has reasoned from this principle to the conclusion that a partnership’s activities (or at least an allocable portion of such activities) can be attributed to its exempt organization partners for purposes of determining whether they qualify for tax-exempt status:

[T]he activities of an LLC treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of section 501(c)(3). A section 501(c)(3) organization may form and participate in a partnership, including an LLC treated as a partnership for federal income tax purposes, and meet the operational test if participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners. . . . However, if a private party is allowed to control or use the non-profit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes. 12

Courts applying these principles have stressed that they must evaluate “all the facts and circumstances,” including how the activity is conducted and controlled, in determining whether the participation in the partnership is only incidentally in furtherance of nonexempt objectives. 13 Control has emerged as an especially important factor; the Fifth Circuit stated that “if the non-profit organization enters into a partnership agreement with a for-profit entity, and retains control, we presume that the non-profit's activities via the partnership primarily further exempt


13 See Redlands Surgical Center v. Comm’r, 113 T.C. 47, 92 (1999); St. David’s Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003).
purposes.” Applying these principles, the IRS has ruled organizations exempt even if their only activity is conducted through a partnership (or LLC taxed as a partnership) with commercial third parties, when the following factors are present:

(i) Participation in the partnership furthers an exempt purpose;

(ii) Both parties receive income in proportion to their contributions to the partnership;

(iii) The officers of the charity controlling the decision to participate in the partnership have no private interest in the partnership; and

(iv) The charity has sufficient control to ensure that the joint activity is carried out in a manner that advances charitable purposes.15

When these conditions are met, the IRS considers the charity to be operating exclusively for charitable purposes—either because the undivided portion of the activities generating income to the other partners should not be attributed to the charity, or because the fact that the charity is not unfairly subsidizing their returns means that its role in facilitating their profits is “incidental to the accomplishment of exempt purposes.” Just as a charity’s direct payment to a for-profit service provider creates a private benefit that is normally incidental to the purposes accomplished by the services, it appears that the IRS has concluded that allowing a for-profit partner to share in the cost of a charitable activity in return for a share of its income also benefits private parties only incidentally.

In Revenue Ruling 2004-51, the IRS extended its analysis of partnership investments to “ancillary” joint ventures, i.e., those joint ventures that do not constitute a substantial part of the participating nonprofit’s activities and thus cannot threaten its exempt status. The IRS determined that a joint venture dedicated to delivering an educational institution’s teacher training seminars remotely through interactive video technology would not result in unrelated business income. In the situation presented, the charity controlled the content of the seminars, even though the for-profit and charity both had to agree on most other business decisions and the for-profit had the deciding vote on where such seminars would be delivered. Because the partnership helped extend the reach of the educational institution’s programs, the educational institution could make sure the content remained educational, and each party’s share of income was in proportion to its capital investment, the IRS concluded that the charity’s income from the arrangement would not be subject to UBIT. Revenue Ruling 2004-51’s degree of charitable control is less than that described in Revenue Ruling 98-15, raising the possibility that the IRS will require stronger control over partnerships through which a substantial portion of the charity’s activity occurs.

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14 See St. David’s Health Care System, 349 F.3d, supra.

Investment in Private Business as a Charitable Activity

Normally, assisting businesses by providing loans or investments unfavorable terms would not constitute a charitable purpose. However, in some cases, the IRS has recognized that aiding such businesses may be an indirect means by which distressed individuals may be aided (typically, when either the employees of the business or the clientele served by the business are minorities, live in a blighted or impoverished area, or otherwise do not have adequate access to economic opportunity). For instance, Revenue Ruling 74-587 provided that certain investments in businesses were charitable when they were made in businesses serving areas where adverse economic conditions or minority ownership made it difficult to attract investors, and priority was given to businesses that would employ or provide training to underemployed individuals from the economically depressed areas or would otherwise help the community. The organization making the investments made sure that the capital extended was reasonable in relation to the legitimate needs of the business; it also held its equity investments only so long as necessary to reasonably assure the success of the business. One year later, Revenue Ruling 76-419 approved an organization that formed an industrial park in a blighted area, attracted businesses to it, and had requirements that they employ a certain number of individuals from the blighted area.

However, the IRS has made clear that a critical factor supporting exemption in these cases was that the organizations somehow targeted their aid in ways designed to ensure that it would in fact create benefits for the needy population in question. Revenue Ruling 77-111 denied exemption to organizations trying to increase traffic to businesses in a blighted area or building a new shopping center to revitalize that area, where the aid was not sufficiently targeted and could help “businesses which are not owned by minority groups and which are not experiencing difficulty because of their location in a deteriorated section of the community.” This was so even though the businesses had to employ a certain number of minority workers. Accordingly, while investing in businesses in economically depressed areas has been ruled charitable, much depends on the investor’s ability to show that each such investment is tailored to provide aid necessary in order to benefit the distressed community; the mere fact that the business is located in an economically depressed area, by itself, may not be enough to demonstrate that the investment serves charitable purposes.

d. Application to Impact Investment Funds

1. Corporate Funds

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\(^{16}\) Rev. Rul. 74-587, 1974-2 C.B. 162; see also Rev. Rul. 81-284, 1981-2 C.B. 130 (granting exemption to a Small Business Investment Corporation that “provides loans to businesses that are not able to obtain funds from conventional commercial sources, and gives preference to businesses that will provide training and employment opportunities for the unemployed or underemployed residents of the economically depressed areas.”).


\(^{18}\) Rev. Rul. 77-111.
Not every impact fund is structured as a partnership. Indeed, many funds focused on attracting tax-exempt investors will structure as a foreign blocker corporation, especially if they invest overseas. This reduces the chances of the fund’s portfolio investments resulting in unrelated business income for the tax-exempt investors or involving them in activities that could threaten their tax exemption.

**UBIT.** When an impact fund is structured as a corporation, its activities and those of its portfolio companies are not directly attributed to the investors. Thus, as long as the investment is not acquired with debt at the exempt organization level, it should not give rise to UBIT.

