High Net Worth Family Tax Report

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Welcome back to Loeb & Loeb's High Net Worth Family Tax Report, bringing you in-depth articles highlighting important topics and providing practical insights for high net worth individuals, with a focus on trusts and estates, tax, family offices and tax-exempt organizations.

In this issue, partner Todd Steinberg and senior counsel Jennifer M. Smith explain why owners of closely held businesses should review their buy-sell planning in light of the recent decision in *Connelly v. U.S.*, in which the U.S. Supreme Court held that the use of life insurance proceeds received by a closely held company to redeem a deceased shareholder's interests increased the value of the company and, consequently, the estate tax value of that deceased shareholder's interests.

Given the increasing popularity of professional sports and growth in the sports industry, partners Brian R. Socolow and Ronelle C. Porter and associate Evan Saunders discuss the unique world of sports investing and the issues potential investors should consider before investing in a sports team or franchise.

In our Family Office Corner, featuring insights on topics of interest to our family office clients, partner Kimberly Eney explores the rapidly expanding area of "impact investing" by family foundations, including the tools available to family foundations contemplating an impact investing program and the associated tax law benefits and considerations.

In other aspects of charitable planning, knowing the tax (or tax-exempt) status and public charity classification of an organization is crucial when selecting grantees to receive charitable funds from a private foundation, distributions from a donor-advised fund or tax-deductible charitable contributions from individuals. Partner Diara M. Holmes reviews various options for checking a charity's status and accessing other information on charities that may be useful to foundations, donor-advised funds and donors in selecting their charitable recipients.

Finally, in case you missed it, partner Alyse N. Pelavin and senior counsel Christina Hammervold summarize the reporting requirements now in effect that require most entities to report beneficial ownership information to the U.S. government, in their alert "New Beneficial Ownership Reporting Requirements Affecting LLCs and Other Entities Are Now in Effect."

Supreme Court Rules on Estate Tax Consequences of Buy-Sell Arrangement

Over the summer, the U.S. Supreme Court decided that life insurance proceeds received by a closely held company and earmarked to redeem a deceased shareholder's ownership interests increased the estate tax value of the company and, consequently, the deceased shareholder's interests. Owners of closely held businesses should review any existing buy-sell arrangements, as this decision directly affects how they will want to structure their business succession and estate tax plans, particularly for family-owned businesses.

Buy-Sell Planning Overview

Many owners of successful closely held businesses have significant wealth concentrated in their companies. The ability to monetize that value becomes crucial at an owner's death to create needed liquidity for the owner's estate and beneficiaries. Buy-sell agreements (BSAs) meet this need by requiring the purchase of a deceased owner's interests at a price set by the BSA, with the company as the buyer (a redemption arrangement), the other business owners as the purchasers (a cross-purchase arrangement) or some variation or combination of both approaches.

BSAs also can fix the fair market value of a deceased owner's business interests for estate tax purposes if they meet certain safe harbor tax rules. Specifically, the BSA must be a bona fide arrangement comparable to similar arm's-length business contracts. It cannot be a method to transfer property to the owner's family members for less than full value. In addition, BSAs must (1) apply both during and after the owner's life, (2) contain a fixed or determinable price for the company's interests and (3) provide that the deceased owner's estate receives at least the same price for the interests as the owner would have received during life.

Funding with Life Insurance

BSAs often use life insurance to fund the purchase of a deceased owner's interests since the policy death benefits provide readily available, income tax-free liquidity at the owner's death. This funding allows the owner's heirs to receive immediate payment from the buyout (rather than relying on deferred payments or promissory notes). In the typical redemption arrangement, the company owns the life insurance and uses the proceeds to redeem the deceased owner's interests at the value set by the BSA.

Estate Tax Implications of Redemptions

Since redemption BSAs require the company to use the life insurance proceeds to redeem the deceased owner's interests, estates have taken the position that any potential increase in the estate tax value of the company (and correspondingly, the deceased owner's interests) from the receipt of insurance proceeds is offset by the redemption obligation. The IRS, however, has repeatedly challenged this position, resulting in a split among the three federal circuit courts that have ruled on the issue—the Eighth Circuit in *Connelly v. United States* (2023) holding yes to an increase in the company's value and the Ninth and Eleventh Circuits holding no to an increase in *Estate of Cartwright v. Commissioner* (1999) and *Estate of Blount v. Commissioner* (2005), respectively.

