

Philanthropic Impact Without Grants

How to Make the Most of Program-Related Investments and Other Funding Alternatives

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AGENDA

- PRIs: legal and tax considerations
- PRIs: examples
- Economic development as charitable activity
- Mission-related investing



**Program-Related Investments
Legal Issues / Gina Kastel**

Background and Context

- For purposes of this discussion, assume the funding foundation is a private foundation
- Public charities can operate similar programs but are subject to fewer regulatory restrictions
- Private foundations are subject to a series of excise tax rules that regulate their operations including prohibition against investments that jeopardize foundation's exempt purposes.

Background and Context

- Program related investments (PRIs) are an exception to the jeopardizing investment prohibition
- Take form of financial investment, but made primarily for charitable purposes
- As previously mentioned, PRI may take form of loan, equity interest, or loan guarantee

Internal Revenue Code Requirements for PRI

- Primary purpose to accomplish charitable purposes;
- Production of income not a significant purpose; and
- The investment cannot involve lobbying or political campaign activity

When are PRIs Useful?

- Large sums of money are needed for projects (PRI can be part of mix of financing)
- Conventional financing unavailable or insufficient
- Grant does not provide the right incentives to recipient to develop sustainable, economically reasonable business practices
- Leverage: PRI helps recipient obtain additional financing
- Foundation wants to be able to “recycle” repaid funds for future loans

Tax Considerations – Five Percent Payout

- Foundations must pay out 5% per year in “qualifying distributions”
- PRI distributions count toward the foundation’s qualifying distribution requirement in the year funds are paid or advanced
- Repayment of PRI loans treated as negative qualifying distributions in the year of repayment
- Loan guarantee does not count toward payout unless foundation actually has to advance funds
- PRIs are not included as investment assets for purposes of calculating the foundation’s qualifying distribution amount

Tax Considerations –Tax on Investment Income

- Foundations must pay a 2% (sometimes 1%) tax on their investment income (ordinary income and capital gains)
- Interest paid on a PRI loan by the borrower is treated as investment income
- Capital gains or losses on PRIs are not treated as investment income

Tax considerations – Excess Business Holdings

- Foundation and its disqualified persons generally may not own an interest in a business in excess of 20%
- Excess business holdings rules do not apply to PRIs, so the foundation own interest in excess of 20%

Tax considerations –Expenditure Responsibility

- Private foundations that make grants to organizations (not individuals) other than section 501(c)(3) public charities must exercise expenditure responsibility to avoid making a taxable expenditure
- PRIs to organizations other than public charities are treated as “grants” for purposes of the expenditure responsibility rules, so foundation must exercise expenditure responsibility

Expenditure Responsibility Elements

- Pre-grant inquiry
- Written grant agreement
- Grantee reports
- Report of grant on Form 990-PF

Recipient must keep funds in a segregated account and use them only for the purposes for which they were advanced

Getting Started: Staff and Board

- Set general program parameters
- Focus areas and objectives
- Ongoing program or occasional activity
- PRI form (equity, loan, loan guarantee)
- Annual budget
- Part of or in addition to regular grantmaking

Use of Intermediaries

- Special expertise
- Buffer between foundation and recipient
- Loss of control

Create Form Documentation

- Program description and eligibility criteria
- Internal policies and procedures
- Application form
- Due diligence checklists
- Expenditure responsibility checklists and agreement

PRI Documentation (as appropriate)

- Loan agreement
- Promissory note
- Mortgage
- Security agreement
- Shareholder/member control agreement

Implementation of Individual PRIs

- Review and evaluate application
- Potential risks and programmatic accomplishments
- Due diligence
- Negotiate PRI terms

PRI Terms: Loans

- Fixed loan or line of credit
- Interest rates
- Length and size of loans
- Documentation
- Security interests
- Forgiveness/default conditions

Equity Arrangements

- Corporate form
- Capitalization issues
- Control/voting rights
- Stock preferences
- Securities/Blue Sky law compliance

Implement:

- Draft documentation
- Obtain board approval
- Execute documentation/close transaction
- Monitor and evaluate

Program Review and Evaluation

- Achievement of charitable goals
- Achievement of financial goals



BLANDIN FOUNDATION

Program-Related Investments
Examples / Wade Fauth

Blandin Foundation - Grand Rapids, MN

- Mission: Strengthening rural Minnesota communities, especially the Grand Rapids area
- Strategic Focus: Rural Economic Assets

When are PRIs Appropriate?

- Is there a viable income stream to support repayment?
- Is there private sector participation in the program strategy?

