Investing Private Foundation Assets In Hedge Funds

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FOUNDATION MANAGERS often ask whether foundations may invest in hedge funds. Hedge fund managers that have created a foundation ask a further question: May the foundation invest in hedge funds affiliated with the foundation's managers or founders?

The inquiries might involve a direct investment, as a limited partner, in the hedge fund, or an investment in an intermediate entity created to enable certain investors to avoid the management fee and performance allocation, or carried interest. Another variation might involve the foundation's pooling a portion of its assets with the assets of family members or related entities. Such pooling, among other things, may broaden investment opportunities by enabling the foundation to participate in investment opportunities otherwise not available to the foundation.

Recent IRS rulings confirm that foundation managers may invest in hedge funds. However, there are traps for the unwary. The tax law prohibits self-dealing transactions and jeopardizing investments. If the foundation manager runs afoul of these rules, the foundation and its managers will be exposed to onerous tax penalties. In addition, the foundation manager should be aware of the tax consequences of investing in funds that generate debt-financed income.

This article provides an overview of the rules governing self-dealing transactions, jeopardizing investments, and debt-financed income, with particular focus on how these rules affect foundation investments in hedge funds.

Self-Dealing Prohibition

General Rules

Most transactions between a foundation and a "disqualified person" are considered self-dealing subject to an excise tax. Disqualified persons include the foundation's managers, officers, trustees, directors and substantial contributors, as well as family members of those classes of individuals. Any owner of more than 20 percent of the voting power of a corporation, partnership, or the beneficial interest of a trust that is a substantial contributor to the foundation also is a disqualified person. In addition, the term includes entities – such as partnerships, corporations and trusts – in which disqualified persons collectively hold more than 35 percent of the ownership or beneficial interest.

The prohibition extends to both direct and indirect dealings with disqualified persons. These rules explicitly prohibit various transactions – such as most sales, exchanges, or leases of property – between foundations and disqualified persons. Most lending arrangements and payments of compensation also are prohibited.

Significantly, in order to assess whether a transaction is permissible, the self-dealing prohibition rules do not apply arm's-length, fair market value standards. These prohibitions apply regardless of whether the transaction is fair, or even generous, to the foundation.

Exceptions to Self-Dealing

There are limited exceptions to the self-dealing rules. For example, a disqualified person may lease property to a foundation, so long as the lease is without charge. There also is an exception for foundation transactions that result in a benefit to a disqualified person that is merely incidental or tenuous.

A foundation also may pay a disqualified person for performing personal services, such as legal, investment advisory, and general banking, if the services are reasonable and necessary to carry out the foundation's charitable purposes, and if the compensation is not excessive. The regulations provide a helpful example involving an individual who both is a foundation manager and owns an investment counseling business. The regulations confirm that the foundation may pay the investment counselor (a disqualified person) reasonable compensation for investment advisory services.

Hedge Fund Investments

Does a foundation investment in a hedge fund managed by a disqualified person constitute self-dealing? Is such an investment a prohibited sale or exchange? Alternatively, is it more akin to paying a disqualified person for investment advisory services, as permitted by the regulations?

In a recent 2003 Private Letter Ruling, a foundation sought to invest most, if not all, of its assets as a limited partner of an entity serving as the general partner of a hedge fund. Significantly, the foundation's grantor and sole trustee owned more than 35% of the general partner and was one of four investment advisors to the hedge fund. By investing at the general partner level, the foundation could avoid the management fee and performance allocation, or carried interest.

The IRS confirmed that the general partner of the hedge fund was a disqualified person with respect to the foundation. Nevertheless, the IRS found that this particular situation was analogous to one in which a disqualified person provides investment services to a foundation. It therefore did not view the investment as a sale or exchange between the foundation and a disqualified person. Important factors contributing to the IRS's decision were: no disqualified person would benefit from the foundation's investment; none of the other limited partners in the general partner had control over the foundation's investment decisions; and, the structure enabled the foundation to make an investment, on favorable terms, that it

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could not have made directly. The IRS therefore concluded that neither the initial acquisition of an interest in the hedge fund's general partner, nor subsequent additional investments in, or withdrawals from, the partnership would constitute self-dealing.