The U.S. Supreme Court accepted review of the *Connelly* case, in part to resolve this split among the circuits.

The *Connelly* Case

Connelly involved a redemption BSA for Crown C Supply, a corporation owned by two brothers, Michael and Thomas. At the first brother's death, the BSA gave the surviving brother the option to buy the deceased brother's shares and, if he declined, required Crown to redeem the shares. Crown purchased a $3.5 million life insurance policy on each brother for redemption purposes.

To determine Crown's value and purchase price for the shares, the BSA required the brothers to agree annually, in writing, on Crown's value. If they failed to agree, they were required to use the average value from two fair market value (FMV) appraisals or obtain a third if the two appraisals varied by more than 10%. The brothers never complied with these express provisions.

Michael passed first, and Crown purchased his 77.18% share ownership for $3 million using the life insurance proceeds it received on his death. The value was agreed to in a settlement between Michael's son and Thomas as part of the estate administration and was reported on Michael's estate tax return as the FMV for his Crown shares. During an IRS estate tax audit, Thomas also obtained a valuation from an outside accounting firm, which determined the FMV of Michael's shares as $3 million, using a total FMV for Crown of $3.86 million. The valuation excluded the $3 million in life insurance proceeds used to redeem Michael's shares, based on the premise that they were offset by Crown's redemption obligation.

The IRS disagreed, arguing that Crown's redemption obligation was not a liability in the ordinary business sense, meaning Crown's total FMV as of Michael's death was $6.86 million ($3.86 million + $3 million of insurance death benefits) and the FMV of Michael's shares was $5.3 million (77.18% of $6.86 million). The IRS issued a notice of deficiency for the additional estate tax due. In subsequent litigation, both a federal district court and the Eighth Circuit held in favor of the IRS, and Michael's estate appealed these decisions to the U.S. Supreme Court.

Supreme Court Decision—Life Insurance Increases Company Value Despite Redemption Obligation

In a unanimous opinion (Opinion No. 23–146, June 2024), the U.S. Supreme Court found in favor of the IRS, ruling that Crown's contractual obligation to redeem Michael's shares did not offset the value of the life insurance proceeds received by Crown to fund that redemption obligation.

The Supreme Court found that taking Crown's redemption obligation into account in determining the company's total value for estate tax purposes effectively valued the company on a post-redemption basis—in other words, after Michael's shares had been redeemed. In the Supreme Court's view, this position ran counter to the purpose of calculating the estate tax, which was to assess how much Michael's shares were worth at the time he died, before any redemption by Crown or its redemption payment of the $3 million in insurance death benefits.

Michael's estate argued that because the redemption price effectively excluded the value of the insurance death benefits, Crown's value both before and after the redemption was the same: $3.86 million. The Supreme Court disagreed, concluding that Crown's total value could not be the same before and after the redemption because a company that pays out $3 million to redeem shares should be worth less after that redemption.

Finally, the Supreme Court dismissed the estate's assertion that this decision would make business succession planning more difficult for closely held corporations, noting that the result in this case was "simply a consequence of how the Connelly brothers chose to structure their agreement."

What To Do Now?

While the logic of the Supreme Court's analysis in *Connelly* may be debated, its decision is binding. Accordingly, closely held business owners should consider the following steps in consultation with their legal counsel and tax/insurance advisors:

