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By Eric L. Johnson and Kristina A. Rasmussen

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Through a case study approach, Johnson and Rasmussen highlight common interactions between the family office and family private foundation and offer planning considerations to reduce exposure to potential excise taxes and penalties.

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Table of Contents

A growing number of wealthy families are making significant charitable and philanthropic commitments. Those families will certainly be a catalyst for positive change in the years to come, whether through the highly publicized Giving Pledge,[1] socially responsible investing and venture philanthropy, or the establishment of family-funded private foundations with missions to solve some of the world's most pressing problems.

These wealthy families often use a family office to centralize the management of and control over family assets and decisions, as well as to plan for family succession. Separately, many wealthy families form private foundations to further the family's philanthropic mission.[2] The family office can be intimately involved with family philanthropy, often providing significant services and support to the private foundation and its activities.

To ensure that its charitable purposes are fulfilled, private foundations are held accountable to a strict set of rules and regulations and can incur costly tax penalties for noncompliance with those rules. Unfortunately, some interactions between the family office and the family's private foundation may inadvertently breach some of those rules. Continued failure to comply with the rules could ultimately result in revocation of the private foundation's tax-exempt status.

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[1] *Available at* http://givingpledge.org.

[2] The term "private foundation" throughout this report is used to cover both private operating and nonoperating foundations legally structured as corporations or trusts, as well as charitable split-interest trusts that are required to follow specific excise tax rules, such as charitable lead trusts and charitable remainder trusts.

This report examines some common situations in which the family office intersects with the family's private foundation activities. They include (1) personal services arrangements between the family office and the private foundation; (2) private foundation co-investment with the family office and other family members or family entities; and (3) cohabitation arrangements — that is, the sharing of space, equipment and supplies, and personnel between the family office and the private foundation.

To properly set the stage for these case studies, we first review two of the more relevant excise taxes that apply in these situations: the section 4941 excise tax on self-dealing and the section 4945 excise tax on excess business holdings. Other excise taxes and issues will be addressed throughout the case studies.

I. Brief Overview of Selected Excise Tax Rules

A. Self-Dealing

Self-dealing is a transaction between a private foundation and a disqualified person. The definition of self-dealing covers a wide range of direct and indirect transactions that are prohibited even though they may benefit the private foundation and not benefit the disqualified person.

When reviewing a transaction to evaluate whether it constitutes an act of self-dealing, it is important to understand which individuals and entities could be considered disqualified persons. The statutory list of individuals and entities defined as disqualified persons reflects a vast array of relationships and ownership, including:

1. substantial contributors (both individuals and entities);

2. foundation managers (officers, directors, trustees, and people with similar powers);

3. individuals who are more than 20 percent owners of substantial contributors;

4. family members of an individual described in 1, 2, or 3, including spouses, ancestors, children, grandchildren, great grandchildren, and spouses thereof (note that family members do not include siblings);

5. entities owned more than 35 percent by a person described in 1, 2, 3, or 4 (through voting power in a corporation, profits interest in a partnership, or beneficial interest in a trust or estate); and

6. government officials.[3]

Decades ago, when the self-dealing rules were put in place, Congress was concerned that donors to private foundations were unduly benefiting from transactions with the foundations, such as sales of stock and payment for services rendered. As a result, it specified acts that would be banned between a private foundation and disqualified persons. Section 4941 identifies the following types of (direct or indirect) activities as prohibited self-dealing:

- the sale, exchange, or leasing of property between a private foundation and a disqualified person;
- the lending of money or other extension of credit between a private foundation and a disqualified person;
- the furnishing of goods, services, or facilities between a private foundation and a disqualified person;
- the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;
- the transfer of the income or assets of a private foundation to a disqualified person, or the use of the foundation's income or assets by or for the benefit of a disqualified person; and
- the agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946(c)), other than an agreement to employ that individual for any period after the termination of his government service if he is terminating his government service within a 90-day period.[4]

There are also several exceptions and special rules, including the following:

- the transfer of real or personal property by a disqualified person to a private foundation will be treated as a sale or exchange if the property is subject to a mortgage or similar lien that the private foundation assumes, or if it is subject to a mortgage or similar lien that the disqualified person placed on the property within the 10-year period ending on the date of the transfer;
- the lending of money by a disqualified person to a private foundation will not be an act of self-dealing if the loan is without interest or other charge and if the proceeds of the loan are used exclusively for purposes specified in section 501(c)(3);
- the furnishing of goods, services, or facilities by a disqualified person to a private foundation will not be an act of self-dealing if it is

[3]Section 4946(a).