Similarly, in an earlier ruling, the IRS concluded that a foundation could invest in a family of mutual funds that received investment services, including underwriting services, from disqualified persons. The IRS held that, because the foundation's share of the fees would be the same as those paid by the general public for the investment advisory services, the compensation paid by the foundation for investment services was not excessive. It also held that the investment services the foundation would receive were reasonable and necessary in order for the foundation to manage its portfolio. Therefore, the IRS concluded that the investment would not be self-dealing.

In yet another ruling, the IRS held that a foundation may invest in investment companies where other equity owners are owned (in part) or managed by disqualified persons. Under the specific facts of the ruling, (1) the foundation's assets would not be considered to meet minimum investment requirements of any other investor; (2) the foundation's participation would not affect any other investor's return; (3) the fees were based on a set percentage of the amount invested; and (4) the foundation's participation in the investment companies would not be advertised to other investors or potential investors.

These IRS Private Letter Rulings – particularly the 2003 ruling – are important developments: they confirm that the IRS, under particular circumstances, is willing to allow foundations to invest in hedge funds aligned with, and managed by, disqualified persons. However, while a Private Letter Ruling is instructive of the IRS's views, it may not be used as precedent and is binding only with respect to the taxpayer obtaining the ruling. Furthermore, under state law, fiduciaries generally must avoid certain self-dealing acts. Therefore, it is best to proceed with caution. If large sums are involved, it may be advisable to seek a Private Letter Ruling, particularly in light of the substantial penalties imposed on acts of self-dealing (discussed below).

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CFTC Proposes CPO/CTA Registration Exemptions; Modifies Interim No Action Relief

By Christopher Wells, Esq.

ON MARCH 17, 2003, the CFTC proposed new rules providing exemptions from registration for certain commodity pool operators and commodity trading advisers, based upon proposals previously submitted by the Managed Funds Association and the National Futures Association. The CFTC also made certain changes to its No Action Relief originally made available on November 13, 2002.

The No Action Relief previously permitted a CPO to claim an exemption from registration as a CPO if all of the participants in each pool are either accredited investors or knowledgeable employees (as defined under SEC rules), non-U.S. persons, or certain other permitted persons affiliated with the pool, but only if the aggregate net notional value of the pool's commodity interest positions does not exceed 50% of the liquidation value of the pool's portfolio.

The CFTC expanded the No Action Relief to provide a second alternate test: The No Action Relief will also be available if the aggregate initial margin and premiums required to establish commodity interest positions, determined at the time the most recent position was established, do not exceed 2% of the liquidation value of the pool's portfolio.

The CFTC also expanded the No Action Relief to provide that a CPO of a fund of funds may claim the relief if the fund of funds trades commodity interests solely by way of its investment in other investment funds, and if the CPO of each such other investment fund has itself either claimed the No Action Relief or has registered with the CFTC as a CPO.

The relief is not automatic, and funds and managers wishing to take advantage of the exemption must file a notice with the NFA.

In addition to amending the No Action Relief, the CFTC proposed a new Rule 4.13(a)(3) that would, if adopted, incorporate a "limited trading exemption" on the same terms as the No Action Relief described above.

The CFTC proposed an amendment to Rule 4.5 that would permit persons subject to the rule (including registered investment companies, banks, insurance companies and pension plans) to commit up to 5% of their net liquidation value as margin and premiums, or to own futures positions with aggregate notional value not to exceed 100% of their net liquidation value, in either case regardless of whether such trades are for bona fide hedging purposes.

The CFTC also proposed a new Rule 4.13(a)(4) that would adopt a more general exemption from registration for a CPO of a pool, without any limitation on the amount of aggregate futures positions held, if the interests in the pool are privately placed and are held exclusively by either:

- natural persons who are Qualified Purchasers (under SEC rules); or
- non-natural persons who are Qualified Eligible Persons under Rule 4.7 or accredited investors.

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Pooling Assets for Investment
A foundation manager might seek to pool a portion of the foundation assets with the assets of family members or affiliated entities. Consolidating assets may ease administration, reduce costs, facilitate diversification, and broaden investment opportunities. If the foundation pools its investments with those of one or more disqualified persons, has the foundation manager exposed himself or herself and the foundation to the self-dealing tax penalties?

