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Charitable constraints

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A few tax considerations are at play if one is donating an interest in a GP or management company, warn tax experts Dahlia Doumar and Carl Merino.

Donor-advised funds (DAFs) have become increasingly popular vehicles for charitable giving in the US, including for donors in the private fund management community. For many such donors, a stake in a fund or its GP or management company (if separate) may be the most logical asset available to fund long-term philanthropic goals. However, certain tax issues, including the rules on excess business holdings, must be considered prior to contribution, particularly if one is donating an interest in a GP or management company.

Why DAFs?

Very generally, a DAF is an account created within a sponsoring public charity whereby the donor (or a designee) is permitted to make recommendations as to charitable expenditures by the DAF and investment of its assets. Provided certain requirements are satisfied, a donation to a DAF is treated as a charitable donation for US federal tax purposes on the date of contribution to the sponsoring charity, despite the fact that the contributed funds may not be further granted for many years. DAFs offer the advantage of a personalized philanthropic fund without many of the compliance headaches, such as minimum annual payout requirements, of a private foundation. Moreover, a donation of appreciated property to a DAF is potentially deductible up to its fair market value, unlike a donation of such property to a private foundation.

Excess business holdings

DAFs, however, like private foundations, are subject to an excise tax on excess business holdings. When a DAF's holdings in a business enterprise, together with those of any "disqualified persons" (generally, the donor or advisor, certain family members and 35 percent-controlled entities of the above) exceed specified ownership thresholds, a 10 percent excise tax is imposed on the "excess" holdings. Failure to timely reduce the excess holdings can result in a 200 percent tax on the remaining excess holdings.

- *20 percent ownership threshold.* A DAF generally may hold up to 20 percent of the voting stock of corporation and up to 20 percent of the profits interest in a partnership (including an LLC treated as a partnership for US tax purposes), reduced by the percentage actually or constructively owned by disqualified persons, without triggering the tax. (The combined ownership threshold is increased to 35 percent if there is sufficient outside control.)

- *2 percent ownership safe harbor.* A DAF generally can own not more than 2 percent of a business enterprise without regard to the interests held by disqualified persons.

- *Five-year rule.* If a DAF acquires an excess business holding “other than by purchase” (for example, a donation), it generally has up to five years to reduce its holdings (or for a disqualified person to do the same) before being subject to the excess business holdings tax. In limited cases, the IRS may grant an extension.

Interest in fund versus GP or management company

An LP interest in a private fund that merely invests in other companies may not be considered a “business enterprise” for purposes of the excess business holdings tax since its own income often is exclusively from passive investments. However, one still must look through the fund to determine whether one’s indirect interests in the underlying portfolio companies (which themselves could be business enterprises) could give rise to excess business holdings. Most managers will not own sufficient interests in the fund itself for the underlying portfolio companies to be an issue.

In contrast, the GP or management company may very well be considered a business enterprise that potentially could trigger the tax, particularly during the early years when fee income may exceed passive investment income. Although DAFs generally have up to five years to reduce excess business holdings acquired by gift, membership interests in GPs and management companies typically are subject to significant transfer restrictions, which could make it difficult to unwind the excess holdings in time to avoid the tax.

Takeaways

- A fund manager donating an interest in a GP or management company should consider limiting such transfers to the DAF and any related DAFs to 2 percent of the outstanding profits interests in order to stay within the 2 percent safe harbor. One could donate more without triggering the tax, but would need to carefully monitor any interests held by the DAF and any disqualified persons (including one’s own interests) to make sure that no one subsequently acquires an interest that could tip the aggregate ownership over 20 percent.

- Whether one is donating an interest in the GP, management company or underlying fund, it is important to discuss the tax implications of the transfer with the sponsoring charity and a tax advisor early in the process. Some charities may be more willing than others to accept such holdings and additional planning may be required.

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