**Exemption.** It is permissible for a tax-exempt investor to invest all of its assets in corporations engaging in ordinary commercial activities, as a way of earning a return that can be used for its exempt purposes. Thus, regardless of whether the particular investments of the fund would have a tight enough nexus to the accomplishment of charitable purposes to qualify as charitable activity in their own right, a charitable investor could invest in the fund without fear that the fund’s noncharitable activities would be imputed to it. Likely there is some outer bound where the likelihood of reasonable investment returns is so low, and the chance of positive charitable impacts so absent or uncertain, that an investment in the fund could be treated as demonstrating a more than incidental purpose of benefiting the fund itself or the private companies it invests in. However, Notice 2015-62 provides considerable cover for organizations to make reasonable judgments trading off charitable impact against financial return. While it directly addresses only section 4944’s taxes on “jeopardizing investments” by private foundations, it provides some grounds for an inference that organizations will not easily have their exemption revoked for investing in an impact fund structured as a corporation, as long as its tradeoff of charitable impact against risk/return profile is within a broad range of reasonable judgments. More care might be warranted if there were relationships indicating a private motive for supporting the impact fund (e.g., if the exempt organization’s managers owned a significant stake in the investment fund or its advisor, or the exempt organization otherwise seemed “captive” to one particular manager and its impact funds).

**Program Related Investment Status.** If a corporate impact fund qualifies as a program-related investment, it seems clear that the investment would be considered to be made at the time the capital is contributed to the fund. Because that may be well in advance of the time when the portfolio companies are selected, exempt organizations may have to determine whether the investment qualifies as “program-related” with only abstract information about the kind of social impact investments the fund plans to make. This timing, in turn, puts the focus on the fund’s processes for selecting companies (and perhaps the character of its managers and the track record of its managers in managing previous impact funds). Key questions to be answered are as follows:

- Do ALL of the portfolio investments need to qualify as PRIs themselves?

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Many funds may attempt to include a variety of portfolio companies, some of which are relatively more profitable or safer investments, thus making room for some investments that do not offer an acceptable risk/reward proposition on their own but offer stellar opportunities for impact.

Note that Private Letter Ruling 200610020 approved an investment in which 85% of the capital had to be invested in ways that qualified as charitable investment. However, the entire fund also served educational purposes by helping individuals learn about angel investing. Something similar might be true of funds run by universities and their business schools to give their students hands-on experience in the investment process.

In some cases, a private foundation invests in return for an agreement that the for-profit company will make certain charitable concessions that it might not otherwise make. For instance, Example 11 in the PRI regulations concerns a private foundation that provides investment to enable development of a drug primarily of benefit in the developing world, in return for a concession that it would be made available in the developing world at prices affordable for that market. In such circumstances, the target company’s charitable activity may constitute only a small part of its overall activity, but the investment might qualify as a PRI because it is made specifically to induce that small charitable activity. In some cases, it might be possible to say something similar about investments in an investment fund: for instance, a foundation might invest in an “opportunity fund” in return for assurance that the opportunity fund will increase the percentage of its investments within opportunity zones that are beneficial to the community or serving low-income populations, for instance by increasing access to health care or other necessary social services.

- Is the qualification as a program-related investment an all-or-nothing determination? Or can a portion of an investment in an impact fund qualify as a PRI, and the rest not qualify? If not, would a fund that made 85% social impact investments be treated the same as a fund that made 95% social impact investments?

- What happens if a fund promises in advance to make social impact investments that would largely qualify as PRIs, but most of the actual investments selected seem not to qualify as PRIs but only as mission-related investments? How much oversight does an exempt investor need to exercise to avoid a claim that it has “ceded control” over whether its assets are being used charitably?

- Given that a PRI must significantly further the private foundation’s own exempt activities and purposes, it seems two different private foundation investors in an impact fund could reach different answers as to whether it qualifies as a PRI. Could they reach different answers with respect to particular portfolio companies within the Fund?
Qualifying Distribution Status. A transfer to an organization controlled by a private foundation is ordinarily not a qualifying distribution. There is an exception for transfers to certain section 501(c)(3) organizations that meet the “out of corpus rules,” but this exception does not appear to apply if the recipient is a noncharitable investment fund organized as a corporation or partnership. For these purposes, it is important to distinguish budgetary control over how the PRI funds are used and control over the recipient more generally:

[A]n organization is “controlled” by a foundation or one or more disqualified persons with respect to the foundation if any of such persons may, by aggregating their votes or positions of authority, require the donee organization to make an expenditure, or prevent the donee organization from making an expenditure, regardless of the method by which the control is exercised or exercisable. “Control” of a donee organization is determined without regard to any conditions imposed upon the donee as part of the distribution or any other restrictions accompanying the distribution as to the manner in which the distribution is to be used, unless such conditions or restrictions are described in paragraph (a)(8) [now paragraph (a)(7)] of §1.507-2 of this chapter (Income Tax Regulations). In general, it is the donee, not the distribution, which must be “controlled” by the distributing private foundation for the provisions of subparagraph (2)(i)(b) of this paragraph to apply. Thus, the furnishing of support to an organization and the consequent imposition of budgetary procedures upon that organization with respect to such support shall not in itself be treated as subjecting that organization to the distributing foundation's control within the meaning of this subparagraph. Such “budgetary procedures” include expenditure responsibility requirements under section 4945(d)(4). The “controlled” organization need not be a private foundation; it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization.20

This definition of control seems to leave broad room to impose conditions as necessary in order to ensure that the PRI actually accomplishes charitable purposes. However, in the fund context, the line between conditions on a particular investment and control over the fund itself can sometimes become murky. Care is needed to make sure that a private foundation has adequate control to ensure its objectives will be served without compromising its ability to claim the PRI as a qualifying distribution. In PLR 200610020, the IRS approved (without discussing the control issue) investment in an impact fund where the private foundation maintained various

20 Treas. Reg. § 53.4942(a)-3(a)(3).
rights to demand that the organization operate in accordance with charitable purposes, and could ask for the liquidation of any portfolio company investment that no longer furthered the Fund’s purposes. The foundation could also have its own participation in any portfolio company terminated if it no longer qualified as a PRI. Although the control issue was not explicitly discussed, the IRS found the expenditures for this project to constitute qualifying distributions, even though some of the actions the foundation was able to require were not limited solely to actions with respect to the use of its own funds.

2. Funds Structured as Partnerships

Many of the questions about the treatment of impact funds structured as partnerships arise from the fact that a partnership may be treated either as a separate entity or as an aggregate of the partners, who are each considered to be engaging in their own portion of the partnership’s activities. Following an entity-level approach, an investment in a particular impact fund would be tested for qualification as a program-related investment in its entirety; following an “aggregate” approach it would be possible instead to consider each of the fund’s investments in portfolio companies separately to determine whether that particular investment, to the extent attributed to the partnership’s exempt partners, should be considered a program-related investment by them. Such an approach would involve substantial administrative complexity, as a private foundation would then need detailed information about when the impact fund’s investments were made and the nature of each investment in order to characterize each investment. Moreover, the foundation could then be dependent on the timing of the fund’s investment decisions, over which it might have no control, in order for it to meet its annual 5% payout requirement.

