# 16 Regulation of Impact Investing by Foundations

## The Swiss and US Perspectives

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### 1 Introduction

The notion of impact has propelled the philanthropic sector toward strategic philanthropy (Kania et al., 2014), characterized by pursuing greater social efficiency and adopting business practices within philanthropy (Neri-Castracane, 2019).

It has been recognized that individuals and entities can leverage their assets to generate a positive impact rather than solely relying on donations or charitable activities in the field. This realization has brought impact investing to the forefront, constituting a burgeoning market. The global impact investing market is estimated to have reached $1.16 trillion in 2022 (Hand et al., 2022), while estimations for Switzerland reached CHF 182 billion in 2022, with an 80% increase (Busch et al., 2023). The Global Impact Investing Network (GIIN) defines impact investments as "*investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return*." These investments can span both emerging and developed markets, aiming for various levels of returns from below-market to market rate, depending on investors' strategic objectives. Impact investments are instrumental in mobilizing private capital at scale for the betterment of both people and the planet, aligning with SDGs 17.3 and 17.5 (United Nations (General Assembly), 2015).

Market players are working to establish definitions that distinguish between sustainable and impact investments. This self-regulation is still evolving, with workable definitions under construction at both national and European levels. For example, the Eurosif White Paper on ESG and sustainable investment classification includes two categories pertinent to impact investment. Impact-aligned refers to investment in companies that have already realized positive company impact, and impact-generating relates to investments that directly create an impact, including both increasing positive or decreasing negative impact (Busch et al., 2022). The Asset Management Association Switzerland (AMAS) issued a self-regulation defining impact investing that stresses:

> [i]mportant differentiating factors from other forms of sustainable investments (namely thematic investments) are the intentionality of an

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> investment in a sector or an activity that has such a positive impact; the management process that allows for a direct impact or an impact approach; and the measurability of the impact (depending on the asset class) through relevant key performance indicators (KPIs).
>
> (AMAS Self-regulation on transparency and disclosure for sustainability-related collective assets (version 2.0), Appendix 1, e)

However, market players must redefine the definition to distinguish between sustainable and impact investments.

Philanthropic entities are also being called upon to participate in these collective endeavors, with foundations being a focal point. Foundations are the sole establishment with no members (or partners) under Swiss law (Art. 80 to 89a of the Swiss Civil Code). They serve as a typical legal form of organization for charitable activities and remain the most utilized vehicle in Switzerland (Opel, 2024). They are, however, not the only legal form of organization that may pursue a nonprofit charitable purpose (Opel, 2024; Neri-Castracane, 2023a).

Although foundations are certainly a major category of philanthropic actors in the U.S., the foundation is not a legal form of organization under US law. A foundation may instead take the legal form of either a nonprofit corporation or a charitable trust (Brody, 2005), and this choice of legal form determines the requirements and procedures for its governance. The nonprofit corporate and charitable trust regimes exist under state rather than national law, though the law across states can be generalized for present purposes. Federal tax law also uses the term "private foundation" to classify a subset of nonprofit, tax-exempt entities eligible for tax-deductible contributions (I.R.C. § 509). This private foundation classification will ordinarily apply to any nonprofit corporation or charitable entity tracing its assets to a single or small group of donors and pursuing its charitable mission primarily through grantmaking rather than operating its own charitable programs (Brakman Reiser & Dean, 2023). To ease the comparative project of this chapter, discussions of foundations under US law refer more precisely to private foundations organized as nonprofit corporations or charitable trusts.

This chapter presents the relevant legal frameworks for asset management of Swiss and US foundations and identifies those components that create challenges for impact investing.

## 2 Perpetuity of Foundations: A Possibility or a Principle?

### *2.1 Perspectives from Switzerland*

Under Swiss foundation law, perpetual existence is traditionally assumed in the absence of explicit directives regarding duration or capital usage in the incorporation deed. This assumption has been reinforced by a Swiss Supreme

Court ruling, which enshrines capital preservation as a fundamental principle of foundation asset management, to be applied to ensure the lasting fulfillment of the foundation's purpose (ATF 108 II 352, c. 5).

Scholars hold differing opinions regarding capital preservation when the deed is silent. One group advocates for the permanent dedication of the foundation's capital to its specific purpose, thereby advocating for perpetual existence (Riemer, 2020; Jakob, 2013). Conversely, a more recent school of thought prioritizes the fulfillment of the foundation's purpose (Grüninger, 2022; Sprecher, 2023; Pfister, 2024; Müller-Rensmann, 2024), a perspective that emerged after the Swiss Supreme Court's jurisprudence.

