Investing Private Foundation Assets

It's Not Your Father's Portfolio…or Your Sister's…or Yours

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Although many founders and managers of private foundations may themselves be sophisticated investors, they do not always understand the legal parameters for investing a private foundation's assets. Some assume that investing for a private foundation is just like investing for individuals, only it's easier because a private foundation is tax-exempt. Actually, there are many legal constraints, both fiduciary and tax, that are unique to private foundation investing.

These generally fall into four broad categories:

1. Prudent investor laws
2. Outright prohibitions on certain investments
3. The 5% payout requirement
4. Special income taxes applicable to private foundations.

Although these rules serve the useful purpose of making sure that charitable monies are not inappropriately squandered and that private foundations are not abused, they can create problems for a foundation manager who is not familiar with them.

Prudent Investor Laws

The most important distinction between investing your own portfolio and a foundation's portfolio is just that: the foundation's assets are not yours; they are owned by a charity. When investing your own portfolio, there are very few legal guides. You may take as much or as little risk as your stomach and wallet will allow. Although diversification of investment holdings may be a good idea, you are not required to do so with your own portfolio. The investment of foundation assets, on the other hand, is governed by legal standards, generally known as prudent investor laws.

State statutes are the first place to find these prudent investor laws. The particular state law that governs investment of private foundation assets depends on whether the foundation is structured as a trust or as a corporation. For trusts, the investing standards are typically found in the state's version of the Uniform Prudent Investor Act (UPIA), whereas the standards for not-for-profit corporations are found in the state's version of the Uniform Management of Institutional Funds Act (UMIFA).

The UPIA mandates diversification of trust investments, unless the Trustee reasonably determines that the purposes of the trust are better served without diversifying. The focus of the UPIA is the decision-making process and the portfolio as a whole, rather than individual investments. Importantly, the UPIA is considered a default rule and may be altered or waived entirely by specific direction in the trust instrument. Under UMIFA, the governing board is required to consider long-term and short-term needs of the foundation, present and future financial requirements, expected total return, price level trends, and general economic conditions. Given these prudent investor laws, are managers required to diversify the foundation's investments? The answer is maybe. Modern investment theorists and historians of the investment markets over the past 75 years would almost uniformly agree that diversification is a prudent investment decision. Diversified portfolios can be structured to reduce risk and volatility without necessarily sacrificing a corresponding amount of return. If this is true, foundations would always be required to diversify their investment holdings because it would be considered imprudent not to do so. But the prudent investor laws have exceptions.

A foundation would not be required to diversify if:

1. The foundation is a trust and the trust document waives the trustees' duty to diversify or the trustees determine that the purposes of the trust would be frustrated by diversifying or
2. The foundation is a not-for-profit corporation and the facts and circumstances lead the foundation's managers to conclude that diversification would not be prudent. (Some diversification may be required by the "excess business holdings" rules.)

In fact, lack of diversification in foundation investing is fairly common where the donor of the foundation contributes a large block of stock in a publicly traded company and the foundation decides to retain the stock.

Outright Prohibitions

More specific than the prudent investor laws, the Federal tax law contains proscriptions against certain types of investments, namely "jeopardizing investments," "excess business holdings" and "self-dealing" transactions, all under penalty of a severe excise tax.

The idea of the jeopardizing investment prohibition is that the foundation should not be making extremely risky investments using charitable dollars. Although the focus here is on each individual investment, the analysis is done in light of the portfolio as a whole. No investment is per se prohibited, but the initial Treasury Department regulations issued in 1972 list the following investments that will be closely scrutinized: margin trading; commodity futures; oil and gas investments; purchase of puts, calls, straddles and warrants and selling short. This list is somewhat dated, however, and the IRS has more recently allowed alternative investments, e.g., hedge funds, to be included in a foundation portfolio where they were a relatively small percentage of the overall portfolio, the portfolio was well diversified and where professional advisors had recommended the investments. Significantly, investments that have a direct charitable purpose, called a program-related investment, will not be considered a jeopardizing investment. For example, a foundation may make loans (as opposed to grants) to a charity that intends to build low-income housing in impoverished city neighborhoods.