Because both section 4944 and section 4943 (the rules to which the PRI rules originally provided an exception) potentially apply to investments in business entities structured as partnerships, it seems reasonable that PRIs should include investments in partnerships, not just those partnerships’ further activities or investments in other entities.

In private letter rulings, the IRS has agreed with that position, treating an investment in a social impact fund as a program related investment at the time it was made. Private Letter Ruling 200610020 (Mar. 10, 2006) treated an investment in a fund as a program-related investment when that fund was going to invest at least 85% of its capital in ways that would qualify as charitable economic development; the fund also was a vehicle to educate participating individuals (former professional athletes) about angel investing.

Similarly, Private Letter Ruling 9834003 (Aug. 21, 1998) considered a coinvestment by a private operating foundation and a charitable hospital in an LLC taxed as a partnership (owned 50% by each charity) that would provide a variety of family support services, apparently to families having foster children. The foundation requested a ruling that either its capital investments into the LLC would be qualifying distributions, or that the foundation’s 50% share of the LLC’s disbursements to provide services to families would be. Instead, the IRS determined that the capital contributions were qualifying distributions as program-related investments, and that 50% of the LLC’s disbursements to provide services would also be treated as qualifying distributions.
directly for the active conduct of the private operating foundation’s activities (the type of qualifying distribution that is helpful for qualifying as a private operating foundation). This appears to provide two qualifying distributions for the same dollar, one upon entering the LLC and another upon being spent by the LLC. However, it may be possible to interpret the ruling differently, to say that for the general private foundation tests, only capital contributions will count as qualifying distributions, while for purposes of the private operating foundation tests, only the LLC’s disbursements will be taken into account. However, the ruling certainly does not explicitly adopt such a distinction.

Thus, available authority seems to weigh in favor of treating an impact fund investment as a program-related investment at the time the private foundation invests, even if the funds are only later actually invested by the fund in ways that advance social impact—but leaves open the possibility that a partnership fund’s subsequent expenditures/investments could themselves constitute program-related investments.

As in the case of corporate impact funds, there are still hard questions about how to tell, before the funds are invested, that they will be much focus an impact fund questions about how to determine whether an impact fund’s investments are sufficiently charitable for a private foundation’s investment in the fund to qualify as a PRI. However, in the partnership context the activities carried out by the fund (and by any portfolio companies structured as partnerships) are also considered activities of the exempt investors, potentially raising additional issues regarding their qualification for exempt status and unrelated business income. Further, a variety of questions arise about the extent to which the partnership’s activities will be attributed to the partners under other rules applicable to exempt investors.

**Exempt Status**

To the extent activity engaged in through a partnership constitutes unrelated business activity, it would count against the total amount of permissible unrelated business activity allowed to the charitable investor. Such activities must not be primary, and some would argue that they should not be substantial either. Of course, if the underlying portfolio companies are not themselves treated as partnerships, then the activity imputed to the foundation may still be passive investment activity.

In addition, in order to be operated exclusively for exempt purposes, a section 501(c)(3) organization must not have a substantial purpose of operating a commercial business or of benefiting private parties. It is not clear whether the standards from the PRI rules already incorporate these requirements. A PRI must not have any significant purpose of producing income, but in context that requirement is usually treated as satisfied if the investment earns a below-market return, or if ordinary for-profit investors would not make the investment on the same terms. In contrast, an organization’s own activities can be held to violate the commerciality

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21 The key regulation is Treas. Reg. § 1.501(c)(3)-1(e). Resolving its meaning is beyond the scope of this outline.
doctrine even if they generate no profits whatsoever; in that context the IRS sometimes requires pricing to be substantially below cost, although whether the overall mix of an organization’s activities is too commercial can depend on a number of other factors as well.

More generally, it is not altogether clear whether every PRI investment that “significantly furthers” exempt purposes and has no purpose of producing income would also meet the standards to be considered exclusively charitable activity if the underlying activity of the target company were deemed to be conducted directly by a charity. For instance, an investment that significantly advances scientific research objectives might be in a company that does not meet all of the criteria developed in the authorities to be considered “scientific research in the public interest,” e.g., because it does not publish its findings promptly enough. Again, a difference between the PRI rules and exemptions standards is most likely where not only the impact fund but also the portfolio companies are treated as partnerships, so that more than passive investment activity is attributed to the charitable investors.

In some cases, an investment may be considered a PRI only because the investment is made in return for the target company adding certain charitable dimensions to its work. At the same time, other portions of that work may still not be charitable, and if the target company is a partnership, the charitable investor may then have a larger set of the target company’s activities imputed to it, which may be harder to justify as exclusively charitable (see the fuller discussion of this point below in the discussion of UBIT from impact funds).

Finally, it is worth noting that in the joint venture context the IRS has focused on whether the section 501(c)(3) organization has sufficient control over the venture to ensure that charitable purposes are served—in Revenue Rulings 98-15 and 2004-51, this included at least 50% board control of the joint venture entity, and perhaps more than 50% control when the joint venture activity is a substantial part of the overall activities. This raises questions about whether and to what extent entity-level control (or at least veto power) is necessary for the joint venture to be considered in furtherance of the charitable investor’s purposes. If so, a further question is whether that control can be exercised jointly by a number of charitable investors, so that no one investor has control (singlehanded control, as discussed above, might keep private foundations from being able to claim qualifying distributions for the PRI). Of course, if the portfolio companies are also operated as partnerships, then the question is whether these rules also require a chain of control sufficient to guarantee the actual charitable functioning of those portfolio companies. At both the fund level and the portfolio company level, charitable control may be a very hard standard to meet, particularly if charitable investors are only a minority of investors in the fund, or if the fund is only a minority investor in the portfolio company. Where such control is absent, it may be possible to institute detailed standards for operation that will ensure that charitable purposes are served, although in some cases this may be difficult; arguably, one reason the IRS has begun focusing on control in the joint venture space is because it is so hard to delineate in advance the difference between a business activity that exclusively furthers charitable purposes and one that impermissively serves commercial or private purposes.

Note that in Private Letter Ruling 200610020, the impact fund approved by the IRS was controlled by all of the members, but the private foundation had the ability to require the fund to
liquidate any investments that no longer qualified as PRIs, and could exit from its participation in any particular investment if necessary to comply with private foundation or exempt status rules. The members were provided information about each portfolio company investment before and after the investment was made. This ruling suggests that in some circumstances control over an impact fund will not be required, and that a combination of reporting and an ability for a private foundation to avoid participation in any problematic investment could be an acceptable substitute for outright majority control, at least at the fund level.