- **Review Existing BSAs and Compliance With Valuation Procedures.** Review any existing BSAs to (1) assess whether the chosen structure (redemption, cross-purchase, etc.) and the corresponding funding method (life insurance proceeds, deferred payments, promissory notes) still accomplish the parties' objectives and (2) confirm the potential estate and income tax implications of the BSA for the owners and the business. This review also should ensure that the BSA complies with the requirements to fix the estate tax value of a deceased owner's interests, including the formula or method provided to determine the purchase price for an owner's interests at death. The owners must follow any valuation procedures specified in the BSA and may want to consider using independent, professional appraisers to help determine the company's FMV in accordance with the agreed-upon valuation procedures.
- **Identify and Evaluate Life Insurance Funding.** Confirm whether the BSA relies on life insurance to fund the purchase of a deceased owner's shares and, if so, who owns the life insurance and receives the policy proceeds. If, as in *Connelly*, the BSA is an insurance-funded redemption arrangement in which the company owns the life insurance and receives the death benefits, consider restructuring the BSA and/or the policy ownership as discussed below to mitigate the owners' potential estate tax exposure from the inclusion of the insurance proceeds in the company's FMV at an owner's death. This issue will be key for owners with estates in excess of the federal estate tax exemption

(which is scheduled to drop significantly in 2026). Also take this opportunity to review the appropriateness and sufficiency of the life insurance coverage (i.e., whether the coverage is still required, whether the death benefit is enough to buy out a deceased owner's interest, whether the policy is performing as initially projected, whether any revisions should be made to the policy funding, premium payments, face amount, product design, etc.).

- **Consider a Different Structure for Insurance-Funded BSAs.** Consider alternatives to redemptions for BSAs funded with life insurance. As the *Connelly* opinion indicates, inclusion of the insurance proceeds in Crown's value was "simply a consequence" of the redemption structure, so a different arrangement presumably could avoid this inclusion risk. Options include cross-purchase arrangements, in which each owner holds life insurance on each other owner and uses the insurance proceeds to buy the deceased owner's interest, and/or the use of trusts or special purpose entities, which are designed to hold the policies on the owners and then purchase the deceased owner's interest in accordance with the trust or entity agreement. Each alternative has unique variations, benefits and challenges that owners and their advisors will need to evaluate and match to the circumstances of the particular closely held business. In addition, there are several issues that the owners/business may need to navigate when restructuring an existing insurance-funded BSA, including compliance with the transfer-for-value and reportable policy sale rules if the restructuring involves the transfer of life insurance. Underwriting issues also may arise if new or additional life insurance is recommended to address an increase in the company's value or to offset tax risks.
- **Document and Periodically Review Agreements, Procedures and Compliance.** Clearly document the terms of the BSA, and keep records of compliance with the BSA's procedures, especially with respect to any required valuations of the business. Conduct periodic reviews to ensure compliance and that the BSA's terms and any life insurance funding continue to meet the owners' business succession needs. These steps are particularly critical when dealing with closely held family businesses.
- **Coordinate Estate Tax Plans With the Business Succession Plan.** Owners should review individual estate plans to understand the potential estate tax implications of the BSA and the impact on their beneficiaries, including which beneficiaries will receive what and when (i.e., lump sum or deferred payments, promissory notes, a portion of the business interest, etc.). Owners should coordinate their estate plans with the BSA as needed and plan for any liquidity needs due to their anticipated estate tax exposure, especially if the BSA defers payment of part or all of the purchase price for their interests over time.

Proceed Carefully and Work With Experienced Advisors.

Consult with legal counsel and tax and insurance advisors before undertaking the restructuring or creation of any BSA. There are numerous legal and tax implications associated with life insurance planning, business succession planning and BSAs, and noncompliance with applicable laws and legal decisions could result in inadvertent tax consequences or failure of a deceased owner's heirs to receive intended amounts.

Investing in a Sports Franchise: Key Considerations for Stepping Into the Game

Investing in a professional sports franchise is not merely a financial transaction: It is an invitation to join an exclusive club, feel the thrill of competition from a very different seat and leave a lasting legacy that touches the hearts and souls of fans. For high net worth individuals and families, owning a professional sports franchise offers a unique opportunity for capital appreciation, societal prestige and other intangible benefits. The following explores some of the essential considerations for investors contemplating this exciting venture.

Why Invest in Sports?