In one ruling, the IRS held that 15 charitable remainder trusts could be members of a family limited liability company along with disqualified persons without triggering the self-dealing tax. (For purposes of applying the self-dealing rules, charitable remainder trusts are considered foundations.) The limited liability company was formed, funded, and controlled by the members of one family, some of whom were disqualified persons with respect to the charitable remainder trusts. The trusts sought to combine assets in a family-controlled entity to diversify their portfolios, achieve economies of scale, obtain more negotiating power, and gain access to investments with higher minimums.

In its ruling, the IRS highlighted the fact that the charitable remainder trusts (foundations for self-dealing purposes) were to pay only the marginal increase in investment expenses attributable to the trusts' participation in the pooled fund. Accordingly, as a result of the pooling, no disqualified person would benefit from a reduction in administrative costs or other fees. It is unclear whether the IRS would have reached the same conclusion if the expenses were shared proportionately among the members of the company: while such proportionate sharing of expenses would reduce the costs previously paid by disqualified persons, arguably any such benefit would be incidental or tenuous.

In another recent ruling, the IRS determined that four charitable remainder trusts (again, foundations for self-dealing purposes), which had the same founders and income beneficiaries, could create and invest in a foreign corporation for the purpose of investing in hedge funds. (By investing through a foreign corporation, the trusts could avoid unrelated business taxable income as discussed below.) Although the trusts were disqualified persons in relation to each other, the investment did not benefit any disqualified person other than the trusts themselves. The IRS noted that the combination of assets would minimize administrative costs, make it easier to diversify investments, and open up additional investment opportunities for the trusts. Accordingly, the pooling of assets was not an act of self-dealing.

Penalties
The consequences of violating the self-dealing rules are harsh. Acts of self-dealing subject the disqualified person, whether or not he or she had knowledge that the activity was prohibited self-dealing, to a 5 percent excise tax on the amount involved for the year in which the self-dealing occurs and for each subsequent year until the self-dealing is corrected.

In addition, if the self-dealing act is not corrected in a timely manner, a 200 percent tax may be imposed on the self-dealer. A tax of 2 1/2 percent of the amount involved is separately imposed on any foundation manager (trustee, director, or officer) who knowingly and willfully participates in an act of self-dealing. While the Internal Revenue Code refers to these charges as taxes, in light of their magnitude, the reality is that they are draconian penalties designed to discourage most dealings between a foundation and a broad class of related parties.

Jeopardizing Investments

Identifying Jeopardizing Investments
A foundation and its managers will be penalized if the foundation assets are invested in a manner that jeopardizes its ability to carry out its tax-exempt purposes. However, the tax code and treasury regulations do not define "jeopardizing investment" and there exists no category of investment that is treated as a per se violation. In considering this indefinable term, one is reminded of Justice Potter Stewart's

classic definition of "obscenity": "I know it when I see it."

Closely Scrutinized Investments
There are some practical guidelines. For example, the regulations provide that the following types of investments will be scrutinized closely: trading on margin, trading in commodity futures, investments in working interests in oil and gas wells, purchase of puts, calls and straddles, purchase of warrants, and selling short. This laundry list was developed over 30 years ago, at a time when some considered puts and calls risky investments. However, under modern portfolio theory, these investments (and others listed in the regulations) may reduce overall portfolio risk. Consequently, as explained below, despite the warning in the regulations, the IRS appears to tolerate such investments if made with care and prudence.

Ordinary Business Care and Prudence Standard
The aim of the jeopardizing investment rules is to ensure that foundation managers exercise "ordinary business care and prudence" when making investment decisions. To that general end, foundation managers should consider the expected return (including both income and appreciation of capital), the risk of rising and falling price levels, the relative size of the investment, and the need for diversification within the investment portfolio. Essentially, an investment will be deemed jeopardizing if it is determined that, in making the investment, the foundation managers failed to provide for the long- and short-term financial needs of the foundation to carry out its exempt purposes.

