INVESTING IN HEDGE FUNDS

Guidelines for Private Foundations

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In the last several years, private foundations have shown a demonstrated interest in alternative investments, especially hedge funds. Hedge funds, which are designed to “hedge” or mitigate the extreme ups and downs associated with frequent buying and selling, can be a beneficial addition to a foundation’s portfolio, but they come with some very important considerations.

When a foundation adds hedge fund investments to its portfolio, a range of issues are presented for consideration and management:

- Prohibitions on the foundation’s financial transactions with insiders;
- Limitations on the extent of the foundation’s permissible ownership interests in business enterprises;
- The exercise of fiduciary obligations of business care and prudence;
- Issues of liquidity; and
- Income tax considerations at funding and during foundation holding of hedge fund investments.

The rules governing these matters often are counterintuitive and may result in adverse consequences to the unwary foundation and its managers. This article outlines the key points to bear in mind when a foundation’s portfolio includes investments in hedge funds, especially those that are managed by foundation insiders.

While this article should help you identify potential trouble spots and provides general legal information about hedge fund investing, it is not a substitute for consultation with an attorney who is knowledgeable about the ever-changing laws that apply to private foundations and the operations of your particular organization.

SELF-DEALING

Generally, a foundation and an insider in respect to the foundation (a “disqualified person”) may not engage in financial transactions with one another, as such transactions would result in self-dealing. The term “disqualified person” includes:

- Any substantial contributor (contributor of more than $5,000 and more than 2% of a foundation’s total funding since inception, or the creator of a foundation formed as a trust);
- Any foundation trustee, director, or officer;
- Family members of substantial contributors, trustees, directors, or officers, including their spouses, parents, grandparents, children, grandchildren, and spouses of children and grandchildren;
- Any person or entity who holds (directly or indirectly) more than a 20% ownership interest—as determined by voting power in a corporation, profits interest in a partnership, or beneficial interest in a trust—in an entity that is a substantial contributor;
- Any entity in which the above disqualified persons hold (directly or indirectly) more than a 35% collective ownership interest as determined by voting power in a corporation, profits interest in a partnership, or beneficial interest in a trust—in an entity that is a substantial contributor;
- Any entity in which the above disqualified persons hold (directly or indirectly) more than a 35% collective ownership interest as determined by voting power in a corporation, profits interest in a partnership, or beneficial interest in a trust; and
- Government officials who hold certain positions enumerated in the regulations.

The penalty for self-dealing is a tax on the disqualified person—not the private foundation—of 10% of the amount involved, regardless of whether the disqualified person knows that he or she is engaging in an act of self-dealing and regardless of whether the transaction is advantageous to
A 5% tax on the amount involved is imposed on a foundation manager, such as an officer, director, or trustee of the foundation who knowingly participates in a self-dealing transaction. If not corrected in a timely manner, a 200% tax is imposed on the disqualified person, and a 50% tax is imposed on any foundation manager who knowingly participated in the act of self-dealing. The tax imposed on foundation managers is limited to $20,000 for each act of self-dealing.

The rules against self-dealing generally prohibit direct financial transactions between a foundation and its disqualified persons, as well as transactions between the foundation and third parties that provide an indirect economic benefit to disqualified persons. Acts of self-dealing prohibited by regulations include:

- Sales and exchanges;
- Most leasing and lending arrangements;
- Use by a disqualified person of a foundation’s income, assets or facilities;
- Payment of excessive compensation to a disqualified person; and
- Payment of compensation to a disqualified person in any amount for certain types of services.

Specifically, unexpected self-dealing violations could result from a disqualified person’s donation to a foundation of a partnership interest in a hedge fund under the following circumstances:

- When capital calls are outstanding at the time of donation, as the foundation’s satisfaction of the calls would relieve the donor’s personal liability to satisfy those calls;
- When the partnership is indebted to anyone at the time of donation, especially if the debt was taken on while the partnership was a disqualified person; and
- When a general partnership interest is donated to the foundation, especially if any limited partner is a disqualified person because the foundation, as general partner, necessarily would render services to disqualified persons.

An exception to the self-dealing rules permits a foundation to pay reasonable compensation to a disqualified person for “personal services,” which encompass banking, brokerage, and investment advisory services. Compensation is considered reasonable, even if it involves substantial amounts, as long as the compensation arrangement represents market rates. Thus, compensation paid by a private foundation to its disqualified person for hedge fund management services should be considered reasonable if the foundation pays no more than the rate paid by the hedge fund manager’s most favored client.

When a private foundation invests in a hedge fund, the foundation’s disqualified person, who may serve as the fund’s manager, often wishes to invest in that fund personally alongside the foundation. Several private letter rulings issued by the IRS indicate that the IRS is willing to permit foundations and disqualified persons to co-invest in hedge funds under arrangements tailored to preclude any direct or indirect benefit to the disqualified persons. Taken as a whole, these rulings suggest that:

- A foundation’s investment in a hedge fund may not be pooled together with an investment made by a disqualified person to enable such person to meet a minimum investment requirement;
- A foundation’s investment in a hedge fund may not be pooled together with a disqualified person’s individual assets to collateralize such person’s margin borrowing;
- The return on an investment made by a disqualified person in a hedge fund may not vary based upon the foundation’s investment in that fund;
- A foundation’s investment in a hedge fund may not affect the cost of an investment made by a disqualified person in that fund;
- The management company of the hedge fund may not advertise a foundation’s participation in or connection with the hedge fund or use it to attract other investors; and
- A hedge fund’s price or value may not be manipulated to benefit any disqualified person on account of the foundation’s investment in that fund.