Example #1

- *Recipient Organization* – Minnesota Diversified Industries
 - Providing employment and training opportunities for workers with disabilities and disadvantages.
- *Purpose* – Establish plastics production facility in Grand Rapids, MN.
- *Income Stream* – Production and sale of plastic letter trays, plastic packaging products, etc.
- *PR I Structure* – Standard debt instrument with fixed term and interest rate; debt forgiveness triggers based on employment and salary levels

Example #2

- *Recipient Organization* – Minnesota Investment Network Corporation
 - Nonprofit that mobilizes and invests equity capital in economically depressed areas of rural Minnesota
- *Purpose* – Capital for equity investments in rural enterprises and mobilization of rural capital through Regional Angel Investor Network (RAIN) funds
- *Income Stream* – Capital gains realized through investments in profitable enterprises
- *PRI Structure* – Near-equity 10 year note with simple interest payment annually and balloon principal payment at end

Example #3

- *Recipient Organization* - Itasca Development Corporation
 - Nonprofit promoting economic health of Itasca County
- *Purpose* – Capital for a commercial property development fund that facilitates the growth of enterprises in the area and provides ‘business acceleration’ services
- *Income Stream* – Lease income and/or capital gains realized from properties developed by the fund
- *PRO Structure* - Near equity 10 year note, no interest, non-recourse, subordinated, share in capital gain or loss of property values 75/25



**Economic Development
as a Charitable Activity**
Hazen Graves

Legal Basis

- Relief of the poor, distressed, underprivileged
- Lessening burdens of government
- Promotion of social welfare by
 - Lessening neighborhood tensions
 - Eliminating prejudice and discrimination
 - Combating community deterioration, juvenile delinquency

Distinguishing Features

- Area that is economically distressed
- Business unable to obtain necessary financing, goods, services, from conventional sources
 - Because of economically distressed area
- Non-commercial terms (below-market rates, expanded eligibility)
- Target businesses most likely to address problem

Example #1: Financing

- *Target area:* High density urban area; high number of failing businesses due to depressed local market, social unrest, instability of work force, limited skills
- *Activity:* Low-interest loans and equity investments in businesses
- *Criteria:*
 - Not able to obtain financing due to risks in establishing business in target community
 - Most likely to provide training and employment opportunities for area unemployed
 - Determined in consultation with government and nonprofit agencies
- *Status:* Charitable

Example #2: Industrial Park Development

- *Target area:* Federally designated economically depressed community with chronic unemployment, underemployment, high poverty rate
- *Activity:* Purchase of blighted land and conversion to industrial park. Lots leased to eligible businesses on favorable terms. Supported by federal funding.
- *Criteria:*
 - Tenant must hire and train significant number of local unemployed persons
 - Must comply with fair employment laws
 - Low-skilled jobs preferred short-term
- *Status:* Charitable

Example #3: Shopping Center Development

- *Target area:* Area suffering from continuing economic decline, due in part to competition from suburban shopping centers
- *Activity:* Acquired land for construction of department store and shopping mall. Sold to city, which leased land to private developer.
- *Status:* Not charitable. Aid not limited to businesses that would locate in the area only because of the existence of the center.



**Northwest Area
Foundation**

*Helping communities
reduce poverty*

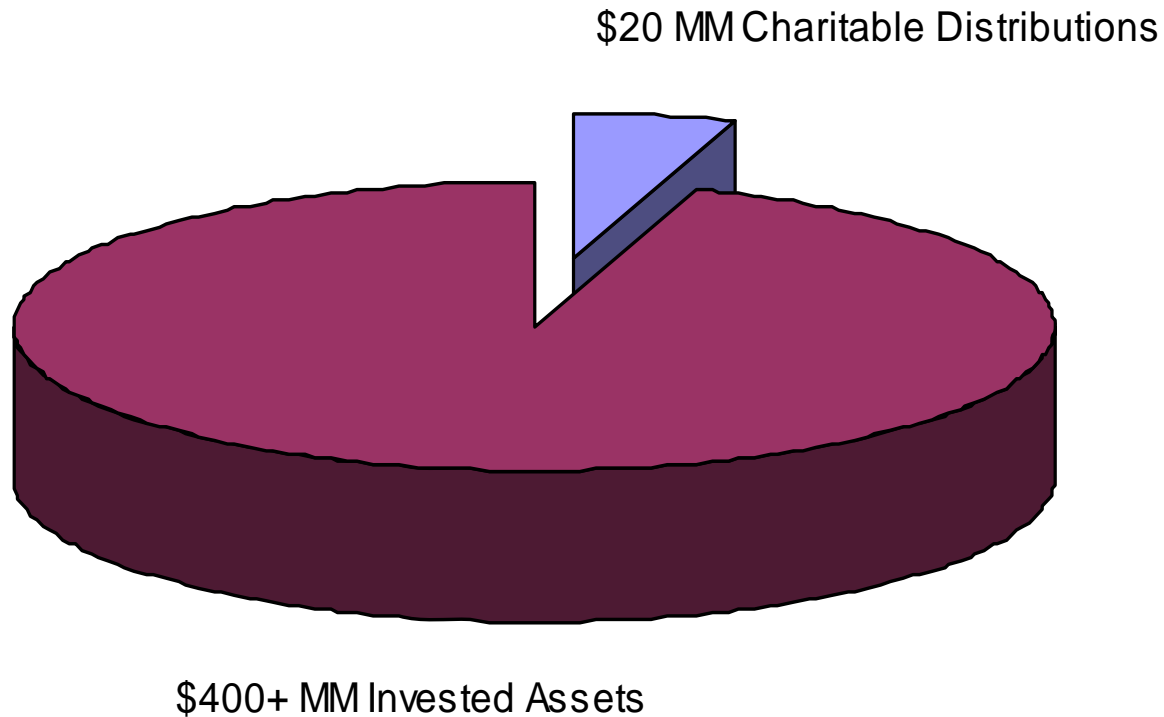
Mission Related Investing at Northwest Area