Both the Federal Act on the Federal Direct Tax (FDTA) and the Federal Act on the Harmonization of Direct Taxes of Cantons and Municipalities (FTHA) stipulate that tax exemption remains feasible provided that the primary purpose is charitable and does not mandate perpetual existence. These laws also address two key characteristics of charitable organizations (including foundations). First, they require effective allocation of capital and profits to charitable purposes (FDTA 56 let. g; FTHA 23 para. 1 let. f; AFC Circ. 12 sec. 2), impacting the foundation's lifespan. The absence of a fixed percentage for annual disbursement allows for flexibility, permitting assets to be retained in years when necessary for long-term projects or significant spending.

In addition, federal tax law mandates that the assets of charitable tax-exempt entities, including foundations, remain dedicated to charitable purposes upon dissolution. Organizations seeking tax-exempt status for charitable purposes must include provisions in their articles of association or incorporation deeds ensuring the transfer of remaining assets upon dissolution to a similarly purposed tax-exempt entity (AFC Crc. 12 sec. 2). However, no specific rule applies to foundations that have renounced their tax-exempt status over the years. This absence aligns with the notion that Swiss foundation law reflects a benevolent legislative approach (Pfister, 2024).

### *2.2 Perspectives from the United States*

For US foundations, perpetual life is not required, but it has long been the norm. In her comprehensive study of the question, Francie Ostrower found that only 8% of the 850 staffed private foundations chose to limit their lifetimes and reported similar findings in other studies available (Ostrower, 2009, 2011). Despite the predominance of perpetual foundations, foundations founded in recent decades have been far more likely to embrace limited lifespans than earlier established foundations (Rockefeller Philanthropy Advisors, 2020). Atlantic Philanthropies has perhaps been the highest-profile US limited life foundation; it distributed its final grants in 2016 (CEP, 2017) and has long been a leader in advocating for limiting the life of foundations to increase impact (Atlantic Philanthropies, 2024). Foundations' individual preferences and those of their donors will determine whether a shift in

approach occurs, as US law leaves the question of the foundation's lifetime entirely in their hands.

Whether a US foundation takes the nonprofit corporate or charitable trust does not impact its capacity to exist in perpetuity. Nonprofit corporate entities are, like other incorporated entities, perpetual by default. Enabling statutes presume that a nonprofit corporation will continue to exist until actively dissolved by action of its fiduciaries (Revised Model Nonprofit Corporation Act (RMNCA) §14.01), although its corporate charter and bylaws can impose a more limited life. At dissolution of a nonprofit corporation, notice (RMNCA §14.03) or approval (Restatement of the Law, Charitable Nonprofit Organizations §3.06) by government entities may be required.

The duration of a charitable trust is likewise presumptively perpetual (Brody, 2005). However, its founder, the "settlor" who donates assets to the trust for charitable purposes, may impose a timeline for its termination (Uniform Trust Code (UTC) §410). Moreover, the assets dedicated to a charitable trust are locked into the charitable stream. If a charitable trust terminates, assets dedicated to its charitable purposes will be transferred to another charitable entity under the *cy pres* doctrine (UTC §413). This is an important distinction between charitable and private trusts; for the latter, limitations on lifespan can apply (UTC §402). The requirement for the preservation of charitable assets is also applied to restricted assets held by nonprofit corporations and sometimes more broadly to nonprofit corporations' charitable assets overall (Brody, 2005).

While federal tax law governing private foundations likewise imposes no mandate regarding foundation perpetuity, its provisions impact norms and practices around foundations' lifetimes. Foundations are subject to a payout requirement, under which they must distribute roughly 5% of their assets each year (I.R.C §4942). This requirement ensures that assets donated to private foundations, which qualify for tax deductions under federal income and transfer taxation (I.R.C. §§170(c), 2055, 2522), are, in fact, distributed for use in operating charitable programs, rather than held in perpetual limbo. Foundations are free to distribute more than 5% of their assets per year, and those choosing a limited lifetime will need to do so, but the floor has, for many in the sector, become a de facto ceiling (Galle, 2016). The payout requirement was imposed under 1969 legislation that created a specialized regulatory regime applicable only to private foundations, other components of which will be discussed further below.

Federal tax law also requires the assets of charitable tax-exempt entities, including foundations, to remain dedicated to charitable purposes on dissolution.

> [A]n organization does not meet the organizational test [for charitable tax exemption] if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.
>
> (Treas. Reg. §1.501(c)(3)-1(b)(4))

Moreover, assets of foundations that terminate without preserving their assets for charitable purposes are subject to a confiscatory tax (I.R.C. §507). These provisions align with restrictions on charitable asset distribution imposed under nonprofit corporate and charitable trust laws in most states.

