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Donated Interests in Hedge Funds And Private Equity Firms

How to maximize deductions when principals give to donor-advised funds

Handled properly, hedge fund and private equity fund interests can play an important role in achieving maximum income tax benefits for principals and their families. If you have clients who are principals of hedge funds and private equity firms, they face some steep obstacles to receiving a full income tax charitable deduction for donations of interests in their companies.[1]

Fortunately, there's a simple solution: a donor-advised fund (DAF).[2] Be warned, though, that charities that sponsor and administer DAFs don't always accept donations of fund interests.

Under U.S. law, giving to a DAF allows the principal to:

- Receive an income tax charitable deduction at the highest level available for fund interests; and
- Have that deduction based on the fair market value (FMV) of the fund interest (rather than the principal's cost basis) at the time of the gift.

Such considerations may be particularly compelling if, before 2018, the principal needs to declare as ordinary income offshore deferred compensation under Internal Revenue Code Section 457A.

Recognizing this income is likely to generate a significant tax liability that your clients may well be advised to offset with the largest tax deduction permissible. (See "The Clock is Ticking,")

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Better to Give to Public Charities

U.S. tax law generally favors gifting hedge fund and private equity interests—which are illiquid assets—to public charities rather than to private foundations (PFs):[3]

FMV vs. cost basis—The value of a gift to charity of an illiquid asset equals the asset's FMV only if the gift is made to a public charity (or operating foundation), such as a museum or school. When an illiquid asset is gifted to a private non-operating foundation, the value of the deduction is limited to cost basis.

The difference in tax savings to a donor can be considerable. Indeed, in the following example, the same $1 million gift to charity would generate a $2,000 tax benefit if made to a private non-operating foundation, but $400,000 if made to a DAF.

Example: Assume the donor is a founding hedge fund principal who invested $100,000 in exchange for limited partnership (LP) interests in his fund. Five years later, his LP interests are worth $20 million. Also assume that his effective income tax rate is 40 percent and that he wants to give to charity a 5 percent LP interest in his fund, now worth $1 million. If he gives the LP interest to a PF, the tax benefit of his charitable deduction would be $2,000 (40 percent of 5 percent of his $100,000 basis). But, if he gives the LP interest to a DAF, the tax benefit of the deduction would be $400,000 (40 percent of $1 million FMV).

Deduction limitations—Because fund interests generally constitute long-term capital gains (LTCG) property, lower deduction limits apply to donations of such property rather than to cash donations. The maximum allowable deduction for such gifts is 30 percent of the donor's adjusted gross income (AGI) and is available only for gifts to a public charity (such as a DAF). If the recipient is a PF, the deduction is limited to 20 percent of the donor's AGI.[4]

Reluctant Recipients

Potential recipients often have some very real concerns about accepting interests in hedge funds and private

equity firms:

Public charities—While donors of fund interests may prefer giving to public charities, the public charities often prefer receiving donations of liquid assets, such as publicly traded stock. Charities can sell those assets and invest the proceeds relatively quickly and on their own terms. Public charities also tend to believe they lack the resources to properly manage complex illiquid financial assets such as fund interests.

PFs—Managers of PFs worry that fund interests create concentration risk in their portfolios and cause greater scrutiny from the Internal Revenue Service regarding actual or perceived "self-dealing." PFs also face a potential payout problem: Fund interests may pump up the value of a PF's assets, but being illiquid, they won't be readily available when it comes time to raise the funds needed to meet the PF's required 5 percent annual distribution.[5]

A Good Solution

Because DAFs qualify as public charities for tax purposes, gifts of capital gains property to a DAF account are subject to the higher 30 percent of AGI deduction limitation. Moreover, the value of the deduction is equal to the FMV of the property transferred.

When principals make a contribution to a DAF, the DAF establishes a separate account for that individual. It can even be named for the donor's family (for example, the Smith Family Giving Fund). Donors make recommendations to the DAF about when and to what public charities distributions will be made from this account. While the DAF sponsoring organization has final say over grants, it's the industry norm to approve distributions to qualified recipients. A few DAF administrators even permit gifting internationally and will vet the proposed foreign recipient.[6]

DAF accounts also have no required minimum annual distributions. The fund interests can remain in the account, and distributions can be made as the fund creates liquidity. Moreover, DAF accounts can name the donor's children or other family members as future advisors regarding investments and distributions.

Follow Five Rules

That said, there are a number of manageable rules to follow when gifting fund interests to a DAF. Here are five:

1. Holding period—Generally, the principal must have owned the interest for more than one year, and his interest must be fully vested. This is because, generally, only LTCG property is eligible for a deduction equal to the property's FMV, and gifts of unvested property simply don't qualify for an income tax charitable deduction.