Of course, in some cases the impact fund is run by an entity that is itself a charitable organization, which can make it much easier to conclude that its activities will be exclusively charitable. In other cases, charitable entities can be involved in a special investment selection committee empowered to make sure that the investments further charitable purposes.

*Unrelated Business Income Tax (UBIT).*

It is commonly said that if an investment is a program-related investment, the income therefrom is mission-related and thus should not be considered subject to UBIT. That is doubtless correct in many cases, and at first glance may seem to follow almost as a matter of logic: if an investment is a PRI, it has a primary purpose of significantly advancing charitable purposes of a foundation, and no significant purpose of producing income. Accordingly, it seems reasonable to conclude that the investment has a “substantial” causal relationship with accomplishing the foundation’s purposes and “contributes importantly” to their accomplishment (the terms that normally must be satisfied for an activity not to be subject to UBIT).22

However, this obscures an important difference between the PRI analysis and the UBIT analysis. The PRI analysis hinges on the purposes of the initial investment; once the investment is made, under the so-called “fragmentation rule,” the UBIT analysis is normally to be applied separately to each stream of income (and even each individual sale).23 Thus, for example, a private foundation might invest in a drug development company primarily in order to assure subsidized access to the drug in the developing world, conceding that the company would also be able to market the drug at commercial rates in the United States and other developed markets. While it may be clear that the purpose of the overall investment is not the production of income, still the commercial sales of drugs to the general public would not generally be considered substantially related to a charitable purpose. Thus, a plausible UBIT analysis might treat the two types of sales differently, resulting in a “substantially related” stream of revenue from sales in the developing world, which might result in a net loss that could not be offset against the profit from sales in the developed world, which would be subject to tax. Similarly, a foundation might make a program related investment to set up a medical lab for a hospital, but if that medical lab engaged in a mix of testing for the hospital’s patients and for other hospitals, the settled IRS

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22 Treas. Reg. § 1.513-1(d)(2)

23 See Treas. Reg. § 1.513-1(b) (setting forth what is known as the “fragmentation rule,” which does not allow particular transactions to be treated as related simply because they are conducted within a larger aggregate of activities that are related).
position is that the testing for other hospitals would not be considered related if the foundation engaged in the activity directly, and the IRS could argue that the result should not be different because of the interposition of a partnership between the foundation and the unrelated activity.

But while this “fragmentation” argument probably cannot be ignored, it is not necessarily dispositive. Various UBIT authorities make clear that activities that would ordinarily be unrelated may be related if, in context, they are undertaken primarily to accomplish exempt purposes. For instance, Carle Foundation v. United States, 611 F.2d 1192 (7th Cir. 1979) upholds the IRS position that a hospital’s pharmacy sales to private doctors’ patients are not substantially related to its purposes (the treatment of its own patients)—but Hi-Plains Hospital v. United States, 670 F.2d 528 (5th Cir. 1982) found such sales to be substantially related when hospital pharmacy access was provided to doctors’ patients in order to encourage more doctors to locate in the area, remedying a shortage of doctors there. Similarly, in the drug development case discussed above, one could argue that the private foundation’s participation (through its investment in the partnership) in developed-world sales activity is required in order to persuade the drug company to develop the drug and make it available to more impoverished populations. Of course, under general UBIT principles, such an argument should fail if the foundation’s involvement in the commercial activity is substantially greater than necessary in order to accomplish the charitable purpose.

Another potentially helpful analogy is to Revenue Procedure 96-32, which provides a safe harbor for when mixed-use housing projects will have sufficient numbers of low-income residents to qualify as low-income housing. At least one private letter ruling suggests that when these standards are met, the overall housing complex is treated as charitable in nature, so that revenue from the housing (including revenue from low-income persons and from others) is not subject to UBIT.

As in the analysis of exemption, above, one open question is whether, for the underlying activity of the impact fund or of the portfolio companies themselves to be considered charitable, it is necessary to have control in the hands of a charitable entity, at least over those aspects of the operation necessary to establish it as charitable (see Rev. Rul. 2004-51).

Other Entity/Aggregate Questions

When an investment is made in a fund that will itself make further investments it raises further questions, such as the following:

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25 See also Rev. Rul. 69-463, 1969-2 C.B. 131 (holding that the provision of office space and administrative services to attract doctors to a hospital facility is “substantially related”).

26 Treas. Reg. § 1.513-1(d)(3).

• If the activities of the fund are attributed to its partners, then should each of its investments be tested as PRIs for purposes of determining compliance with the expenditure responsibility rules of section 4945 or similar excise taxes (e.g., section 4966 for DAFs)? For instance, if the impact fund makes a further investment in a portfolio company that is supposed to qualify as a program related investment, should it have to exercise expenditure responsibility? If it failed to get the required reports, could the private foundation investor be held liable for taxes under section 4945 for its allocable portion of the investment? Note that Private Letter Ruling 200610020 included representations that the fund entity would comply with the private foundation rules in various respects.

• If a DAF invested in a partnership operating a microfinance fund that made program-related investments to individuals, would it be considered to be making (through the partnership) prohibited distributions to individuals taxable under section 4966? Would it matter if the DAF did not have control over the selection of the individuals?

• Similarly, even if it is determined that the investment in the fund is a program-related investment, and thus not a jeopardizing investment or an excess business holding, does that automatically extend to particular portfolio companies? Or would each portfolio company investment also need to be analyzed to confirm that the foundation’s indirect holdings in that portfolio company would not constitute an excess business holding or jeopardizing investment?

• As discussed above, the available authorities seem to support a qualifying distribution at the time capital is contributed to an impact fund structured as a partnership, and potentially also support a qualifying distributions as the partnership makes disbursements. If a private foundation has too much control over the entity for the contribution to the partnership to be treated as a qualifying distribution, can the distributions out of the partnership still count as qualifying distributions?

**Guidance Needed**

Right now, it can be very difficult to tell whether a particular impact fund’s investment strategy is sufficiently targeted at charitable goals for the IRS to treat it as charitable, particularly since many such funds have a range of mission-related and program-related investments. A revenue procedure providing safe harbors as to what mix of investments would be considered acceptable for an impact fund, as Revenue Procedure 96-32 did in the case of low-income housing, could significantly increase exempt organizations’ ability to support impact funds without undue legal risk.