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Hedge Fund and Other Nontraditional Investments

In the 2003 ruling described earlier, the IRS determined that an investment in a hedge fund (through its general partner) was not a jeopardizing investment despite the following: the investment involved most, if not all, of the foundation assets; and the fund purchased publicly-traded derivatives, such as puts, calls, and straddles, and sold securities short. Critical to the IRS's reasoning was the fact that the securities held by the hedge fund were sufficiently diversified. At any given time, the hedge fund was expected to hold positions in 60 to 70 different companies, with no one investment in a company representing more than a stated percentage of the securities issued by that company.

... if a charitable remainder trust is found to have even a nominal amount of UBTI, the trust is subject to taxation on all of its income for that tax year.

The IRS observed that ordinarily a foundation's investment of substantially all of its assets in one company (here, the hedge fund's general partner) would be a jeopardizing investment due to a lack of diversification. However, given the specific facts, the proposed investment in the hedge fund's general partner was viewed as an indirect investment in the hedge fund's underlying securities. (The IRS also held that, due to this pass-through treatment, the investment would not constitute an excess business holding.)

Other factors in the 2003 ruling presumably were relevant in the IRS's decision that the investment would not constitute a jeopardizing investment. The IRS noted that the hedge fund had a history of low volatility. The IRS also observed that the foundation would have the ability to withdraw its investment twice a year, providing the opportunity for regular liquidity.

The determination as to whether an investment is jeopardizing is to be made taking into account the foundation's portfolio as a whole. For example, in one ruling, the IRS confirmed that a nontraditional investment, such as a fund that invests in futures and forwards, may be deemed non-jeopardizing if it fits into an overall prudent investment plan. In another ruling, the IRS has determined that an investment in a managed commodities fund, with little or no correlation to the stock market, may add diversity to a portfolio that otherwise is heavily stock market dependent. The IRS also concluded, in a separate ruling, that a foundation's investment of less than 30 percent of its total assets in six different funds was not a jeopardizing investment.

Despite these favorable rulings, it is essential that the foundation manager document carefully that the decision to place foundation assets in these categories of investments is made with care and prudence. Such analysis will help the foundation manager avoid federal tax penalties (described below) and fulfill fiduciary duties under state law.

Penalties

If the IRS concludes that a foundation has made a jeopardizing investment, an initial excise tax of 5 percent of the amount invested will be imposed on the foundation. If the foundation does not remove the jeopardizing investment during the taxable period in which it was made, an additional tax of 25 percent of the jeopardizing investment will be imposed. In addition, a tax equal to 5 percent of the amount invested, capped at $5,000, may be imposed on any foundation manager who participated in making the investment knowing that it was a jeopardizing investment. Such a manager may be subject to a tax at the same percentage rate, capped at $10,000, if he or she refuses to consent to the removal of the jeopardizing investment.

Unrelated Business Taxable Income

While most foundation investment income will not be subject to tax, unrelated business taxable income, or UBTI, is subject to income tax. UBTI generally does not include dividends, interest and capital gains. However, it does include most debt-financed income. If the foundation is a partner in an investment partnership, such as a hedge fund, that receives some of its income from debt-financing, the foundation will be required to pay federal income tax on its proportionate share of the partnership's UBTI. The consequence of having UBTI for a charitable remainder trust is more dire: if a charitable remainder trust is found to have even a nominal amount of UBTI, the trust is subject to taxation on all of its income for that tax year.

To avoid UBTI, foundations, like charitable remainder trusts and pension funds, may make investments in hedge funds having a corporate (as opposed to a partnership) structure. These corporate funds usually are created offshore. The amounts distributed by the corporation are in the form of dividends or capital gains, and therefore are not classified as UBTI. The IRS has recently ruled that, through such offshore corporate entities, a foundation may avoid the issue of UBTI. In other words, the corporate shell cleanses what otherwise might be considered debt-financed income.

Conclusion

Through its Private Letter Rulings, the IRS is signaling a willingness to allow foundations to invest in hedge funds. Indeed, these rulings have involved hedge funds managed by disqualified persons, as well as hedge funds investing in puts, calls, straddles, futures and forwards. Furthermore, in one ruling, it was anticipated that the foundation might invest all of its assets in a hedge fund managed by a disqualified person. Nevertheless, the foundation manager should proceed with caution: private letter rulings are fact dependent, the federal tax rules concerning foundation investments are complex, and the potential monetary penalties can be substantial.

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