CHARITABLE GIFTS OF PRIVATE FUND INTERESTS

Supplemental Material for Exempt Organization Committee of the Taxation Section of the American Bar Association
Charitable Gifts of Private Fund Interests

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Exempt Organization Tax Diligence Checklist for Gifts of Private Fund Interests
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I. Legal Issues Common to 501(c)(3) Organizations:

A. Unrelated Business Income (“UBI”): Charity needs to follow the typical UBI analysis. To oversimplify: identify the type(s) of income that will pass through the investment fund to the charity’s return. If it is active, presumably UBI unless activity is sufficiently related to exempt purposes; if it is passive (dividend, rents, etc.), presumably not UBI unless it is debt-financed or if the investment fund is a controlled subsidiary of the charity. Specific issues that could come up in private fund context, include: (1) obtaining sufficient visibility into the fund to evaluate UBI likelihood prior to gift, (2) risk of fund-level borrowing in connection with portfolio investments that might turn passive income to debt-financed UBI, and (3) “phantom” UBI: charity recognizing UBI by virtue of lower-tier partnership interest, but not receiving distributions reflecting the income.

B. UPMIFA: Depending on size of charity receiving the gift, an interest in a private fund could present prudent investment and diversification issues. If the donor is expecting the charity to retain the donated interest, there are three basic choices: (1) do nothing, in which case the Uniform Prudent Management of Institutional Funds Act (UPMIFA) applies and a relatively small charity may be under pressure to diversify (if there’s no market for the interest, it may be a moot point), (2) have the donor impose a transfer restriction in the gift agreement, which relieves the pressure on the charity but should reduce the amount of the charitable contribution deduction (Rev. Rul. 2003-28), or (3) have the donor authorize retention of the asset, effectively opting out of UPMIFA, which means the charity still needs to evaluate retention based on the best interests of the charity, but is not subject to UPMIFA’s diversification requirements and can consider all relevant factors (e.g., keeping a major donor happy).

C. Qualified Appraisal: As with most gifts other than gifts of cash or publicly traded securities, the donor needs to secure a qualified appraisal from a qualified appraiser to receive a deduction for the donated private fund interest. These requirements can be found in the recently finalized regulations (Treas. Reg. 1.170A-17).

II. Tax Issues Specific to Private Non-Operating Foundations:

A. Charitable Contribution Deduction: A gift of a private fund interest to a private non-operating foundation results in a comparatively unfavorable deduction: the lesser of the taxpayer’s basis and fair market value, and only usable to the extent of 20% of the taxpayer’s adjusted gross income. Compare the result to a gift of a private fund interest to a private operating foundation or public charity (including a donor-advised fund) which results in a fair market value deduction usable to the extent of 30% of the taxpayer’s adjusted gross income. As such, if a donor is giving a private fund interest to a private non-operating foundation, instead of a private operating foundation or public
charity, the presumed income tax motivation is shifting appreciation/income to a tax-exempt vehicle prior to recognition.

III. Tax Issues Specific to Non-Operating Private Foundations and Private Operating Foundations (collectively, “PFs”):

A. Self-Dealing: Co-Investment with Disqualified Persons (“DPs”) (DPs own 35% or less of the fund and all portfolio companies): If the PF is receiving a gift of a private fund interest in which some of its DPs have ownership interests (but less than 35% in aggregate), the mere receipt and ownership of the interest is not an act of self-dealing, but there are guidelines from various private letter rulings to observe going forward: (1) the amount the DP pays in fees and costs should not be reduced as a result of the PF’s participation in the co-investment; (2) the DP’s investment should meet the fund’s minimum investment amounts without aggregating its and the PF’s investment; (3) purchase or sale of investments must not be an attempt to manipulate the price of investments to the advantage of a DP; (4) the investment return accruing to the DP should be unaffected by the PF’s participation; and (5) the DP should not advertise the PF’s participation or obtain any marketing benefit as a result of the PF’s participation.

B. Self-Dealing: Investment in a DP (DPs own more than 35% of the fund or a portfolio company): Receiving a direct or indirect interest in a fund or portfolio company that is itself a DP by virtue of DPs owning 35% or more of the profits interest or voting stock, respectively, creates a very high degree of risk for self-dealing. While the mere receipt of the gift may not be self-dealing, almost any subsequent direct or indirect transaction between the PF and the entity (e.g., paying fees, making a capital contribution, a redemption that does not meet an exception) is an act of self-dealing on its face. While the IRS has issued favorable rulings in the past that did not consider it an act of self-dealing to enter or exist an investment partnership that was a DP (e.g., PLR 200318069, PLR 200420029, and PLR 200551025), they are difficult to square with the text of Section 4941 and there is significant doubt that they reflect the IRS’s current position.