A Winning Track Record. Over the past three decades, professional sports franchises and their respective leagues have consistently outperformed the broader U.S. stock market. While not every team has been a slam dunk, aggregated data across sports leagues reveals impressive returns that outpace the S&P 500. Between 2002 and 2022, National Football League (NFL) franchises have appreciated 600%, with the average team now worth approximately $3.5 billion (see reporting from *Sportico* here). It is not just prominent U.S. sports leagues that are seeing incredible growth. Since 2019, the valuations of Formula 1 teams have surged by a staggering 276% (see *Forbes* article here).

These gains are driven primarily by long-term capital appreciation that is recognized upon the sale of a professional sports team, making sports investments attractive to investors. The recent sale of teams in leagues as old as the NFL and as new as the National Women's Soccer League (NWSL) underscore this trend. The Washington Commanders' $6.05 billion sale in 2023 and the San Diego Wave FC's $113 million sale earlier this year represented returns of over 330% and 4,700%, respectively.

The Revenue Game. The accelerating growth in valuations of sports franchises is likely to persist as long as sports leagues continue to score big in terms of revenue and growth. Live sports remain dominant in U.S. television ratings, accounting for 97 of the top 100 broadcasts in 2023, increasing from 94 of the top 100 broadcasts in 2022 (see *Sportico* articles here and here). The value of broadcast deals also keeps soaring, ultimately translating into more dollars for networks, teams and owners. According to *Forbes*, the NFL's TV rights agreements alone could exceed $126 billion by 2033, representing approximately $4 billion for each NFL team (see article here). With this broadcast domination, many investors expect that sports leagues and their teams will continue to cash in.

Historically, men's sports have commanded viewers' attention and held a firm grasp on most of the revenue generated by professional sports. Interest in women's sports has begun to increase, however, resulting in new expansion teams for certain leagues, private equity funds focused solely on women's sports and, of course, more lucrative broadcast deals. Since many aspects of women's sports are relatively new, undervalued and actively seeking investments, this area may present greater opportunities for investors that can get in on the ground floor. For example, women's professional sports have seen record-breaking success in broadcast deals, team sales and viewership, such as a four-year broadcast deal worth $240 million for the NWSL, inked in 2023, and record viewership for this year's Women's NCAA Basketball Tournament, which capitalized on the popularity of players such as Caitlin Clark and Angel Reese. This year's championship game drew a record 18.9 million viewers, while the men's championship game only drew 14.8 million viewers (see Nielsen article here). Overall, 2024 is shaping up to be a historic year for women's sports, with women's "elite sports" predicted to generate revenue in excess of $1 billion, a 300% increase from 2021 (see Deloitte article here). There are many scenarios in which the number of teams within the WNBA and NWSL increase in the next several years, which may create even more investment opportunities.

Navigating the Buying and Selling Process

Limited Opportunities. Buying a sports franchise is a unique endeavor that differs greatly from the purchase of other assets. Opportunities are scarce, as there are a limited number of teams in any given league and usually only a small number are for sale in their entirety or open for minority investment. Many teams are family owned and have been so for generations, including the Kansas

City Chiefs (the Hunt family), the Chicago Bears (the Halas/McCaskey family), the Los Angeles Lakers (the Buss family) and the New York Yankees (the Steinbrenner family). Many family-owned teams and their respective leagues seek to ensure continuance of family ownership and control. In fact, leagues such as the NFL have recently made it easier for teams to remain family-owned (see *Sports Business Journal* article here). Potential buyers or investors need to understand the acquisition process to enhance their likelihood of success.

Substantial Required Capital. Even if an acquisition opportunity is identified, the most important aspect of the process will be raising the substantial capital required to fund the purchase. Given the fast-growing valuations of sports teams, many individuals seek co-investors to form an ownership group that purchases the sports team through a suitable special purpose vehicle. Most leagues, however, limit the total number of team owners, exacerbating the shortage of acquisition opportunities already limited by the low supply of teams and the high cost of purchasing one. For example, the NFL limits a team's ownership group to 25 people (see *Sportico* article here). Another source of financing is debt, yet many leagues also limit how much debt financing may be used to purchase a team. The NFL's current maximum is $1.1 billion, which represents only 18.18% of the price paid for the recent purchase of the Washington Commanders (see *Sports Business Journal* article here). Given the rapidly escalating value of sports teams, the leagues likely will need to review these policies as fewer prospective buyers will have the capability to purchase available franchises.