2. No encumbrances—The interest being gifted can't be subject to any liability; if it is, the donor's transfer of that liability is deemed a triggering event, which may create income realization and capital gains tax due if the liability exceeds the interest's basis.

3. Appraisal—A qualified appraiser should appraise the fund interest being gifted. The IRS is unlikely to consider a quarterly mark as a sufficient valuation, particularly as the interest being transferred would undoubtedly be subject to a valuation discount.

4. No personal benefit—The IRC imposes restrictions on the activities of both public charities and PFs to assure that no ongoing personal benefit inures to the donor who receives a charitable income tax deduction. Best practices for complying with these restrictions should include:

- **No management fees**—Fund interests contributed to a DAF shouldn't be charged a management fee, incentive fee or carry because the principal of the fund would be paid a portion of that fee. Either a separate no-fee share class should be created for the contribution, or a waiver of fees should be memorialized in an agreement between the principal making the donation and the DAF.
- **Not counted toward the principal's minimum**—If the principal's fund requires that he have a minimum amount of assets invested in the fund, any interest owned by the principal's DAF shouldn't be counted toward that minimum, as that could be deemed an indirect personal benefit.
- **No "endorsements"**—Generally, charities that operate DAFs won't accept the gift of a fund interest that constitutes more than 10 percent of the fund's value. The concern is that potential investors could view accepting a greater percentage as an endorsement of the fund, thus creating an indirect benefit to the principal.

5. Unrelated business taxable income (UBTI)—Charities generally aren't subject to ordinary income tax, but an exception applies if the charity holds a flow-through interest in an active business or an interest in a company that owns passive investments, but has mortgaged property or other debt. Borrowing effectively gives rise to debt-financed income that's taxable to charities as UBTI at ordinary income tax rates.

The Clock is Ticking

Before Jan. 1, 2018, certain non-qualified, deferred compensation from hedge funds must come ashore

Make no mistake about it: Investment principals are facing the end of a 10-year grandfathering period that allowed them to keep certain non-qualified, deferred compensation in their offshore funds through 2017.

They'll need to report this compensation as taxable income in the United States before Jan. 1, 2018. Taxes on those assets will generally be due in April 2018, whether the income is "phantom" or tangible.

For many, the tax bill is likely to be considerable.

If a significant portion of your client's compensation is being paid in kind, the client will naturally want to consider borrowing to pay the tax bill, rather than unwinding important investments.

But, your clients also may want to take this opportunity to expand or begin their philanthropic efforts.

Donations that qualify for the income tax charitable deduction in 2017 are an excellent way to take some of the sting out of their tax bills.

Form Defines Options

Some fund principals may receive their deferred compensation payouts in cash or unrestricted, publicly traded stock.

However, many are likely to receive in-kind fund interests or other illiquid assets. It's even possible that funds may make book entry-only distributions and that principals will receive nothing tangible.

Even so, Internal Revenue Code Section 457A will deem the repatriation of the deferred compensation to have occurred for tax recognition purposes. This will create a significant phantom income tax problem for those principals: A substantial tax bill will be due in April 2018, with no cash on hand to pay it, except from other sources or by borrowing.

It's wise to plan as soon as possible for any anticipated income taxes. Part of that planning may entail making gifts to charity in 2017 to offset the expected income tax burden.

This planning is complicated by the fact that the principal's holding period for any assets received in satisfaction of the deferred compensation due begins on the date the asset is received. For instance, publicly traded stock received on Jan. 1, 2017, as payment of deferred compensation due, wouldn't be considered long-term capital gains (LTCG) property until Jan. 2, 2018, a new tax year. This means a gift of that stock made in 2017 wouldn't qualify for a charitable deduction based on the stock's fair market value (FMV), because the stock wouldn't be considered LTCG property.

Investment principals should be sure that property they intend to donate qualifies for a charitable income tax deduction that maximizes economic value. If in-kind fund interests are received in satisfaction of the deferred compensation and donated shortly thereafter, the charitable deduction would be limited to cost basis. But, that cost basis may be equal, or very close, to FMV, as the interests would have been received and gifted almost simultaneously.

In thinking about what your clients should give, it's worth considering two types of capital assets:

- **Cash or marketable securities**—If your clients own cash or marketable securities that are LTCG property, they could give those assets to a private foundation or to a charitable lead annuity trust that would be treated as a grantor trust for income tax purposes. Their gifts to those entities, as well as to a donor-advised fund (DAF), would be deductible based on the FMV of the asset donated.
- **Illiquid LTCG assets**—Your clients will receive a tax deduction for the full FMV of those illiquid assets, such as fund interests, only if their gifts are made to public charities, such as DAFs (provided they also satisfy the charity's rules associated with such gifts) or private operating foundations.