## 3 The Risk/Return Profile

### *3.1 Perspectives from Switzerland*

In the absence of legal provisions on foundation asset management, Swiss jurisprudence has only established negative criteria by prohibiting speculative or overly risky investments (ATF 108 II 352, c. 5). Unless provided otherwise in the deed, Swiss foundations must be managed in the manner of a relatively prudent investor, with latitude given to the board of directors to take certain investment risks.

When investing foundation assets, and unless specified otherwise in the deed, the principles of liquidity, return, security, risk diversification, and asset preservation must be considered (ATF 108 II 352, c. 5). Acknowledging the possible contradiction of these principles, the Swiss Supreme Court confirmed that they must be applied in consideration of all circumstances in a manner that ensures lasting respect for the purpose of the foundation and that the principle of proportionality must also be observed (ATF 108 II 352, c. 5). With this acknowledgment, the Swiss Supreme Court applied to foundations' boards an investment judgment rule, under the control of the supervisory authority (Art. 84 para. 2 Swiss Civil Code), to operate as would an investor in a range between a very prudent and relatively prudent investor.

The type of investments and associated percentage limits authorized by law for Swiss pension funds, as outlined in Art. 49 et seq. of the Ordinance on Occupational Retirement, Survivors, and Disability Pension Plans (OPP2), are recommended as a compass by the Swiss Supreme Court (ATF 124 III 97, c. 2c). The fiduciary duty incumbent upon Swiss pension funds, which entails a responsibility to secure capital over the long-term for the benefit of the investee, is not present in ordinary funds. Consequently, the stringent regulations applicable to Swiss pension funds are not directly applicable by analogy to ordinary foundations; instead, they may only serve as a guiding framework.

The latitude of the foundation board to deviate from the return principle in the absence of specifications in the deed is further shaped by the scholarly debate on capital preservation. Advocates emphasizing the importance of the capital dedication requirement argue that in the absence of any specifications in the deed regarding capital preservation or authorization to utilize it, the capital remains untouchable, and only accrued benefits are available for investment (Riemer, 2020; Jakob, 2013). Conversely, proponents of the view that the foundation's purpose is paramount permit the use of capital for the intended purpose within the discretion of the board (Grüninger, 2022; Sprecher, 2023; Pfister, 2024; Müller-Rensmann, 2024). Within this

perspective, investments with lower returns, for which such lower returns were anticipated, can be linked to the utilization of the foundation's assets. This latter perspective could find support in tax legislation, as tax exemption on capital is granted only for capital "*exclusively and irrevocably allocated to these [public service or public utility] purposes*" (FDTA 56 let. g; FTHA 23 para. 1 let. f). Investing in high-return sectors might align with the prudent investor approach from a financial standpoint, but a direct capital allocation to this objective could conflict with the public utility objective. Currently, this perspective lacks support from case law and tax authorities.

### *3.2 Perspectives from the United States*

US foundation assets must be managed in the manner of a prudent investor. Historically, this sometimes meant that the investment of charitable funds, including those held by foundations, was subject to investment-by-investment review and even barred from particular investment vehicles. Modern US law, however, applies the prudent investor standard with respect to a foundation's overall investment portfolio (Restatement of the Law of Charitable Nonprofit Organizations §2.04(b)). Each investment should be considered in light of how its risk and return profile will affect this portfolio, taking into account the value of diversification.

State organizational law imposes prudence mandates regarding foundation investments through the fiduciary obligations applicable to foundation managers. Again, the legal form adopted by a particular foundation will determine the source of these mandates, though the origins of the prudent investor concept lie in trust law. Trustees (including trustees of charitable trusts) are fiduciaries bound "*to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust*" (Restatement of the Law, Third, Charitable Trusts, §90). Nonprofit corporate directors and officers face prudent investor mandates as well. Indeed, the widespread adoption of uniform statutes imposing largely overlapping trust and corporate duties of prudence with respect to the investment of charitable assets has resulted in near complete convergence (Restatement of the Law of Charitable Nonprofit Organizations § 2.04, cmt. b). Whether they serve an incorporated foundation or one formed as a charitable trust, act directly or through prudent delegation to investment managers or to other experts (UPIA §9; UPMIFA §5; UTC §807), state organizational law demands that US foundation leaders invest prudently, considering risk and return across a diversified portfolio of assets.