IV. Tax Issues Specific to Donor-Advised Funds

A. Section 4958 – Prohibition on Compensation to Donor-Advisors: What if the Donor is a Fund Manager? IRC Section 4958(c)(2) makes any “grant, loan, compensation, or similar payment” from a fund to a donor-advisor (or his or her family members or 35%-controlled entities) an automatic excess benefit transaction. In absence of guidance to contrary, one would presume that this rule does not extend to a DAF owning an interest in a private fund which compensates the donor-advisor as investment manager, as the language appears to contemplate a payment directly from the DAF. Also compare the language of IRC Section 4958(c)(2) above with the language in IRC Section 4958(c)(1) for traditional excess benefit transactions (economic benefit “directly or indirectly to or for the use of” a DP).
B. Section 4966 – Prohibitions on Taxable Distributions: Capital Contributions.
Section 4966 prohibits distributions to non-public-charities without expenditure responsibility. Generally inapplicable to a DAF holding an interest in a private fund. If the DAF made a capital contribution to a private fund, that would presumably not be a “distribution” within the meaning of IRC Section 4966, otherwise any investment made without exercising expenditure responsibility would violate Section 4966. Query whether there should be a different result if the investment in a fund would be a PRI for a private foundation, as that is arguably more similar to a grant than an ordinary investment.

C. Section 4967 – Penalty on Distributions That Result in More Than Incidental Benefits: Capital Contributions and Co-Investment. There is no analogue to IRC Section 4941’s “use of assets to benefit a DP” catch-all for donor-advised funds. Instead, Section 4967 is limited to a distribution that results in a “more than incidental benefit” to a donor-advisor (or their family or controlled entity). So, the DAF’s receipt of an interest in a private fund that is co-invested with a donor-advisor is unlikely to be an issue under Section 4967. Query whether the same answer applies to later capital contributions into a fund in which a donor-advisor is a co-owner and whether the co-investment guidelines for PFs should apply in those situations.

V. Tax Issues Common to PFs and Donor-Advised Funds: Excess Business Holdings – a Step-By-Step Approach:

A. What Holdings Are Attributed to the PF/DAF that Need to Be Evaluated? First, apply the constructive ownership rules to determine what the PF or DAF is deemed to own (Treas. Reg. 53.4943-8). The interests of a partnership are always deemed to be owned by their partners. The interests of a corporation are attributed to the voting stockholders, unless the corporation is an active trade or business.

B. 95% Passive Income Exception (or otherwise not an active trade or business): Perhaps the most common way to rule out an excess business holding is the 95% passive income exception, which provides that if 95% or more of the income from an activity is passive, it is not a business holding (though any entities it owns are attributed up and need to be analyzed under Section 4943). Note that the 95% exception is not the only basis for finding that an entity is not an active trade or business (see PLR 199939046, finding that an investment partnership which functioned as a holding company of interests in lower-tier partnerships was not a business enterprise for Section 4943 purposes, even though the 95% exception was not met).

C. 2% De Minimis Exception: If the PF or DAF owns 2% or less of the voting stock and 2% or less of the value of all outstanding shares of stock, then the PF or DAF is not treated as having excess business holdings, even if the DPs own an unlimited amount of stock in that corporation. Similarly, the PF or DAF may own 2% or less of the profit interest and 2% or less of the capital interest in a partnership or other unincorporated joint venture. The benefit to this exception is that if it can be made at the fund level (i.e., the
PF or DAF owns 2% or less of the fund), there is no need to investigate the portfolio companies because each of those interests is necessarily also at 2% or below.

D. Constructive Ownership – Possible to Confirm 20% or Below of Every Portfolio Company? A PF or DAF and its DPs together, are permitted to hold up to a combined 20% of the voting stock of a corporation (or a 20% profits interest in a partnership or beneficial interest in a trust). The PF or DAF is permitted to own an unlimited quantity of non-voting stock in a business corporation if all of the DPs together own 20% or less of the voting stock.

- If the aggregate profits interest in the fund itself is 20% or less, then that is a positive sign, BUT still need to confirm that DPs do not have any interest in portfolio companies either directly or through other funds that would push the aggregate interest above 20% (query how easy that is to determine with certainty, given private funds’ willingness to share information -- for that reason, being able to rely on the 2% exception is ideal).

- If the aggregate profits interest in the fund itself is greater than 20%, the PF or DAF needs to investigate each portfolio company it is deemed to own constructively (e.g., an aggregate 45% interest in a fund that owns 80% of the voting stock of an active portfolio company is a 36% interest in the portfolio company and an excess business holding), in addition to identifying any DP interests in the underlying portfolio companies.

E. Application of 35% Limit. If it can be shown that an unrelated third party or group of third parties exercise effective control over the business corporation, the 20% limit stated above is increased to 35%. Section 4943(c)(2)(B). Although the statute only applies this rule to corporations, Treas. Reg. Section 4943-3(c) extends it to partnerships. Query how this rule should be applied in the context of the typical limited partnership. Does the 35% rule apply to every limited partner interest in a limited partnership because the general partner always has control? Or, does the DAF or PF need to show an unrelated third party that controls the vote to remove the GP?

F. 5 (or 10) Year Exception: For private fund interests received by gift, the 5 year grace period under Section 4943(c)(6) should apply, such that the above analysis is primarily a long-term issue. This period is extendable to 10 years by private letter ruling and a showing that diligent efforts have been made to eliminate the excess business holding.