[4]Section 4941(d)(1).

done without charge and if the goods, services, or facilities are used exclusively for purposes specified in section 501(c)(3);
- the furnishing of goods, services, or facilities by a private foundation to a disqualified person will not be an act of self-dealing if it is on a basis no more favorable than that on which those goods, services, or facilities are made available to the general public;
- except for a government official, the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services that are reasonable and necessary to carrying out the foundation's exempt purpose will not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive; and
- any transaction between a private foundation and a corporate disqualified person under a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization will not be an act of self-dealing if all the securities of the same class as that held by the private foundation are subject to the same terms and if those terms provide for the private foundation's receipt of no less than fair market value.[5]

To deter self-dealing, a tax equal to 10 percent of the amount involved in the act of self-dealing is assessed.[6] This tax applies for each year in the tax period, is imposed on the disqualified person, and is not abatable, even if there is reasonable cause.[7] Further, a tax of 5 percent is imposed on a foundation manager who knowingly and willingly participates in an act of self-dealing.[8] Correcting the act of self-dealing (that is, undoing the transaction) is also required, and the private foundation must be left in no worse a position than it would have been in had the transaction not occurred.[9] If the self-dealing is not corrected, a 200 percent tax may be imposed.[10]

B. Excess Business Holdings

A foundation must also limit its ownership of businesses. Private foundations may not control a substantial interest in a business enterprise, such as a corporation or partnership. Here, the definition of a business enterprise is crucial. A business enterprise is the active conduct of a trade or business, including any activity carried on for the production of income from the sale of goods or the performance of services, that constitutes an unrelated trade or business.[11] Bond holdings do not constitute a holding in a business enterprise unless they are considered an interest in the business. Further, a leasehold interest in real property is not an interest in a business enterprise, even if the rent is based on the income or profits of the property, unless the leasehold interest is an interest in the income or profits of an unrelated trade or business as defined in section 513.[12] If a foundation is investing in a business to further an exempt purpose such as a program-related investment, that investment is not considered a business enterprise for purposes of the excess business holdings rules.

The most commonly used exception to the term "business enterprise" is a business in which at least 95 percent of the gross income is derived from passive sources, including dividends, interest, annuities, royalties, rental income from real property, and gains or losses from the disposition of property.[13] The 95 percent test is calculated each year, or an average of the previous 10 years may be used.

In general, a private foundation can hold an investment of up to 2 percent in any business (the 2 percent de minimis threshold).[14] However, a private foundation will be deemed to have excess business holdings when it, together with all disqualified persons, owns more than 20 percent of the voting control of a business enterprise.[15] Under some circumstances, the 20 percent amount can be increased to 35 percent.[16]

In many instances, an investment partnership that holds passive investment assets would not be considered a business enterprise and therefore could give a private foundation and other disqualified persons the ability to collectively invest. Be careful, however, to look through to the underlying holdings of a partnership. For example, if a private foundation owns 30 percent of Partnership A and A's assets consist of 100 percent of the stock of a corporation (a business enterprise), the private foundation would be deemed to own 30 percent of the corporation. In this example, the private foundation would be deemed to have excess business holdings unless the 35 percent limitation applied.

Excess business holdings are subject to a 10 percent excise tax on the value of the excess holdings.[17] This tax applies for each year in the tax

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[5] Section 4941(d)(2).
[6] Section 4941(a).
[7] Section 4962(b).
[8] Section 4941(a)(2).
[9] Section 4941(e)(3).
[10] Section 4941(b).

[11] Reg. section 53.4943-10(a)(1).
[12] *Id.*
[13] Reg. section 53.4943-10(c)(1).
[14] Section 4943(c)(2)(C).
[15] Section 4943(c)(2)(A).
[16] Section 4943(c)(2)(B).
[17] Section 4943(a)(1).

period and is imposed on the private foundation, but it may be abated if the foundation can demonstrate reasonable cause. Correcting the excess business holding (that is, undoing the transaction) is also required, such that no interest in the business enterprise held by the foundation is classified as an excess business holding.[18] If the excess holdings are not corrected, a 200 percent tax may be imposed.[19]

If a transaction by a disqualified person creates an excess business holding for a private foundation, the foundation has 90 days from the date it knows of the holding to dispose of it and avoid the 10 percent excise tax.[20] The determination of when the private foundation is deemed to know of the holding is based on the facts and circumstances. In all instances, a private foundation that knowingly enters into a transaction that creates an excess business holding must immediately divest of the investment and pay the excise tax. A private foundation that receives a holding in a business enterprise by gift, bequest, etc. (other than a purchase) has five years to divest of the excess business holding and avoid the excise tax.[21] An additional five-year period can be requested.[22]

Given the complexity surrounding the self-dealing and excess business holdings rules, it is important to consider these elements before a private foundation makes an investment with a disqualified person. It is equally important to monitor the investment throughout its duration. For example, a capital call may swing a private foundation's ownership significantly and present excess business holdings problems.