II. Coinvestments between Private Foundations and Disqualified Persons:

a. Joining Limited Partnerships in Which Disqualified Persons Already Hold 35% or More of the Interest
With certain limited exceptions, section 4941 of the Code categorically prohibits acts of self-dealing between a private foundation and its disqualified persons, regardless of whether those acts benefit or harm the foundation. However, the IRS has consistently recognized that co-investment in a partnership or similar investment vehicle is not a *per se* violation of the self-dealing prohibition. Indeed, the private foundation rules implicitly condone such arrangements by stating that a foundation together with its disqualified persons cannot own more than 20% of a business enterprise—implying such co-ownership is acceptable so long as the business holdings limits are not exceeded.28 A number of private letter rulings have stated the permissibility of co-investment arrangements in broad terms on the theory that the investments of the private foundation and its disqualified persons typically do not affect one another economically:

In joint or co-investment situations, when a private foundation makes an initial investment, acquires an additional interest in the partnership entity after its formation and initial funding or withdraws its interest, there is neither an economic benefit to the, [sic] other investors nor does the ownership or holding of the other investors change in any economic or other material respect.29

In addition, coinvestment cannot meet the definition of most of the specifically enumerated types of self-dealing, which generally require a direct or indirect payment, extension of credit, purchase, sale, or other transaction between the disqualified person and the private foundation in question. When a private foundation and a disqualified person invest in a common partnership, there is no direct transaction between them. Depending on the order of investments, of course, the foundation may indirectly be selling or purchasing a profits interest to or from investment partnership *partially owned* by a disqualified person. However, the regulations make clear that such partial ownership does not render a transaction indirect self-dealing unless the partnership itself is 35% owned by disqualified persons (in which case it a disqualified person in its own right) or controlled by the Foundation.30 Similarly, although the disqualified person may be selling or purchasing a partnership interest to or from an investment partnership partially owned by the private foundation, the foundation’s ownership does not render that transaction a prohibited sale or purchase unless the private foundation controls the partnership.31

More complicated questions arise if more than 35% of the profits interest in an investment fund is held by disqualified persons. In that case, the question arises whether the purchase of an interest in the fund is a sale by a disqualified person (the fund 35% owned by disqualified persons) to the private foundation of an interest in the fund itself. Even if a fund is not 35% controlled by disqualified persons at the time the foundation invests initially, additional disqualified persons entering the fund to subsequently may convert the fund into a disqualified

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28 See I.R.C. § 4943(d)(3)(B); PLR 200423029 (June 4, 2004).
29 See, e.g., PLR 200551025 (Sept. 28, 2005); PLR 200420029 (Feb. 19, 2004).
30 Treas. Reg. § 53.4941(d)-1;
person, potentially rendering it an act of self-dealing or the private foundation to exit the fund (if such exit is treated as a sale of the partnership interest back to the disqualified fund).

In a number of private letter rulings now more than a decade old, the IRS avoided this potentially harsh result by concluding that certain investments in and withdrawals from investment funds should not be considered sales or exchanges. This allowed the IRS to focus on whether the substance of the coinvestment arrangement was such that the assets of the private foundation were not being used to provide any more than incidental benefits to disqualified persons. In some rulings, the IRS did this simply by arguing that the coinvestments at issue should be treated as distinct from sales or exchanges because one investor’s investment has no material effect on the economic situation of any other investor, as in the passage quoted above. In other rulings, the rationale of the IRS is more cryptic, simply concluding that the transaction does not involve a sale or exchange because of the applicant’s representations about state law.

However, since that time, it appears that the IRS and Treasury may be considering their position further. For the past several years, the Treasury Department’s Priority Guidance Plan as included in item which in its current version reads as follows: “Guidance under §4941 regarding a private foundation's investment in a partnership in which disqualified persons are also partners.” It is not clear whether Treasury simply intends to provide more detailed guidance about how to make sure that the cost sharing inherent in coinvestment relationships does not inappropriately benefit disqualified persons at the expense of private foundations, or whether it may make more wholesale changes. There is at least the possibility that new guidance could reverse the position allowing coinvestments in investment funds even when they are more than 35% owned by disqualified persons.

The current state of flux has elicited able defenders of the conclusions reached in the private letter rulings; the interested reader can read at least three articles considering the subject in depth. One key factor in most of the rulings is the relative liquidity of the funds involved; in the typical case, the funds were invested in readily marketable securities, and fund investors were

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32 See, e.g., PLR 200551025 (Sept. 28, 2005); PLR 200420029 (Feb. 19, 2004); PLR 200318069 (May 2, 2003).

33 See, e.g., PLR 200043047 (July 18, 2000); PLR 200423029 (June 4, 2004).


35 See Douglas M. Mancino and Ofer Lion, Co-Investing With Disqualified Persons—IRS Guidance, Please, 24 TAXATION OF EXEMPTS 31 (2012); Jamison Shipman, Private Foundations and Co-Investments—Another Reason There is No Self-Dealing, 24 TAXATION OF EXEMPTS 10 (2012) (arguing that the investment fund should be treated as an aggregate of partners whose economic condition is not altered by the addition of more investors); Douglas M. Mancino and Ofer Lion, Co-Investing With Disqualified Persons, 23 TAXATION OF EXEMPTS 3 (2011) (arguing that in substance the typical investment fund partnership is just a means of having the investors pay the fund manager for investment management services).
allowed to withdraw some or all of their holdings at regular intervals during the year. Thus, in
several of these cases the fund, though a partnership for tax purposes, seemed to constitute little
more than a mechanism for tracking each individual investor’s account balance as the fund
manager managed their pooled assets. In this sense, the private letter rulings’ assertion that in
the co-investment relationship the entry or exit of one investor does not cause “the ownership or
holding of the other investors [to] change in any economic or other material respect” makes
sense—when a new investor enters the fund, the manager purchases additional securities to
match the rest of the portfolio; the other investors still have the same account balance and the
same exposure to the securities in the portfolio. On the other hand, Mancino and Lion are right
to note that additional investors can materially impact economics by decreasing average costs, so
it is not entirely true that the economic situation of the other investors is unchanged36 (although
in many of the rulings at least the most concrete cost savings were allocated so that the marginal
cost savings attributable to the foundation’s assets went solely to the foundation).