Jean Adams

Northwest Area Foundation

- Mission: To help communities reduce poverty
- Program Strategy: Identify, share and advocate what works to reduce poverty
- Mission Related Investment Theory: Providing access to capital in an underserved region will help build capacity to reduce poverty

Deployment of NWAF Resources



Background

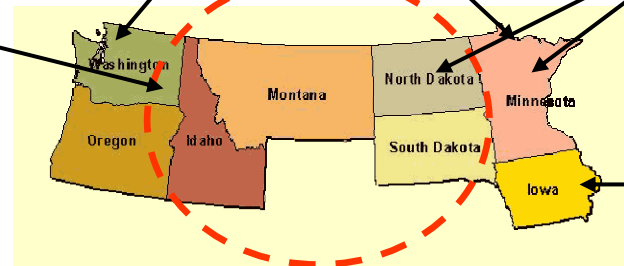
- June 2001: Presentation and report by Investors' Circle: MR Investment Strategies for Philanthropic Institutions
- June 2002: Co-sponsored Investors' Circle workshop of foundations involved in MRI
- July 2002: Investment Committee makes allocation of 10% to private Equity
- April 2003: Hired Community Development Venture Capital Alliance to do research on direct investment strategy
- August 2003: Recommendation for PRI/MRI strategies made to NWAFF Investment Committee
- August 2004: Became limited partner in Invest Northwest

Gap Analysis

Sponsors in Eastern Washington/Idaho are eager supporters and are increasingly joining together

Traditional VC focus

Current investment focus of CDVC funds



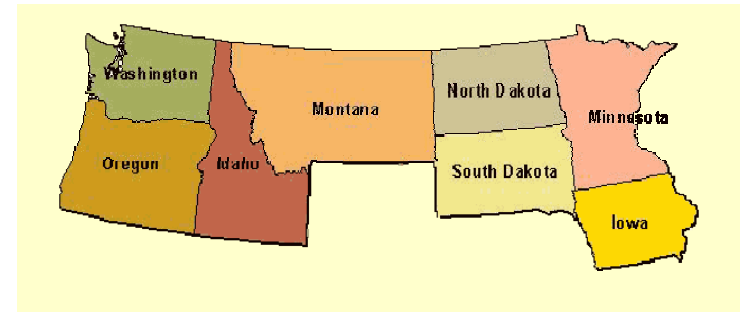
Proactive business and investment enabling environment

Opportunities for NWAFF given capital scarcity and need for seed/early stage investment, combined with investment and business development schemes

Gap Analysis

Compelling investment target zone for NWAf:

- ✓ Eastern Washington/Idaho provide investment incentives, a positive enabling environment, and new efforts to mobilize angel groups through establishment of networks
- ✓ Angels in the Dakotas and Iowa are seeking to mobilize through implementation of the RAIN template
- ✓ Seed and early stage investing is lacking, ideally suited to active community development investing
- ✓ Robust new small business creation and employment generation



NWAf could play a significant role in addressing the seed/early stage investment gap as well as mobilizing local capital sources for later stage investing

A Two-Pronged Approach

1. Create a “mission related” venture capital fund

Invest Northwest:

A regional private equity fund seeking venture capital returns and regional development by investing in private, middle-market, growth and later-stage companies.

- Managed by InvestAmerica – offices in Iowa, North Dakota, Washington, Minnesota (through Minnesota Investment Network Corporation), Missouri.

Invest Northwest Criteria

- Manufacturing, service, distribution and technology companies
- Sales of \$5M-100M; could be less with growth-stage companies
- Companies located in Idaho, Iowa, Minnesota, Montana, North Dakota, Oregon, South Dakota and Washington
- Investments aimed to retain or create living wage jobs, provide health care and benefits, build community wealth
- Post-investment involvement follows traditional VC approach, brings added value to portfolio companies

A Two-Pronged Approach

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2. Create a Program Related Investment Pool

- PRIs made for the creation or expansion of community development financing products with the potential for reducing poverty in communities and increasing long-term assets for individuals and families

PRI Criteria

- Community Development Financing Institutions
- Eight-state geography
- Underserved communities
- Poverty reduction focus
- New or expanding CD financing products
- Post-investment involvement includes creation of learning network

Broadening the Investment Spectrum





www.nwaf.org

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