The excise tax on "excess business holdings" was enacted by Congress to combat the perceived abuse of families using their private foundations to continue control of family businesses. In general, a private foundation and its founders, managers and family members may not, together, own more than 20% of the controlling interests of a business entity. If the foundation exceeds the limits, it will be required to sell off the excess. There are exceptions to these rules where the business holding is less than 2% of the outstanding ownership interests and where the business is "functionally related" to the charitable purposes of the foundation. For example, where a foundation's purpose was to promote musical education, the foundation was permitted to own 80% of a music publisher that concentrated on classical music and little-known composers.

A "self-dealing" transaction, also forbidden, is a transaction between the private foundation and an insider or his or her family members (called a "disqualified person"). Technically, a foundation investment that is managed by a firm owned by a disqualified person is self-dealing. However, there is a broad exception to the prohibition for reasonable compensation paid to service providers, including investment managers, who happen to be disqualified persons. Under this exception, the IRS has granted private rulings allowing the investment by a private foundation in mutual funds and investment partnerships managed by disqualified persons.

The 5% Payout Requirement

An investor of foundation assets must be aware of the amounts that a foundation is required to pay out annually in order to satisfy its legal obligations. In short, a foundation is required to pay out in charitable grants and reasonable administration expenses a minimum of 5% of the average value of the foundation's investment assets for the prior year. If the foundation had an average of $1 million of investment assets in its first year, its mandatory distribution for the second year is $50,000, payable by the end of the second year. In each succeeding year, the foundation must continue to distribute the mandatory amount based on the prior year's average asset value. If the charitable distributions in a year exceed the required amount, the excess may be carried forward for five years to offset the mandatory amount in the succeeding years.

The 5% payout requirement should affect a foundation manager's investment decisions. Foremost, the payout requirement will inform the decision on how much should be allocated to equities, fixed income and alternative assets. A recent study revealed that a simple weighting of 65% in equities and 35% in fixed income may not be sufficient to meet the payout requirement and sustain the foundation's inflation-adjusted purchasing power in perpetuity. If that is true, then the foundation investor may be required to take more risk by having a higher weighting of equities or explore alternative assets, the returns of which may not correlate to the public capital markets. Secondarily, the foundation needs to consider cash requirements to make the charitable distributions, and how and when it will be raised. As discussed below, the sale of investment assets will generate a tax, albeit a small one.

Special Income Taxes

Private foundations are exempt from paying regular Federal income tax, but they are subject to two separate taxes on investment income: (i) the excise tax on net investment income and (ii) the unrelated business income tax (UBIT). The excise tax is a 2% tax on interest, dividends, capital gains, rents, royalties, etc., reduced by expenses incurred to generate the income. The rate can be reduced to 1% in a year where the foundation's charitable grants exceed its average distribution level for the prior five years. This tax is somewhat controversial, and there are constant proposals to reduce or eliminate it, including a bill pending in Congress at the time this was written which would reduce it to 1% for all foundations.

The UBIT is a tax at corporate rates imposed on the income of private foundations that is generated from a regularly carried on trade or business not related to its charitable purposes (other than the foundation's ever-present need for money). The UBIT was intended to prevent unfair competition between for-profit enterprises, which are required to pay income taxes, and not-for-profit organizations, which are tax-exempt. In general, passive investments like dividends, interest, capital gains, and rents are not subject to the UBIT because they are not derived from a trade or business.

Because many private foundations allocate a portion of their investment portfolios to alternative investments, questions often arise about whether hedge funds and private equity investments are subject to the UBIT. Private equity funds and hedge funds that use leverage as part of their investment strategy will often distribute income that is subject to the UBIT. If these funds are structured as partnerships, the character of the income flows through to the investors, including private foundation investors. For this reason, many hedge funds and private equity funds offer an offshore model that is structured as a corporation in order to attract tax-exempt investors. Instead of distributing debt-financed income, which triggers the UBIT, the offshore corporation distributes dividends, which do not.

Investment Guidelines Can Help

Investing is a complicated enough task without overlay of prudent investor laws, prohibited transactions, payout requirements and special income taxes. Written investment guidelines that include these rules can be a helpful reminder of what should and should not be done. But foundation managers will go a long way toward living up to these standards if they simply remember that they are investing charitable dollars and not their own.

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