League Approval. An often overlooked final hurdle is league approval. In addition to financial requirements and background checks, a league's commissioner and board of governors (the current owners of the league's teams) will scrutinize potential owners to ensure they are a good fit for the league's ethos and brand.

Minority Ownership Considerations

Controlling vs. Noncontrolling. An attractive alternative to complete or controlling team ownership is the purchase of a minority stake in a sports team. This option could be especially appealing for investors who want to acquire an interest in a billion-dollar team but do not have or want to raise the required capital for full or majority ownership. It also provides a means for existing team owners to realize liquidity or add famous or otherwise noteworthy new owners who could add value to the team's brand.

While there is some clout associated with being a partial owner of a team, potential investors must understand that a minority owner typically does not call the shots. Many leagues want a clearly defined controlling owner who wields genuine management control and voting power and sits on a league's board of governors. Therefore, a minority interest will provide limited rights and protections under the team's governing agreement. Restrictions also may apply regarding the ability to liquidate the interest and exit the investment, including requiring preapproval from the controlling owner and the league or preventing liquidation of the interest until there is a complete sale of the team. For these reasons, minority interests, if allowed, are normally sold at a liquidity discount of 20% – 50% (see *Sportico* article here).

The Private Equity Avenue. Indirect minority ownership of a sports team through a private equity fund is another avenue for consideration for certain potential investors, as many leagues are revising their respective ownership rules to allow for investment by institutional funds. The National Basketball Association (NBA), the National Hockey League (NHL), Major League Soccer (MLS), Major League Baseball (MLB) and the NWSL all allow their respective teams to sell a limited portion of their interests to private equity funds. Additionally, on Aug. 27, 2024, the NFL and its current team owners approved the ability of private equity funds to invest up to 10% of an individual team's equity. All NFL-approved private equity funds may hold an equity interest in up to six teams but may not have any governance rights and are required to maintain their equity interests for at least six years, among other league requirements. Some of the most active funds in this space include Arctos Sports Partners, Ares Management, Beautiful Game Group, Dyal Homecourt Partners, Sixth Street Partners and Galatioto Sports Partners.

Additional Economic Opportunities and Benefits

The Real Estate Play. Today, sports are more than just what happens on the field or court. Sports and sports-adjacent businesses have become their own business class, with greater extensions of the teams into adjacent business ventures geared to generate more liquid revenue and enhance team value. New stadium builds is one area where this plays out. A recent trend among owners of many teams within the NFL, NBA and MLB has been a push for state-of-the-art stadiums and arenas surrounded by "entertainment districts" that can provide enhanced entertainment experiences for fans even when the team is not on the field or court. These new districts are typically mixed-use developments that include the stadium, dining and shopping facilities, apartments, and office space.

Perhaps the best example of this trend is Stan Kroenke, owner of the Los Angeles Rams, and his 298-acre Hollywood Park site that is home to SoFi Stadium, an artificial lake, a 6,000-seat theater, office space, apartments, hotels, shops and restaurants. Owner-developed entertainment districts like Hollywood Park provide complementary revenue sources for team owners and a growing opportunity to capitalize on soaring real estate valuations in the U.S. As noted by Victor Matheson, an economics professor at College of the Holy Cross in Massachusetts, "having an entertainment district that generates money 365 days a year is way better than the model of a walled fortress surrounded by a moat of parking lots" that is used a handful of times a year. "NFL parking lots are about the worst possible use of real estate you can think of," he adds. "You'd much rather have a stadium in a dense area where you can generate money all the time" (see article here).