It is worth noting that reversal of the current IRS ruling position could entail significant hardship
for current private foundations invested in funds 35% owned by disqualified persons; they might
suddenly find themselves unable to exit the fund in question because of its status as a
disqualified person.37 Furthermore, it could complicate even investments in funds that would
ultimately be owned less than 35% by disqualified persons, since the order in which investors
contributed their funds could temporarily lead a fund to be more than 35% owned by disqualified
persons. If the IRS and Treasury do reverse course and prohibit private foundations from
purchasing interests in partnerships 35% owned by disqualified persons, it would make sense to
provide some exception for investments all happening pursuant to a common plan within a fixed
time frame (e.g., 90 days), so that accidents in the order in which investors deliver their money
do not create apparent problems.

b. Payment of Carried Interest to Disqualified Persons

What if a private foundation invests in an investment partnership where the managing partner is
a disqualified person? In such a case, the managing partner generally receives an asset
management fee, often 2% of assets under management, as well as “carried interest,” which is a
performance fee in the form of a profit allocation that is greater than the managing partner’s
capital contribution to the partnership. The standard carried interest in many private equity
 partnerships is 20%. While self-dealing generally prohibits transactions between a private

36 Mancino & Lion (2012), 24 TAXATION OF EXEMPTS at 33.

37 Arguably, a private foundation could exit such a fund under any fair-market, generally
applicable uniform redemption offer allowing all of the partners to withdraw. However, section
4941’s exception for such redemption offers expressly only applies to corporate redemptions. See
I.R.C. § 4941(d)(2)(F); see, e.g., PLR 200734023 (May 30, 2007) (applying this exception in the
case of a limited partnership). If Treasury were to abrogate the general exception for
co-investment arrangements currently reflected in its private letter rulings, it should confirm that
this exception is available to partnership as well as corporate liquidations, redemptions, and
reorganizations.
foundation and a disqualified person, an exception is provided which allows payment of compensation to disqualified persons who perform personal services, where the compensation is not excessive. However, the portion of any payment that represents payment for property may not be treated as payment of compensation. An example in the regulations provides that payment for investment management services qualifies for the personal services exception to self-dealing. Is there any reason to believe that this example should not be extended to the “2 and 20” paid to the managers of investment partnerships?

The IRS has privately ruled that payment of investment advisory fees were not direct self-dealing, because they were paid by the partnership and not directly by the private foundation limited partner. In addition, the IRS ruled that the payment of investment advisory fees was not indirect self-dealing because the payment qualified for the personal services exception. The ruling does not discuss how the investment advisory fees were set or whether they included a performance fee but does state there was no evidence in the file to indicate that the fees were unreasonable. In another private letter ruling, the IRS concluded that where an investment fund in which a private foundation invested paid a fee based on assets under management to a disqualified person, the payment would not result in direct or indirect self-dealing. In most investment partnerships, the private foundation will be one of many investors, all of whom share in the fee paid by the partnership to the manager. Does this by definition make the fee not excessive? Is there an argument that the profit allocation to the managing partner is in effect a sale by the limited partner of a portion of its profits interest? This seems hard to imagine, as generally the partnership agreement from day one allocates the disproportionate profits interest to the managing partners. It seems difficult to argue that the limited partner could sell an interest to which it was never entitled in the first place.

III. Select Issues in International Investment

a. Global Intangible Low-Taxed Income (GILTI)

Effective for taxable years after December 31, 2017, section 951A of the Code, enacted as part of the 2017 Tax Cuts and Jobs Act (the “Act”), requires that a U.S. shareholder of a controlled foreign corporation (“CFC”) include in gross income such shareholder’s global intangible low-taxed income (“GILTI”) for the taxable year. The Act generally established a participation exemption system under which certain earnings of a foreign corporation could be repatriated to a corporate U.S. shareholder without tax. Recognizing that the participation system could encourage multinational corporations to locate highly-profitable intangible assets overseas to avoid U.S. taxation, Congress enacted section 951A to combat U.S. tax base erosion.

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38 PLR 8726004 (March 3, 1987).
39 PLR 201031036 (August 6, 2010).
40 Section 951A(a).
Section 951A subjects deemed intangible income earned by a CFC to U.S. tax on a current basis, similar to the treatment of subpart F income. Very generally, Section 951A accomplishes its purpose by imposing a tax on U.S. shareholders on certain earnings of a CFC in excess of 10% of the cost basis of the CFC’s assets. The Code sets forth the calculation to determine GILTI through the use of several new technical defined terms of art. In summary, GILTI means, with respect to any U.S. shareholder, the excess (if any) of (i) such shareholder’s “net CFC tested income” for such taxable year over (ii) such shareholder’s “net deemed tangible income return” for such taxable year. Corporate taxpayers are permitted a 50 percent deduction, which essentially taxes GILTI at half of the normal tax rate. Of note, GILTI is determined at the U.S. shareholder level. Generally, a U.S. shareholder is a U.S. person who owns, or through the applicable attribution rules are considered as owning, 10 percent or more of the CFC’s stock by vote or value. A person is only a U.S. shareholder for purposes of GILTI if the person owns stock in the CFC on the last day of the taxable year of the CFC.

On August 21, 2018 the IRS issued Notice 2018-67 to provide guidance for, among other topics, the application of GILTI to UBIT under section 511. Generally, subpart F income is exempt from UBIT under section 512(b)(1). Because GILTI is not subpart F income, there was some question of whether GILTI must be included in UBTI or could be excluded under the same rationale that subpart F income is excluded. In Notice 2018-67, the IRS stated that an inclusion of GILTI would be “treated as a dividend which is generally excluded from UBTI.” The IRS reasoned that although GILTI is not technically an inclusion of subpart F income under section 951(a)(1)(A), GILTI is generally treated in a similar manner to subpart F income for other provisions of the Code and should for purposes of UBIT as well.

b. Section 965 Inclusion (Tax in 2017 Only)

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42 “Net CFC tested income” generally means the CFC’s gross income for the year with certain exceptions, such as excluding the CFC’s subpart F income. Section 951A(c).

43 “Net deemed tangible income return” generally means 10 percent of the aggregate of the U.S. shareholder’s pro rata share of the qualified business asset investment of the CFC. Section 951A(b).

44 Section 951A(b)(1).

45 Section 250(a)(1)(B). The deduction is reduced to 37.5 percent for taxable years beginning after December 31, 2025. Section 250(a)(3)(B).

46 Section 951A(b)(1).

47 Section 951(b). The Act expanded the definition of U.S. shareholder by expanding the class to those who own 10 percent of the value of the corporation.