Federal tax law, too, embraces the mantra of prudence. One of the many regulations targeting foundation practices is the so-called "jeopardizing investment rule." This rule imposes penalty taxes on foundations and their managers that "*invest[ ] any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes*" (I.R.C. §4944). An offending

organization can be taxed 10% of the jeopardizing investment initially, with an additional 25% tax if the "*investment is not removed from jeopardy*" (I.R.C. §4944(a)(1), (b)(1)). Foundation managers who participate in jeopardizing investments can be taxed 10% of the offending investment as well. While fearsome on the page, in practice, compliance with state law fiduciary obligations for prudent investment should prevent the application of these penalties (Treas. Reg. §53.4944-1(a)(2)(i)).

This overlap has led some commentators to argue that the jeopardizing investment rule is of little moment (Schmalbeck, 2004), though its single exception, for "program-related investments" or PRIs, has had somewhat greater influence. The tax code defines PRIs as "*investments, the primary purpose of which is to accomplish one or more [charitable purposes], and no significant purpose of which is the production of income or the appreciation of property*" (I.R.C. §4944(c)). Although PRIs may carry greater risk and lesser return than alternatives, they avoid characterization as jeopardizing investments based on their design to achieve charitable purposes rather than generating financial returns (Treas. Reg. § 53.4944-3(a)(2)(i)). Treasury regulations offer a series of examples that clarify that regulators envision typical PRIs as investments unattractive to other investors and generating below-market returns (Treas. Reg. § 53.4944-3(b)).

Essentially, US tax law views program-related investments as closer to foundation grants than investments (Brakman Reiser & Dean, 2023). This perspective explains two further exceptions applicable to PRIs. Pivotally, program-related investments qualify toward the annual 5% payout requirements to which foundations are subject (Treas. Reg. §53.4942(a)-3(a)(2)). Even though a PRI may eventually generate a return, it is treated at its inception – dollar for dollar – as the equivalent of a grant to an operating charity that would generate a 100% loss. In addition, PRIs are exempt from federal tax law limiting the size of the stake a foundation may hold in any business entity (Treas. Reg. §53.4943-10(b)), to be discussed further in section 4.2 below.

Built on experiments undertaken by the Ford Foundation in the mid-twentieth century (Wimpee, 2019), the PRI exception written into the federal tax law in 1969 has come to define the field of investments intended to substitute for grantmaking in search of charitable gains. The field, however, has been slow to expand in practice. In his 2016 randomized sample of foundations with over 25 years of data available, Professor Galle found "*barely one-tenth of 1% of foundation assets [wa]s given over to these 'program-related investments'*" (Galle, 2016, p. 1198). High transaction costs frustrate PRI utilization due to both continuing regulatory uncertainty around which investments will qualify and the low deal size of many acceptable investments (Brakman Reiser, 2020). That said, an open empirical question remains regarding how many opportunities exist where investment will be a superior means to achieving charitable goals compared to grantmaking (Gunther, 2019b).

## 4 Investment in Equity and Restrictions on Business Holdings

### *4.1 Perspectives from Switzerland*

A 1987 Swiss Supreme Court decision made tax exemption for shareholder foundations contingent upon maintaining equity participation below 20% of shareholdings in a company. This restriction was abolished with the adoption of the third sentence of Art. 56 let. g of FDTA in 1990, a provision also mirrored in Art. 23 para. 1 let. f FTHA, which stipulates that tax exemption remains feasible provided that the primary purpose of public utility is not compromised by an overriding interest in preserving the company. Subsequently, case law acknowledged that even full ownership of a commercial enterprise by a shareholder entity may qualify for tax exemption if the primary purpose of public utility is upheld (ATF 147 III 287, c. 8.2).

Nevertheless, the Swiss Parliament introduced two specific prerequisites for tax exemption when a shareholder foundation holds a significant shareholding. These requirements include the subordinate position of the interest in preserving the company relative to the primary purpose of public utility and the foundation's abstention from managerial activities within the commercial entity.

In essence, while there exists no legal ceiling on the number or proportion of shares that a foundation may acquire as an equity investment in a commercial company, the acquisition of a significant shareholding – to be understood as a stake allowing control over the commercial company – triggers additional obligations under Swiss tax law. Compliance with these obligations necessitates notably the absence of managerial involvement by the foundation within the commercial entity, except for one individual designated to act as a liaison (AFC Circ. 12 sec. 2).

