DAF Insights for Advisors

Expertise and tools to help advisors deepen the philanthropic conversation

Contributing Hedge Fund Interests to your Donor-Advised Fund

By Joseph Gajewski, SVP of Investment Operations & Compliance

If you have clients who are managers or principals of a hedge fund, you probably know that their compensation can vary each year. In fact, for hedge fund investment professionals managing equities, the average total compensation package of $1.4 million is roughly 25 percent base pay and 75 percent variable compensation, according to a 2018/2019 Institutional Investor report.[1]

Clients with philanthropic goals, however, can donate a hedge fund interest during a particularly high-income year to offset income with a significant tax deduction—and ultimately have more to give. It is a smart move to donate your best asset—that is, one that has appreciated the most in value. The hitch is that your clients may wish to use the value of this asset to give to multiple charities, but few—if any—are likely to accept complex assets like hedge fund interests.

Fortunately, sponsors of donor-advised funds (DAFs) like National Philanthropic Trust have the expertise to handle such gifts. Contributions to a DAF receive the most advantageous tax treatment. Your clients can take a full, fair market value tax deduction—as determined by a qualified appraisal and as long as the interest was held for more than one year—and avoid capital gains taxes on the sale. A similar contribution to a private foundation would be deductible only for the asset's cost basis.

Last year, for instance, a couple from New York—Joe and Amy—decided to open an NPT DAF to make extensive grant recommendations in education and the arts.[2] Amy was a principal of a hedge fund who had initially invested $100,000 in limited partnership interests in her fund. In ten years, her LP interests grew to $20 million, making it an excellent asset to give to charity. The couple decided to donate 5 percent of their LP interests, or $1 million.

For the donors, the process was relatively straightforward. First, they had to provide NPT with documents to complete due diligence and to facilitate the transfer of their ownership, including the private placement memorandum, organizational documents (e.g. limited partnership agreement), transfer agreement, subscription agreement and other documents related to the fund. NPT conducted operational due diligence on the fund, which generally takes four to six weeks, and the costs were paid out of the assets in the DAF. The client's only additional responsibility was to obtain a qualified appraisal of the gifted interest for tax deduction purposes.

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Contributing Hedge Fund Interests to your Donor-Advised Fund (continued)

Once approved by NPT, the hedge fund interest was transferred to NPT to be held in the couple's DAF. They received a $1 million tax deduction, owed no capital gains taxes and saved $370,000 in income taxes (assuming a 37 percent federal income tax rate). If they had sold the hedge fund interest, they would have had to pay $199,000 in capital gains taxes (20 percent tax on $995,000 in long-term capital gains), reducing their amount available to gift to $801,000. Their income tax savings would also drop to $296,370 (37 percent income tax on $801,000). If they had given their LP interest to a foundation, they could have deducted only the cost basis—5 percent of the original $100,000 investment, or $5,000. This would have saved them just $1,850 in income taxes (37 percent of $5,000).

With an eye to growing their philanthropic capital, Joe and Amy recommended that their DAF remain invested in the hedge fund and contributed an additional $100,000 in liquid assets for grantmaking and charitable administration fees. The hedge fund interest can be held in the DAF while it continues to appreciate in value.[2] Unlike some other DAF sponsors, with an NPT DAF, donors are able to recommend that the DAF hold up to 90 percent of its value in illiquid assets, as long as the DAF has at least 10 percent of its value in liquid assets, like mutual funds and exchange traded funds. The liquidity is required for grantmaking, paying charitable administrative fees and, if applicable, to pay unrelated business income tax (UBIT) on taxable income generated by the illiquid assets.

Today, Joe and Amy enjoy making ongoing grant recommendations and planning for a future of giving.

If you'd like more information on how your clients can contribute complex assets like hedge fund or private equity interests to a DAF, our experts can guide you through the process. Please contact NPT by phone at (888) 878-7900 or by email at npt@nptrust.org.

Joseph Gajewski is the Senior Vice President of Investment Operations and Compliance. With more than 25 years of experience in financial services, Mr. Gajewski is responsible for overseeing donor account opening, investment and contribution processing, and ensuring that NPT's investments comply with all applicable policies.

NPT does not provide legal or tax advice. This blog post is for informational purposes only and is not intended to be, and shall not be relied upon as, legal or tax advice. The applicability of information contained here may vary depending on individual circumstances.

ENDNOTES

[1] Institutional Investor Report: Global Hedge Fund Compensation, 2018/2019 Global Research Teams Insight
[2] Names and details changed to protect donor anonymity.
[2] Depending on the circumstances, including the donor's role with the fund, management and incentive fees may need to be waived in order for NPT remain an investor in the fund and to avoid the imposition of penalty excise taxes.

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