48 Section 951A(e)(2).

49 Notice 2018-67. See also, e.g., PLRs 201430017, 201043041 and 199952086.


4811-7409-7796
As previously noted, the Act allows U.S. corporations going forward to avoid tax on their foreign dividends from certain 10% controlled foreign corporations. However, instead of simply wiping the slate clean with respect to past accumulated earnings, the Act imposes a one-time tax on U.S. shareholders holding at least a 10% interest in the “accumulated deferred foreign income” earnings of a CFC or any other foreign corporation having at least one corporate U.S. shareholder that holds 10% or more of the voting power. The tax is imposed by imputing their proportionate share of the accumulated deferred foreign income to the U.S. shareholders, and then providing them an offsetting deduction so that the income is taxed at rates much lower than the top marginal rate of 35% (15.5% to the extent of the foreign organization’s cash available to pay the tax, and 8% to the extent the deferred foreign income is invested fixed assets).\textsuperscript{51}

The income inclusion applies to any U.S. shareholder (defined using pre-Act law as someone who directly, indirectly, or constructively owns at least 10% of the voting power) of a foreign company that is a CFC, as well as a U.S. shareholder of any other foreign company (other than a PFIC) that has a U.S. shareholder that is a corporation.\textsuperscript{52}

The Act provides that the inclusion increases “the subpart F income of such foreign corporation.”\textsuperscript{53} As such, the typical exclusion from UBIT for subpart F income (discussed above) should apply to the section 965 inclusion amounts. The IRS has not confirmed such treatment and a confirmation from the IRS on that point would be helpful.

On August 1, 2018, the Treasury Department issued proposed regulations under Section 965 (the “Proposed Section 965 Regulations”). The Proposed Section 965 Regulations answered several open questions regarding the application of section 965 to exempt organizations. First, the preamble to the Proposed Section 965 Regulations provide that the inclusion “generally is included in the calculation of gross investment income of a private foundation for purposes of determining the excise tax imposed under section 4940.” The preamble notes that gross investment income under section 4940 does not include the inclusion amount to the extent such amount is included in calculating the foundation’s UBIT. Although, the section 965 inclusion amount is subject to certain deductions,\textsuperscript{54} the preamble to the Proposed Section 965 Regulations provide that the section 965 deduction is not treated as an ordinary and necessary expense paid or incurred for the production or collection of gross income for purposes of the deduction permitted under section 4940.\textsuperscript{55} Accordingly, the full amount of the inclusion is generally subject to the excise tax of section 4940. These deductions effectively decrease the rate of tax on the section 965 inclusion from the full corporate rate to a reduced rate of 8% or 15.5%; by denying these deductions in the calculation of the section 4940, the Act essentially requires payment of tax on

\textsuperscript{51} Section 965.

\textsuperscript{52} Section 965(e).

\textsuperscript{53} Section 965(a).

\textsuperscript{54} Section 965(c).

\textsuperscript{55} Section 4940(c)(3)(A).
the section 965 inclusion at the full 2% or 1% rate rather than further reducing the tax to a fraction of the full excise tax.

For taxable entities, the scope of the section 965 inclusion means that the 2017 income inclusion typically only applies if the foreign corporation has at least one U.S. corporate shareholder that would benefit from the after-2017 100% deduction for dividends of foreign earnings under section 245A (although constructive ownership rules can cause the tax to apply to non-corporate U.S. shareholders due to fairly remote constructive ownership by a U.S. corporation). But the law and available guidance does not explicitly protect exempt organizations formed as corporations from being treated as U.S. corporate shareholders. They may have to take into account the section 965 for purposes of section 4940 even though other provisions prevent them from claiming the benefit of the section 245A deduction to exempt them from the section 4940 excise tax with respect to section 965. Thus, private foundation U.S. shareholders that are corporations could be subject to a tax under section 4940 to the extent they actually or constructively own 10% of the voting power in foreign companies engaging in active trades or businesses, where other nonexempt U.S. shareholders (or private foundations organized as trusts) would not be. However, while constructive ownership (including downward attribution through foreign or U.S. entities) can be used to determine whether an entity is a U.S. shareholder, only actual direct or indirect ownership is taken into account when determining how much of the foreign entity’s post-1986 earnings and profits should be attributed to the U.S. organization.

Although certain taxpayers may make an election to pay the section 965 inclusion tax over 8 annual installments, because section 4940 imposes an excise tax rather than an income tax, such election may not be available to private foundations.

While the section 965 taxes under section 4940 were to be included on 2017 tax year returns (and so are generally past due for calendar year filers, whose returns were due by May 15 or, if extended, November 15 of 2018), filers with other fiscal years may still not have had to file the return including these amounts (particularly if they properly filed a six-month extension).

c. Changes to the Controlled Foreign Corporation Rules

Prior to passage of the Act, U.S. shareholders of a foreign corporation could be subject to various anti-deferral rules. For purposes of this outline, we focus on three principal classes of foreign organizations:

- Controlled foreign corporations (CFCs)
- Passive Foreign Investment Companies (PFICs)
- Other foreign subsidiaries carrying on active trade or business activity and not producing subpart F income

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56 Section 965(h).
An entity qualifies as a CFC by being more than 50% owned (by vote or value, directly, indirectly or constructively) by “U.S. shareholders.” Under prior law, a “U.S. shareholder” for purposes of the CFC and related rules was defined as a U.S. person owning (directly, indirectly, or constructively) more than 10% of the voting power of the stock of a foreign corporation. The Act amends that rule effective for tax years beginning after December 31, 2017, stating that a 10% ownership interest by value will be sufficient to make someone a U.S. shareholder.

If an entity qualifies as being a “controlled foreign corporation” (CFC), its subpart F income (including most investment income) is included in the U.S. shareholders’ income as it is earned by the CFC (proportionally to their direct or indirect interest in the CFC without application of the constructive ownership rules of section 958(b)).

If an entity is not a CFC but does not qualify as having enough active business income or assets (relative to passive assets or income), the foreign corporation will be classified as a passive foreign investment company (PFIC). Absent special elections, the income of a PFIC is not attributed to the U.S. investors prior to actual distribution, but at the time of distribution, the investors must pay a supplemental tax representing an interest charge on the excess distributions, reflecting the value of the deferral. Under pre-Act law, whether an entity was controlled by U.S. shareholders or not, typically these antideferral regimes did not cause early inclusion or subsequent interest charges on income of active trade or business entities. Thus, under pre-Act law, such businesses could keep earnings offshore indefinitely, with no U.S. tax or U.S. inclusions until the earnings were eventually distributed to U.S. shareholders. The GILTI and Section 965 regimes discussed above modify those rules. Because the GILTI rules will be applied using the newly expanded definition of CFC, an increasing number of foreign active businesses will result in inclusions in the income of the exempt organization.