In reference to the second requirement stipulated by tax law concerning significant shareholding, a notable point of contention emerged from a controversial decision by the Swiss Supreme Court (ATF 147 III 287). This jurisprudence interpreted the subordinate position of interest in preserving the company as prohibiting financial interdependence between the foundation and the commercial entity. Consequently, this interpretation imposes constraints on certain investment strategies available to the foundation. However, this decision failed to convince many scholars, as it did not thoroughly analyze the legitimacy of the equity investment in light of private law requirements (Opel, 2021) and the principles of prudent investment, including the application of the business judgment rule to investments (Neri-Castracane, 2023b; Dorasamy & Tisma, 2023; Jakob, 2023). The emphasis on preserving the company was asserted without considering factors such as the absence of company over-indebtedness and the reasonableness of the investment in improving the financial stability of the investment target from the perspective of a prudent investor.

Presently, this jurisprudence effectively impedes the establishment of new shareholder foundations, with foundations holding more than 50% of the shares in commercial companies, despite being based on an incorrect

characterization of business preservation as an economic purpose (Riemer, 2020; Panchaud, 2022; Neri-Castracane & Bottge, 2024).

### *4.2 Perspectives from the United States*

US state corporate and trust law imposes no specific restrictions on foundation business holdings, but federal tax law does. Like all federal tax law limitations on foundation practices, these restrictions operate through penalty taxes, which apply if foundations fail to follow them. The so-called "excess business holding" rules impose a 10% penalty tax on any stake a foundation holds in an individual business beyond the "permitted holdings" level (I.R.C. §4943), generally 20% of an investee corporation's voting stock. This initial 10% tax, however, is only the first cut. If a foundation fails to divest itself of its holdings above the permitted level, a second confiscatory tax of 200% of the holdings applies. This tax is so high that it essentially forces divestment. Disincentivizing foundations from amassing significant stakes in business firms is another way to reduce potential losses from poor investment choices (Brakman Reiser, 2020). It also avoids distracting foundation leaders from their charitable missions and limits opportunities for self-dealing in leaders' related firms. *Id.*

The nuances of these rules clarify that the concerns behind them lie with mission drift and the entanglement of foundations and their leaders with the businesses in which they invest. As mentioned earlier, the excess business holding penalties do not apply to program-related investments. A new exception created in 2018 after years of lobbying waives the entire regime when foundations receive 100% ownership of a business enterprise through inheritance or other gifts and the business and foundation operate independently (I.R.C. §4943(g)). The category of permitted holdings also counts not only the foundation's direct holdings but also those of substantial contributors, foundation managers, members of their families, and related parties (including related foundations) (I.R.C. §4943 (c)(2)). Moreover, if a private foundation can establish "*that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation*," the ceiling on permitted holdings rises substantially to 35% of investee entities (I.R.C. §4943 (c)(2)(B)).

## 5 Investment as a Commercial Activity

### *5.1 Perspectives from Switzerland*

While foundation law does not pose any obstacle for foundations to pursue commercial activities, tax law concerning public utility tax exemption does. Under the requirement of the primacy of exempt purpose, tax authorities mandate that any commercial activity remains ancillary to the foundation's primary purpose. A non-ancillary commercial activity suggests a for-profit purpose and distorts competition, thereby impeding tax exemption (Peter & Merkt, 2019).

There is no definitive threshold beyond which a commercial activity transitions from ancillary to non-ancillary. Swiss courts generally acknowledge that once a commercial activity contributes more than 50% of the total revenue, it is considered non-ancillary. Consequently, while the principle of yield incentivizes foundations to invest in assets generating returns, tax regulations may either encourage investments with low returns or discourage investments that would result in revenues surpassing donations and subsidies. It is noteworthy that this rule is inapplicable to grantmaking foundations, where revenues should be compared with expenditures. However, Swiss law lacks a spending rule and merely prohibits hoarding when tax exemption is granted.

Similarly to the qualification of business preservation as a commercial purpose, the classification of equity or debt investment of a tax-exempt entity's own assets as a commercial activity is subject to debate. Scholarly opinion (Panchaud, 2022; Opel, 2023; Müller-Rensmann, 2024) contends that managing such assets does not constitute a commercial activity. This perspective finds support in a recent case from the Federal Administrative Court, appealed to the Swiss Supreme Court (BVGer, 1.12.2023, A-865/2021, c. 3.2.3.1). The issue holds significant sensitivity for the Swiss tax administration.

Another proposal underlying the Zurich tax administration's stance on entrepreneurial support by foundations (see below 6.1.) is that entrepreneurial support (impact investing) is an activity (investment) within the framework of purpose implementation and support, not asset management whose fundamental goal is to generate a market-standard return (Opel, 2023; Sprecher, 2024).