Tax Advantages and Estate Planning. In addition to the vanity perks of team ownership, there are several tax advantages that can be beneficial to high net worth individuals and families and make team ownership a tax-efficient income tax planning tool. With proper structuring, the purchaser of a sports team can generally amortize the purchase price over time to offset the purchaser's income in the following years. This includes the purchase price attributable to tangible assets such as stadiums (if privately owned), practice/office facilities, equipment and vehicles, as well as intangible assets such as goodwill, all of which can significantly reduce taxable income or create tax losses for new owners for years after their purchase. The greatest advantage may be the ability to amortize the value of players' contracts purchased with a sports franchise, potentially allowing the owners to both deduct the salaries paid as operating expenses and amortize the contract's value over the contract term. Note, however, that the IRS has signaled it will step up scrutiny of partnerships in the sports industry that report significant tax losses and review whether the income and deductions causing the losses are reported in accordance with the tax rules.

High net worth individuals and families should consider essential estate planning methods for ensuring tax efficiency and avoiding family disputes after the sports team owner's death, which may include making lifetime gifts to irrevocable trusts and/or using family limited partnerships or limited liability companies (LLCs) to mitigate estate and gift taxes on skyrocketing franchise values and planning for paying estate tax liabilities without needing to sell equity interests of the franchise. Leagues may also require a succession plan to address transfer of ownership when an owner dies, and heirs of owners should be prepared to work with the league's organization to gain approval and facilitate transfers of team ownership after death. Early preparation and communication among family members, other beneficiaries and the league will be crucial for streamlining the transfer process.

Navigating the Challenges

Long-Term Investment Horizon. Potential investors should appreciate that sports team investments often don't yield dividends or regular distributions like traditional investments do. Typically, the value of a sports team is not fully recognized or realized until a team enters into a sale process and begins to receive bids from prospective buyers. Investors should carefully consider their investment horizons given that returns may not be seen until the sale of the team.

Fan and Media Scrutiny. Along with the highs of professional team ownership can also come the lows. Owners tend to face intense fan and media scrutiny in connection with the team's performance, coaching personnel decisions and player personnel management. Such scrutiny can thrust investors (and perhaps their families) into the media spotlight.

Owners of sports teams also are facing greater scrutiny regarding potential sources of funding and any favorable tax treatment received in connection with building or renovating stadiums and arenas in which their teams play, including resistance from residents and local politicians, as has happened with the Kansas City Chiefs (see here) and the Chicago Bears (see here).

The Final Drive

For high net worth individuals and families, investing in a sports franchise is a unique opportunity that can provide tremendous financial upsides along with great intangible benefits. If an investor can get past the velvet ropes, raise the necessary capital, sustain the long-term investment horizon and weather the emotional ups and downs of asset performance, the rewards can be significant.

Family Office Corner: Family Foundations, Impact Investing and the Tax Laws

While family foundations commonly advance their charitable missions through their grant-making, many are exploring how to make a similar impact through their investments. Harvard Business School's Project on Impact Investing notes that "impact investing has become a central, rapidly expanding part of the investment landscape in the United States and across the world."

Family foundations are embracing this new landscape, and the federal tax laws provide quite a bit of flexibility for them to engage, particularly with respect to so-called program-related investments, which are treated similarly to grants. The following explores the tools available to family foundations that are contemplating impact investments and the associated tax law considerations.

What Are Impact Investments?

The Global Impact Investing Network, a network of organizations dedicated to increasing the scale and effectiveness of impact investing around the world, defines impact investments as those "made with the intention to generate positive, measurable social and environmental impact alongside a financial return." Foundation impact investing can take a variety of forms, including socially responsible investing through the use of investment screens, mission-related investments and program-related investments.

Socially Responsible Investing and Screens

Screens are essentially filters that help identify acceptable investments based on established parameters. Foundations can invest for impact by using mission-aligned screens to determine which companies or sectors should or should not be included in their investment portfolios. For example, a foundation focused on combating climate change could use a negative screen to construct an investment portfolio that prevents the foundation from investing in the oil and gas industry. Alternatively, a foundation may work with an investment advisor to implement positive screens that enable the foundation to build an investment portfolio with companies that have strong reputations for their governance, environmental and/or labor practices.

Mission-Related Investments and Program-Related Investments

In addition to screens, a family foundation may identify specific impact investment opportunities and then structure them as mission-related investments or program-related investments.