Action Plan

Regardless of the nature of the distributions your clients receive, if they're affected by IRC Section 457A, they should take steps quickly to determine not only the amount of income they'll be deemed to receive in 2017, but also what, if any, assets they'll actually receive.

This information will go a long way toward informing their decisions about what charitable planning best suits your clients before the Section 457A deadline arrives.

— Thomas McGraw, Carolyn A. Reers & Jordan Sprechman

Investing in an offshore version of the fund, if available, is an option for blocking UBTI income. If the principal holds interests in the onshore fund, it may be possible for him to contribute his onshore interests to a DAF and then have the DAF immediately sell those interests and reinvest the proceeds in the offshore fund.[7]

If there's no offshore fund, investment returns may be sufficient to warrant the UBTI drag on the DAF account's total return. However, the DAF administrator will require the donor to contribute cash to the DAF account to cover any UBTI tax payable.

Sponsoring Organizations

Sponsoring organizations—the public charities adminis-

tering the separate accounts of their donors—technically control the investments held in each donor's account; donors retain the more limited right to advise on distributions and make recommendations with respect to investments.

Of course, because a DAF is controlled by an independent charitable entity, it needs to have its own requirements met before it accepts the contribution of an interest in a hedge fund or private equity fund. The DAF sponsor will want to conduct due diligence on the fund and ensure that the investment is permissible under its investment policy guidelines. It will also want to have the right to sell the fund interest when and in the manner it chooses.

More sophisticated DAF sponsors accept donations of fund interests, but require a written, signed donation

DAFs generally provide donors with more privacy than PFs do.

agreement so that all terms of the contribution and management of the assets are clear.[8]

Typically, that agreement provides:

- A description of the fund interest being contributed and a representation that such contribution is less than 10 percent of the overall assets in the fund.
- Confirmation that no management fees, incentive fees or carry are being charged on the fund interest to be held by the DAF.
- Confirmation that the donor isn't receiving anything more than a tax benefit, either directly or indirectly, as a result of the gift.
- For the DAF to be held harmless against future liabilities that may be incurred, such as capital calls, clawbacks or other financial obligations.
- For any UBTI to be covered either by income distributions from the fund or from an additional contribution from the donor.
- That the DAF may liquidate its position at any time based on the redemption terms of the fund. Although this is required, keep in mind that DAFs that accept these contributions do so with the intention of maintaining their position in the fund, provided the fund continues to meet or outperform its benchmark.

Privacy

DAFs generally provide donors with more privacy than PFs do.

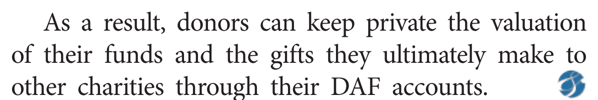
PFs must annually report the names of their board members, contributions received and grants made during the year. All this goes on an information return, Form 990-PF, which is filed annually with the IRS and is available to the public.

Contributions to DAFs and grants from them can be made without attribution, so donors can retain as much anonymity as they want.

PFs are also required to list annual income and expenses and to provide a balance sheet of assets and liabilities on Form 990-PF.

DAFs don't file a Form 990-PF. There's no separate report or tax return required for the donor's separate DAF account.[9]

As a result, donors can keep private the valuation of their funds and the gifts they ultimately make to other charities through their DAF accounts.



Endnotes

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2. A donor-advised fund (DAF) is a fund (or account) established, owned and controlled by a sponsoring charitable organization to which donors may contribute and thereafter may provide non-binding recommendations regarding distributions from the fund or the investment of fund assets.
3. Donations to public charities are generally treated under the Internal Revenue Code more favorably than donations to private non-operating foundations on the theory that the donated amounts to the former are put to more immediate use for the public good.
4. The deduction limitations applicable to gifts of cash are 50 percent of adjusted gross income (AGI) if the donee is a public charity and 30 percent of AGI if the donee is a private foundation.
5. Private non-operating foundations are required to distribute 5 percent of the average fair market value of, *in essence*, their *net investment* assets each year.
6. This is true of the Charitable Giving Fund, the DAF offered by J.P. Morgan in conjunction with National Philanthropic Trust, a sponsoring organization and a public charity.
7. The DAF could still have unrelated business taxable income (UBTI) accumulated between the date of contribution and the date of sale and purchase, which suggests that the donation and sale should be made at the beginning of the year. The underlying assets donated should also be scrutinized to determine whether any of the gain realizations may be subject to UBTI.
8. This is true of the DAF sponsor with whom J.P. Morgan partners.
9. DAFs are accounts of sponsoring organizations, which are public charities. A sponsoring organization, as a public charity, generally files a Form 990. This form doesn't require the sponsoring organization to identify donors' separate accounts.

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