Until now, Swiss case law and tax authorities have generally viewed investments of a substantial portion of a tax-exempt entity's assets as either having a commercial purpose or constituting a non-ancillary commercial activity rather than being solely for asset management or purpose implementation. Decision ATA/1254/2019 of the Geneva Court of Justice is an illustration of an investment in real estate. The impact of the new Zurich tax administration remains uncertain.

### *5.2 Perspectives from the United States*

As with business holdings, tax law rather than state organizational law dominates restrictions on business activities by US foundations. Nonprofit corporations and charitable trust law typically permit formation for a broad set of "lawful purposes" (RMNCA §3.01; UTC §494), rarely restricting these organizations from conducting businesses and sometimes explicitly empowering them to do so (RMNCA §3.02(16)). In contrast, property tax exemption, which also operates at the state rather than federal level, takes pains to avoid the extension of this benefit to properties used for commercial purposes by charitable entities (Gallagher, 2002).

Federal income tax law provides charitable exempt organizations must be organized "exclusively" (§1.501(c)(3)-1(a)(1)) for "*religious, charitable,*

*scientific, testing for public safety, literary, or educational purposes*," or to foster amateur sports or prevent cruelty to children or animals (I.R.C. §501(c)(3)). Regulations further instruct that an organization "*will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes*" (Treas. Reg. §1.501(c)(3)-1(c)(1)) but preclude charitable tax exemption for entities found overly "commercial" (Colombo, 2007). Moreover, the "unrelated business income" of otherwise tax-exempt charitable organizations is subject to tax at ordinary trust or corporate rates (I.R.C. §§511–13).

The unrelated business income tax (UBIT) is the most important constraint for typical foundations. As their charitable activities are largely confined to grantmaking, they ordinarily conduct no direct operations – business or otherwise – blunting concerns about crossing the commerciality line. Nevertheless, UBIT taxes all income derived from "*any trade or business*" (I.R.C. §511) "*regularly carried on*" (I.R.C. §512) and "*not substantially related to*" (I.R.C. §513) the foundation's charitable purposes.

Trade or business under UBIT is defined broadly enough to include a foundation's investing program, but a key exception protects income derived from investments unless those investments are debt-financed (I.R.C. §512(b)(1), (4)). Combined with their reliance on leverage, the pass-through tax structure utilized by private equity funds, hedge funds, and similar investment vehicles means direct investments of these types will often be treated as debt-financed and, therefore, taxable under UBIT (Silber & Wei, 2015). Rather than eliminating this entire asset class, foundations frequently rely on a so-called "blocker," a corporate entity organized and funded by the foundation in a zero- or low-tax foreign jurisdiction. When the blocker, rather than the foundation, makes and receives income from the desired investment, the income can then be transmitted to the foundation with the taint of debt financing removed. The blocker technique provides a useful, though imperfect, workaround. It functions most tax-effectively with offshore investments and requires additional expenditures to create and maintain the separate blocker entity (Silber & Wie, 2015).

## 6 The Pursuit of the Philanthropic Purpose through Investments

### *6.1 Perspectives from Switzerland*

Swiss law does not preclude ordinary foundations from making any particular type of investment. Debt, equity, and hybrid investments are permissible for Swiss foundations; however, tax laws impose additional criteria. For debt investments, compliance necessitates the absence of conflicts of interest, thereby prohibiting loans to members of the foundation's board (as per ATF 131 II 1; TF, 2C_385/2020 of June 25, 2020, c. 5.3.2). On the other hand, equity investments must adhere to the business holding restrictions (see above 4.1). Any investment must avoid being qualified as a commercial activity.

Aligning investments with the mission (or purpose) of a foundation has long been neglected in investment approaches, even though the Swiss Supreme Court provided that investment principles must be applied to ensure the "*lasting respect of the purpose of the foundation*" (ATF 108 II 352, c. 5).

Support toward the mission alignment of investment and program-related investments has found an echo in soft law instruments, notably the Swiss Foundation Code (SFC, 2021). This code provides governance best practices for foundations as well as Norm 15 of the Zewo quality seal for nonprofit organizations. Written by supporters of the perpetual life presumption of foundations, SFC 2021 recommendations 24 and 25 attempt to bridge the asset management principles developed by the Swiss Supreme Court with the primacy of the purpose. Recommendation 24 insists on the importance of impact, providing that:

> *In addition to general investment principles and the legal and financial framework, the foundation board also takes the foundation's overall impact into consideration. […] Everything that a foundation does forms part of a cohesive whole. Its grant-making activities, asset management and administration combine to produce an overall impact. That is why its asset management activities cannot simply be based on conventional investment principles, such as asset preservation and returns, but must also strive to make an additional impact. This can be done using mission-based and sustainable investments in particular.*

while recommendation 25 stresses the key role of the board of directors in ensuring alignment with the mission, as it states:

> *It specifies whether and, if so, how assets should be used to implement the foundation purpose (mission-based investments). It at least ensures that no investments contradict the foundation's purpose. […] In the case of mission-based investments that do not generate a return that is typical for the market, the foundation board must define how it expects the investment to contribute to fulfillment of the foundation purpose in order to make up for potential loss of returns in comparison to conventional investments, and therefore justify the relevance of the investment to the foundation purpose. If an asset generates a reduced return or even a loss, the standard that must be applied to the mission-based investment as a grant benefit is that the foundation purpose could not have been implemented more effectively using the lost return or income through other forms of funding.*

Impact investing strategies were initially introduced by foundations (Clarkin & Cangioni, 2016), and UBS Optimus Foundation decided to adopt this approach. However, due to the absence of explicit provisions in its deed, the foundation was compelled to negotiate with regulatory and tax authorities.

The Zurich tax administration introduced new regulations in 2024, making a clear distinction between venture philanthropy investment approaches and Mission-Related Investments (MRIs) and Program-Related Investments (PRIs). This distinction delineates "entrepreneurial funding models" (representing venture philanthropy, i.e., support to social enterprises) and "more traditional investment modes" like MRIs and PRIs. The former category comprises grants that resemble financial outlays in the foundation's financial records, with no anticipation of return. The underlying rationale asserts that investments characterized by an inherent *à fonds perdu nature* lack a for-profit motive at the time of investment.

In light of this differentiation, the Zurich tax administration clarified that "entrepreneurial funding models" such as loans (including social impact bonds and development impact bonds), participations, and convertible loans do not preclude tax exemption, even if there is potential for a return flow of funds to the nonprofit institution. However, it is incumbent upon the foundation to demonstrate that the funds are allocated to areas lacking a viable market, thereby facilitating investments that profit-oriented entities would not undertake. This codification reflects a particular understanding of the criteria of additionality, which are recognized as essential characteristics of impact investing (Hockerts et al., 2022; Brest & Born, 2013; Bugg-Levine & Emerson, 2011). Additionally, such investments are restricted to the scope of the foundation's actual support activities, and the funds returned must be used again for charitable purposes. The new regulations do not provide specific details about the beneficiaries despite implying that they should be social enterprises. The Zurich directive permits program-related investments but does not encompass impact investing in a broader context.

### *6.2 Perspectives from the United States*

Modern US law does not preclude foundations from making any particular type of investment. Instead, as noted above in section 3, state organizational and federal tax law requires foundation leaders to make each investment prudently, given its risk, return, and place within the entity's overall portfolio. That said, regulations elaborating on the regime for penalizing jeopardizing investments indicate "*trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of 'puts,' 'calls,' and 'straddles,' the purchase of warrants, and selling short*" will be more closely examined for compliance with these rules (Treas. Reg. § 53.4944-1(a)(2)(i)), and therefore warrant additional caution.

US law also answers the question of whether a foundation may – or indeed should – align its investment with its charitable mission largely through the lens of its prudent investing mandates. Recent updates to state and federal law clarify the permissibility of the practice, often called mission-related investing, to distinguish it from the narrower PRI concept, but do not mandate it (Brakman Reiser, 2020). Instead, each foundation is left to decide

what portion, if any, of its endowment it will use to pursue its charitable goals and how it will do so. In doing so, foundation fiduciaries must confront the fact that MRI can involve trade-offs between value alignment and risk-adjusted financial return and can also impact the ability to diversify. Without the statutory carveout available for PRIs, the excess business holdings rules (I.R.C. §4943) discussed in section 4.2 can impose limits as well.

Reformulations and amendments have now resolved decades of uncertainty as to whether state organizational law permits fiduciaries of US foundations and other charitable organizations to engage in mission-related investing (Gary, 2011). Widely adopted uniform acts describing duties of prudent investment for charitable trustees and nonprofit directors make clear that the purposes of a charitable trust are a proper consideration in selecting investments (UPIA §2; UPMIFA §3(a)). Of course, the charitable purposes of the foundation – not the individual fiduciaries – are the key parameter. Investments designed to serve a fiduciary's own interests, whether financial or otherwise, will violate the duty of loyalty. The 2007 Restatement (Third) of Trusts clarified that mission-related investing by charitable trustees could comply with the duty of loyalty:

> *to the extent the charitable purposes would justify an expenditure of trust funds for the social issue or cause in question or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust.*
>
> (Restatement of the Law, Third, Trusts, cmt. c)

Furthermore, even if mission alignment is established, foundation fiduciaries must still carefully consider the risk and return profiles of mission-related investments, as well as their place within a diversified portfolio. Advances in socially responsible investing techniques may ease this process (Gary, 2011, 2019).