Mission-Related Investments. Mission-related investments are subject to all the same tax law considerations as a foundation's traditional investments, including the rules on prudent investing and the unrelated business income tax. The mission focus, however, enables a foundation to still meet prudent investing standards even if the financial returns are slightly lower than those of traditional investments in the portfolio. As a mission-related investment, a foundation may decide to invest, for example, in a fund exclusively supporting early-stage companies focused on clean technology, renewable energy and sustainable living. Although for-profit investors are also investing in the fund and there is a strong potential for financial upside, there is investment risk associated with startup companies. Accordingly, a foundation may decide to characterize this investment as mission-related to clarify that the mission tie provides the basis for investment prudence despite the associated risk.

Program-Related Investments. Unlike mission-aligned screening programs and mission-related investments, program-related investments fall outside the prudent investing standards, allowing a foundation to take on even greater risk. They can be made in a variety of forms—including loans, equity and convertible debt—and to various types of entities, including other 501(c)(3) organizations and startup companies. To qualify under the tax rules, the investment must satisfy the requirements of Internal Revenue Code (IRC) Section 4944(c), which defines "program-related investment" as an investment that (1) has as its primary objective the accomplishing of one or more charitable purposes, (2) does not have as a significant purpose the production of income or the appreciation of property and (3) does not participate in or seek to accomplish lobbying or campaign activities. Foundations also must impose obligations on a program-related investment recipient to ensure compliance with these requirements.

So, for example, if a foundation supports higher education access for low-income communities, it could make an equity investment in a startup company providing tutoring software to community colleges. However, to ensure that this investment advances the foundation's charitable purposes, the foundation would need to enter into a side letter with the company requiring that the tutoring platform be made available for free to community colleges located in low-income communities.

Tax Law Considerations

The primary tax law consideration in impact investing is avoiding "jeopardizing investments"—investments that jeopardize the carrying out of the foundation's tax-exempt purposes, which are subject to a 10% excise tax on the invested amount. The Treasury regulations provide that an investment jeopardizes the carrying out of a foundation's tax-exempt purposes if the foundation managers, "in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes." IRS guidance relies on state law for evaluating prudence, so foundations should ensure that their impact investments meet applicable state standards.

In this regard, program-related investments receive more favorable tax treatment in certain aspects compared with mission-related investments and those involving mission-aligned screens. For example:

- Program-related investments fall under an exception to the excise tax on jeopardizing investments and also are often eligible for a similar exception to prudent investing standards under state laws.
- Program-related investments are treated like grants, and the amount of a program-related investment is excluded from the definition of "net investment income" that is subject to tax under IRC Section 4940.
- With the exception of recaptures, program-related investments are not counted in the calculation of a foundation's payout requirement under IRC Section 4942 and are treated as qualifying distributions for these purposes.
- Program-related investments are not subject to the tax on excess business holdings under IRC Section 4943.

Foundations, however, must exercise "expenditure responsibility" over program-related investments made to recipients that are not Section 501(c)(3) public charities. Expenditure responsibility generally requires the foundation to (1) see that the grant is spent solely for the purpose for which it is made, (2) obtain full and complete reports from the recipient on how the funds are spent and (3) make full and detailed reports on the program-related investment to the IRS. The expenditure responsibility rules also require foundations to enter into an agreement with the recipient of a program-related investment that must include specific obligations regarding the use, recordkeeping and reporting of the foundation's funds.

Developing an Impact Investing Program

Family foundations seeking to develop an impact investing program should consult with outside advisers, including investment advisers and legal counsel, to ensure that impact investments are evaluated and made in the context of the foundation's overall investment portfolio. Additional steps for creating and implementing an impact investment approach also should include the following:

- The foundation's board of directors (or board of trustees) and its investment committee, as applicable, should make the decision to engage in impact investing and ensure the decision is addressed in the foundation's investment policy.
- The foundation should develop a process and document its procedures for evaluating opportunities, tracking the impact investments and ensuring compliance with the tax laws and any applicable state law prudent investing standards.
- The foundation should follow the same due diligence procedures for impact investments that it uses for traditional investments, while incorporating additional measures to address mission ties and/or the advancement of charitable purposes. For program-related investments, the foundation should coordinate its consideration of these investments with the determination that, as program-related investments, they fall outside the foundation's traditional investment standards. This determination helps demonstrate that, as required by the tax laws, no significant purpose of the program-related investment is the production of income or the appreciation of property.