The constructive ownership rules have also been broadened by eliminating prior section 958(b)(4), which prevented downward attribution from a foreign partner, trust beneficiary, or controlling stockholder to the corresponding partnership, trust, or corporation. The immediate impact of this rule is that a U.S. corporation, partnership, or trust can be deemed a U.S. shareholder of a foreign company because it has a foreign controlling shareholder or partner or trust beneficiary that itself directly or indirectly owns 10% of the foreign company.

d. Effects of the Foregoing Changes

1. Effects on “Blocker” Corporations

It is not uncommon for United States tax-exempt entities to invest through foreign “blocker” corporations, so that income from the underlying investments that might otherwise constitute

57 I.R.C. § 951.
58 See I.R.C. §§ 1291 et seq.
59 2017 Tax Cuts and Jobs Act § 14213(a).
UBIT can be earned by the foreign corporation, with the U.S. tax-exempt receiving nontaxable dividends or subpart F inclusions treated similarly to dividends. Where the underlying investments are foreign, there is no tax at the blocker level either.

Blocker corporations can be controlled by U.S. shareholders, in which case they qualify as CFCs (and thus not as PFICs, unless they were PFICs before becoming CFCs). Typically, at least non-captive blockers focus control in non-U.S. parties, so that they cannot be considered CFCs. For most tax-exempt entities, the status of the blocker as a PFIC is not significant, because the income when it is distributed is tax-free dividend income, and so there is no “interest charge” on the subsequent distribution.\(^{60}\) (This would not be the case if, for example, the investment in the blocker were debt-financed at the tax-exempt level; leverage at the blocker level does not disturb this tax-free treatment.) Similarly, even if the blocker is a CFC, the subpart F income attributed to the charitable U.S. shareholder would presumably be similar to dividend income, and thus should not be subject to UBIT in normal circumstances.

The Act also does away with an exception that had not required the U.S. shareholders of a CFC to include their allocable subpart F income on their return if it qualified for a period of fewer than 30 consecutive days. Now, any period of time as a CFC can trigger such inclusions. This could complicate the formation of blockers used as funding vehicles, since a U.S. shareholder might be an early investor and thus, on a purely temporary basis, own more than 50% of the entity prior to the time that other investors come in.

As a result of the changes to the definition of U.S. shareholder, most “captive” blockers or blockers set up by an investment fund to accommodate a few U.S. entities will qualify as CFCs, and in general more blockers will be treated as CFCs. This will mean more current income inclusions under subpart F of the Code, and under section 1248, even direct or indirect dispositions of such interests will generate deemed dividend income to the extent of attributable earnings and profits of the CFC (rather than long-term capital gains). It may also mean that the organization needs to take steps to terminate PFIC status of a blocker that had been a PFIC, so that it will not be subject to both PFIC and CFC rules. And nonprofits may have new obligations as U.S. shareholders to file Forms 5471 with respect to their investments in foreign corporations, and to get enough information to determine what their includible subpart F income is.\(^{61}\)

2. Potential Effects of the New Provisions on Other Exempt Organizations

\(^{60}\) See Treas. Reg. § 1.1291-1(e), § 1.1298-1(c).

\(^{61}\) IRS Notice 2018-13 indicates that a shareholder who is considered a U.S. shareholder solely because of downward attribution from a foreign person will not have to file a Form 5471 as a Category 5 filer (this is the category applicable to U.S. shareholders of CFCs) so long as no U.S. shareholder actually owns, directly or indirectly, any stock in the CFC. However, this exception is narrow enough that in many cases entities whose actual direct or indirect holdings are far below the 10% threshold will still have to file.
There are limited cases in which the expansion of the subpart F income rules under the Act to include more kinds of income (e.g., GILTI) on more U.S. shareholders and more CFCs (by expanding the definition of U.S. shareholder) will have actual tax consequences for tax-exempt U.S. shareholders. To be sure, to the extent an exempt organization owes tax on its investment income (for instance because it is a private foundation or section 501(c)(7) social club, because it is a section 501(c) organization subject to the section 527(f) tax, or because the investment income in question is debt-financed), the new rules may result in additional tax. But these cases are fairly rare. And guidance has clarified that the new rules will also result in additional inclusions for purposes of the section 4940 tax; presumably the same would also be true for calculation of the university endowment excise tax under section 4968.

Less clear is how the new rules will affect other exempt organization rules that depend on the character and amount of the exempt organization’s income, such as the following:

- determination of public support under section 509(a)(1) or section 509(a)(2)
- determination of adjusted net income for purposes of meeting the payout tests for private operating foundations or Type III non-functionally integrated supporting organizations
- determination of the amount of “internal support” of an organization seeking to qualify as an integrated auxiliary

If applied in these contexts, the Act could affect the outcome in two ways: first, by accelerating income before it is actually available and distributed to the entity, and second, by converting long-term capital gains from disposition of these assets (which is often ignored under the public support or payout calculations) into deemed dividend income (which is typically taken into account as current income). Because in many cases an exempt organization may not itself control the entity in which it is a 10% owner, it seems potentially harsh to hold it responsible for such income for payout purposes, given its inability to obtain the income and apply it for charitable purposes. And the tax deferral reasons for treating sales of CFCs as ordinary income do not necessarily warrant treating such sales any differently than any other sales of long-term assets for public support or payout purposes. Thus, it is not clear whether the artificial deemed income inclusions of the Act should, as a policy matter, be taken into account in determining an organization’s net income for these other purposes.

These concerns are especially strong with respect to the section 965 inclusion. For certain organizations having long-standing interests in foreign companies with significant earnings and profits, the size of this one-time inclusion, and the fact that it is treated as ordinary income rather than long-term capital gain, could be large enough to have unpredictable and unintended consequences for the U.S. entity’s public support or annual payout calculations. It seems that this kind of accumulated 30-year inclusion has little bearing on the character of the organization’s normal public support or the level of its payout as a general matter. And such inclusions could occur even if the exempt organization is only a minority owner of the foreign business, and thus unable to actually gain access to its assets in order to meet any increased spending obligation. Whatever the effect that the new rules have on public support classification
and payout tests generally, it would seem appropriate for Treasury to issue guidance holding that inclusions under section 965 should be disregarded for purposes of such tests.

Treasury has ample room to issue guidance restricting the application of these new rules to exempt organization classification tests. The Code already recognizes that for other similar purposes, such as the income test for REIT qualification, at least section 965’s 2017 deemed repatriation of offshore earnings should not be taken into account.\(^\text{62}\)

If guidance is not forthcoming, tax-exempts considering investments through foreign blockers or in foreign companies may wish to consider whether the investment will change the amount or timing of required distributions or change the organization’s public support percentage in unfavorable ways.

\(^{62}\) I.R.C. § 965(m)(1)(A).