Clarity regarding mission-related investments' permissibility under the jeopardizing investment prohibition arrived in 2015 Treasury guidance. It advised that:

> *[w]hen exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes. 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 furtherance of the private foundation's charitable purposes.*
>
> (I.R.S. Notice 15–62, 2015, p. 3)

These changes surely relieved any remaining anxiety among MRI's early adopters (Brakman Reiser, 2020), and the Ford Foundation in part credited the increased clarity for its adoption of a new MRI commitment to shift up to one billion of its twelve-billion-dollar endowment to MRI over ten years (Walker, 2017). But while much discussed, US foundations have not undertaken widespread adoption of MRI (Parks, 2020; Gunther, 2019a). By the summer of 2020, a survey of 250 foundation leaders found that still, only 22% were actively considering changes to their investment practices using strategies like MRI and program-related investments (Dalberg, 2020). A 2024 study of 65 primarily US foundations with endowments between $11 million and $16 billion found "*just 5% of the investable assets held by foundations are being allocated to impact investments [defined to exclude PRIs]*" (Bridgespan Social Impact, 2024, p. 2).

## 7 Conclusion and Recommendations

### *7.1 Key Insights and Findings*

Without more regulatory encouragement or industry pressure to change, most US and Swiss foundations appear to be sticking with a century-old, bifurcated model of philanthropy. Foundations' grantmaking staffs give money away on one side of the house, while investment managers on the other side invest for maximal risk-adjusted return on the other, and never the twain shall meet.

The key distinction between the jurisdictions is their stance on the perpetuity of foundations, specifically their obligation to preserve capital. In the U.S., this principle remains operationally the default. Foundation founders can opt to spend down, but perpetuity will be presumed if they do not explicitly make and memorialize that choice. For the typical US foundation contending with a perpetuity imperative, the need to preserve the foundation's spending power into the future places at least some limits on the type and extent of program-related and mission-related investing in which they can engage. However, in Switzerland, although tax authorities firmly maintain that tax-exempt entities cannot deviate from the obligation to preserve capital, some scholars argue that this doctrine should be secondary to focusing on implementing the foundation's purpose. If accepted, this stance will provide greater flexibility to Swiss foundations seeking to engage in impact investing.

With the new clarity and openness to the practice, additional regulatory incentives or changes in industry norms could encourage foundations to explore the potential that MRI offers to make headway on their charitable goals with the 95% (in the U.S. or more in Switzerland) of assets they retain and invest.

Regulatory intervention could play a pivotal role in facilitating the expansion of this movement. Private foundations, particularly those that have already served as catalysts for change, such as UBS Optimus Foundation in Zurich, Switzerland, could also help drive this initiative forward.

Following private discussions, the Zurich tax authorities have pioneered new regulations in Switzerland, paving the way for foundations interested in engaging in this direction. However, such foundations must demonstrate their commitment to specific criteria. While this approach is currently exclusive to Zurich, other cantons may consider adjusting their practices to compete as philanthropic and impact hubs.

This contribution demonstrates that in the U.S. and Switzerland, the practice of impact investing often necessitates prior agreement with tax authorities. These procedures, which are costly in terms of time and money, will reduce the number of potential adopters. Otherwise, investments must be directed toward either minimally or unprofitable projects, which would instead be called expenditures. Without rethinking the primary characteristics of nonprofit organizations, especially their temporal dimension and the interaction between their purpose and assets, the phenomenon will likely remain marginal.

### *7.2 Future Directions and Areas for Further Research*

Regulatory clarity is an important, initial step toward expanding impact investing by foundations. Switzerland and the U.S. have recently made important gains toward this goal, but in each jurisdiction, more work remains. Swiss tax authorities have removed some obstacles but still need to define impact investing in workable terms, developing a definition that avoids reliance on undefined concepts such as social enterprises or the absence of a viable market. In the U.S., widely adopted uniform state laws and federal tax law accept that foundations have broad discretion to pursue impact investing, and the categories of program-related and mission-related investing provide helpful clarity. Yet, uptake remains limited. A fuller embrace of impact investing cannot be expected in either jurisdiction without reckoning with the underlying issue of foundation perpetuity and capital preservation, and may well require regulatory requirements or incentives beyond mere permission. Further research should explore the potential for such further regulatory interventions to encourage foundations to explore the benefits of MRIs and navigate the complex landscape of impact investing.

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