- The foundation may want to develop template documents, such as loan agreements or side letters, to ensure that it appropriately addresses the various tax law considerations.
- The foundation may consider obtaining a tax opinion that an investment qualifies as a program-related investment. Reliance on such an opinion can provide a basis for the foundation to avoid excise taxes under IRC Section 4944(a) if the IRS subsequently determines on audit that the investment did not qualify as a program-related investment.

Finally, as family foundations embrace impact investing, the sponsoring organizations of donor-advised funds are also increasingly supportive of impact investing and should be consulted regarding any interest in employing impact investing strategies through a donor-advised fund.

Charitable Planning – How to Check Tax-Exempt Status

Knowing the tax (or tax-exempt) status and public charity classification of an organization is crucial when selecting grantees to receive charitable funds from a private foundation, distributions from a donor-advised fund or tax-deductible charitable contributions from individuals. Grant-makers and donors should always confirm this status before making the grant or donation. There are various ways to check a charity's tax-exempt status and access other information about the charity, such as its recent IRS returns or copies of its tax-exempt determination letter.

Go to the Source

Potential donors and grant-making foundations can always contact a charity directly to ask for written confirmation of its current tax-exempt status or a copy of its tax-exempt determination letter or initial exemption application, which the organization is required to share under the tax code. Often, a charity's mission, programs and/or operations will have evolved over the years since the exemption application was filed, so it may be more useful to request copies of the charity's recently filed IRS information returns, such as Form 990, 990-EZ, 990-PF and 990-T. In addition to the exemption application, a charity is required to provide its three most recent information returns upon request.

In the context of a formal grant application, these requests are routine. For individual donors or for funders who prefer to conduct initial due diligence before engaging directly with a charity, there are some easy and efficient ways to check public sources for the same information.

Use IRS Search Tools

The IRS' Tax-Exempt Organization Search (TEOS) will confirm whether a charity is in the IRS Publication 78 Data (Pub. 78), which lists organizations that can receive tax-deductible contributions. Under the tax rules, users may rely on Pub. 78 to determine the deductibility of their contributions. Note that certain eligible donees—such as churches, subordinates exempted through a group exemption and governmental units—may not be listed, so their exempt status may need to be confirmed directly. TEOS also allows users to view a charity's recently filed Form 990s and determination letters issued since Jan. 1, 2014. Alternatively, users can request copies of charitable returns or determination letters that are not available on the IRS website by filing Form 4506-A (by mail or fax) or Form 4506-B (by email) with the IRS, although it will likely be easier to request this information directly from the charity. For more detailed information about a charity, you can also search the IRS Business Master File (BMF), available via a link on the IRS website.

Check Privately Run Sites

The IRS tools can be cumbersome to navigate, so for a quick check of a charity's recent data and Form 990s, many donors and funders refer to Candid.org's site, Guidestar, which is itself a nonprofit platform. There you can access financial and governance information about every nonprofit organization in IRS Pub. 78 and view their Form 990s. For a subscription fee, donors and funders can use Guidestar's Charity Check service to obtain a time-stamped report confirming an organization's current status in IRS Pub. 78 and the IRS BMF and to check whether the charity is listed on the Automatic Revocation List. Charity Check also will confirm the organization's Office of Foreign Assets Control (OFAC) status.

In addition, ProPublica.org, an investigative journalism platform, offers Nonprofit Explorer, a public, searchable database of Form 990s.

For donors/funders seeking more in-depth analysis about charities, various nonprofit sector organizations rate charities based on measures such as performance/impact, leadership and governance, financial accountability and stewardship, transparency in fundraising, and organizational culture. Charity Navigator and Better Business Bureau's Wise Giving Alliance are two such ratings platforms that may be helpful.

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