Another factor for a foundation to consider prior to investing in a hedge fund is the possibility that the foundation would do so via an indirect investment through a disqualified person partnership. A straightforward reading of the self-dealing rules would prohibit a foundation from investing in such

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1 Although private letter rulings are binding only in respect of the taxpayers obtaining them and may not be cited as precedent, such rulings are routinely analyzed to reveal the IRS’s positions.
manner because the investment in the disqualified person partnership would represent an exchange of capital for an ownership interest between the foundation and its disqualified person, which is a prohibited transaction. In several private letter rulings, however, the IRS has permitted foundations to invest indirectly in hedge funds through investments in disqualified persons under narrow circumstances, including where:

- A foundation’s investment was a means to obtain the disqualified person’s investment management services and to avoid a management fee and performance allocation, or carried interest; and

- A foundation’s investment enabled it to invest in the hedge fund on favorable terms that the foundation could not have made directly.

Due to the lack of binding authority in this area and the possible imposition of penalties on self-dealers, a disqualified person should be cautious when investing alongside a private foundation and a private foundation would be well advised to consult counsel before investing in an entity that is a disqualified person.

**EXCESS BUSINESS HOLDINGS**

A foundation’s level of ownership in private equity may be limited by the IRS’s excess business holdings rules. To the extent that a foundation owns more than the maximum allowed ownership percentage in a business, the foundation may be subject to a penalty on such excess holdings in that business. If a foundation is found to have excess business holdings, a 10% tax is imposed on the value of the excess holdings. The value of the excess holdings is calculated by reference to the day during the taxable year in which such holdings were the greatest. Moreover, the IRS may impose an additional 200% excise tax if the foundation fails to dispose of its excess holdings in a timely manner.

These excess business holdings rules apply only to a business that is a “business enterprise,” which is defined by regulations as an entity that engages in the active conduct of a trade or business, including any activity regularly carried on for the production of income from the sale of goods or the performance of services. A passive investment vehicle that derives 95% or more of its gross income from “passive sources” is not considered a business enterprise and, therefore, the excess business holdings rules do not apply to an investment in such an entity. Generally, the Internal Revenue Code defines “passive sources” to include dividends, interest, payments with respect to certain securities loans and annuities, royalties, rents, and capital gains. In a private letter ruling, the IRS indicated that a partnership would qualify as a passive investment vehicle if it invests only in partnerships that generate only the above types of passive income.

To remain in compliance with the excess business holdings rules, the combined direct and indirect voting power of a foundation and its disqualified persons in a business enterprise structured as a corporation generally may not exceed 20%. Similarly, this rule generally limits the combined direct and indirect profits interests of a foundation and its disqualified persons in a partnership to 20%. Hedge funds typically are established as partnerships for tax purposes; therefore, this analysis will focus on the application of these rules to partnerships.

**Under narrow circumstances, the IRS has permitted foundations to invest indirectly in hedge funds through investments in disqualified persons.**

Under a special de minimis exception, a foundation may own up to two percent of a business enterprise without regard to the ownership levels of its disqualified persons. In the context of a business enterprise taxed as a partnership, the de minimis exception would apply only if two conditions are satisfied: (1) the foundation owns no more than two percent of the partnership’s profits interest; and (2) the foundation owns no more than two percent of the partnership’s overall value, taking into account both profits and capital interests in that partnership.

Under certain conditions, the level of permitted holdings of profits interest may be increased to as much as 35% if it can be demonstrated that a party other than the foundation and its disqualified persons has “effective control” of the business enterprise. Here, the term “effective control” means the ability, directly or indirectly (and whether or
not actually exercised), to direct or cause the direction of the management and policies of a business enterprise. Such control can be obtained in any number of ways, such as through the use of voting trusts or contractual arrangements.

If all of a foundation’s disqualified persons collectively own no more than 20% of a business enterprise’s profits interest, the foundation may own an unlimited percentage of the enterprise’s capital interest. Where the foundation and its disqualified persons can show that a third party has effective control of the business enterprise, this special rule is applied by reducing 20% with 35%.

If a foundation and its disqualified persons collectively own a greater profits interest in a business enterprise than the maximum percentage allowed, the following special rules apply to determine if and when a penalty will be imposed in respect of its excess holdings:

- **Donated profits interests**: A foundation that receives a donation or bequest of a profits interest in a partnership that would result in an excess business holdings violation has five years to dispose of the excess holdings. If the foundation does so, no penalty will be imposed.

- **Profits interests acquired by disqualified persons**: If the maximum percentage limitation is exceeded because one or more disqualified persons acquire too great a profits interest in the business enterprise, the foundation (rather than its disqualified persons) must dispose of the excess holdings within 90 days of the date it knows or had reason to know of the event that caused it to have such excess holdings. If the foundation does so, no penalty will be imposed.

- **Profits interests purchased by foundation**: If the maximum percentage limitation is exceeded because of a foundation’s purchase of a profits interest in the business enterprise, the foundation’s knowledge at the time of purchase dictates the consequences of its purchase:
  
  - **Interests purchased innocently**: If the foundation did not know, or have reason to know of prior acquisitions by disqualified persons of profits interests in the partnership, and no violation would have occurred as a result of the foundation’s purchase of a profits interest in that partnership but for such prior unknown acquisitions by disqualified persons, the foundation must dispose of its excess holdings within 90 days of the date it knew or had reason to know of the excess holdings violation. If the foundation does so, no penalty will be imposed.

- **Interests purchased knowingly**: If the foundation knowingly purchases a profits interest in a business enterprise that will immediately cause the foundation’s ownership percentage in that enterprise to exceed the maximum percentage allowed, the foundation is subject to a penalty immediately.

**JEOPARDIZING INVESTMENTS**

When considering an investment in a hedge fund, a private foundation should take into account that such investment might be a jeopardizing investment if it puts at risk the foundation’s ability to carry out its exempt purposes. The purpose of the jeopardizing investment rule is to shield private foundation assets from excessive risk, so as to maximize both capital and income available for charity. A jeopardizing investment concern would arise if a foundation were to make an investment without exercising ordinary business care and prudence. In exercising the requisite standard of care and prudence, the foundation’s managers may consider the expected return, the risks of fluctuating price levels, and the need for diversification of the portfolio. The regulations specify that the determination of whether an investment is a jeopardizing investment should be made on an investment by investment basis, in each case taking into account the foundation’s portfolio as a whole. The determination of whether an investment is a jeopardizing one is made at the time of the investment. Thus, an investment ultimately causing the foundation to realize a loss will not be considered a jeopardizing investment if such investment, at the time it was made, was judged by the foundation’s managers to be non-jeopardizing. For this reason, it is of key importance that the foundation’s managers maintain records documenting the exercise of care and prudence at the time investments are made.

Certain types of investments are regarded by the regulations as having a higher degree of risk and are subject to closer scrutiny. Conceding that no category of investment will be treated as a per se jeopardizing investment, the regulations then list certain types of investments that are subject to close scrutiny by the IRS, including securities purchased on margin, commodity futures, and puts, calls, straddles, and warrants. This list was subsequently expanded by the IRS to include investments in hedge funds. However, a number of foundations have been issued private letter
rulings indicating that their direct and indirect investments in hedge funds were non-jeopardizing. The IRS’s reasoning in each ruling was based on one or more of the following factors:

- The hedge fund investment fit into an overall prudent investment plan;
- The hedge fund’s assets were sufficiently diversified; and
- The hedge fund investment provided sufficient liquidity to meet the foundation’s needs.

The penalty imposed on a foundation for making a jeopardizing investment is 10% of the amount invested. Further, a tax equal to 10% of the amount invested, limited to a maximum tax of $10,000, may be imposed on a foundation manager who knowingly participates in making a jeopardizing investment. If the foundation does not remove the jeopardizing investment in a timely manner, an additional tax of 25% of the jeopardizing investment may be imposed on the foundation.

A hedge fund interest is included in the asset base used to calculate a foundation’s annual five percent minimum distribution requirement, and a foundation must obtain an annual valuation of its interest in such fund for purposes of calculating that requirement. If an investment in a hedge fund is illiquid, does not make periodic cash distributions, and constitutes a large proportion of the foundation’s investment portfolio, the foundation may face a serious cash flow problem. The foundation should ensure that it owns sufficient other liquid or income-producing assets upon which to draw in order to make necessary grants and pay taxes and operating expenses.

**UNRELATED BUSINESS INCOME TAX**

A foundation may unexpectedly be subject to unrelated business income tax (UBIT), at for-profit tax rates, if it directly or indirectly (via a partnership interest) does either of the following:

- Borrows funds to acquire an investment, such as an interest in a hedge fund; or
- Derives income from a regularly carried on trade or business that is unrelated to the foundation’s exempt purpose.

Generally, the character of any item realized by a partnership is maintained when it flows through to its partners. Therefore, if a foundation invests in a hedge fund established as a partnership (or a limited liability company taxed as such) that realizes unrelated business income attributable to the partnership’s activities or investments made with borrowed funds, a proportionate share of unrelated business income will flow through to the foundation. A foundation considering an investment in a hedge fund should bear in mind that the foundation may be liable for income tax on its proportionate share of unrelated business income, even in the absence of cash distributions made by the partnership to the foundation.

**OTHER CONCERNS**

Although a discussion of a foundation’s direct or indirect investments in foreign hedge funds established as corporations or partnerships is beyond the scope of this paper, such investments may obligate the foundation to file certain forms with the IRS, such as forms 926, Return by a U.S. Transferor of Property to a Foreign Corporation, 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships, etc.
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