With a base level of understanding about self-dealing and excess business holdings, we can now turn to the case studies.

II. Personal Services Arrangements

A. Case Study: The Miller Family

The Miller Family Office (MFO) is a full-service family office that serves the various extended members, trusts, and related entities of the Miller family. MFO was founded by its patriarch, John Miller, but ownership has transitioned to his two sons, Henry and Arthur. Among other services, MFO provides accounting, tax return preparation, and investment consulting services to the extended family and trusts in exchange for a market-based fee.[23]

John also formed the Miller Family Foundation (MFF), a private nonoperating foundation that supports education causes. MFF maintains its own well-diversified investment portfolio.

The MFF manager is interested in having MFO provide these same services to MFF. You have been asked to provide advice on this potential relationship.

The self-dealing limitation casts a wide net and includes the payment of compensation from a private foundation to a disqualified person. MFO is clearly a disqualified person because MFF was wholly funded by John and MFO is wholly owned by his two sons.[24]

Fortunately, there is an often-used exception that permits a private foundation to avoid an act of self-dealing if (1) the compensation is for personal services, (2) the objective of the services is to carry out the tax-exempt purpose of the foundation, and (3) the total amount of compensation is not excessive.[25]

B. The Provision of Personal Services

Several examples in the regulations clarify the definition of personal services, even though the term is not specifically defined.[26] According to the examples, personal services include the services of attorneys and investment advisers. In fact, one of the examples is similar to a family office arrangement:

> C, a manager of private foundation X, owns an investment counseling business. Acting in his capacity as an investment counselor, C manages X's investment portfolio for which he receives an amount which is determined to not be excessive. The payment of such compensation to C shall not constitute an act of self-dealing.[27]

Also, private letter rulings expand on the concept of personal services. Although those rulings may not be cited or relied on as precedent, they can be instructive. One letter ruling concluded that a newly formed family office's provision of tax services, administrative services, and management services was personal services.[28] Another letter ruling concluded that the provision of asset management

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[18] Reg. section 53.4943-9(c).
[19] Section 4943(b).
[20] Reg. section 53.4943-2(a)(1)(ii).
[21] Section 4943(c)(6).
[22] Section 4943(c)(7).

[23] Although irrelevant to this case study, we'll assume that MFO qualifies under the SEC family office rule and is exempt from investment adviser registration.
[24] As defined in section 4940(d)(3)(i) and (iii).
[25] Section 4941(d)(2)(E).
[26] Reg. section 53.4941(d)-3(c)(1).
[27] Reg. section 53.4941(d)-3(c), Example 2.
[28] LTR 9238027.

services, coordination of tax matters, and other financial services was personal services.[29] Note, however, that not all services are necessarily considered personal services. In one decision, the Tax Court noted that the services must be "professional and managerial in nature," and it distinguished those services from maintenance, janitorial, and security services.[30]

Turning back to our case study, it would appear that the accounting, tax return preparation, and investing consulting services that MFO proposes to provide to MFF should clearly fall under the personal services exception.

C. Compensation That Is Not Excessive

To determine whether compensation for the provision of personal services is not excessive, the self-dealing regulations direct us to the income tax regulations.[31] The income tax regulations do not provide any bright-line tests, but they indicate that the compensation must be reasonable and in an amount "as would ordinarily be paid for like services by like enterprises under like circumstances."[32]

Further, keep in mind that the term "not excessive" (and the personal services exception generally) should be considered side by side with the private inurement doctrine. That doctrine requires that no part of the net earnings of tax-exempt charitable organizations,[33] including private foundations, inure to the benefit of persons in their private capacity.[34] Thus, the concept of private inurement includes excessive or unreasonable compensation, and a private foundation must be able to support the position that the compensation provided to a disqualified person is reasonable and not excessive.

So what should MFF do to demonstrate that the proposed compensation charged by MFO is not excessive? First, an objective compensation method should be established. This can be accomplished by determining that the compensation provided to MFO is similar to others in comparable positions or by using compensation studies by an independent party.[35] Second, the compensation method should be applied regularly and continuously, and care should be taken that the other MFO family clients are not directly or indirectly benefiting from the arrangement (that is, a private inurement issue). Finally, the compensation method should be memorialized through contemporaneous documentation, such as a services agreement between MFO and MFF.[36]

Accordingly, assuming MFO takes the necessary steps outlined above, its provision of personal services to MFF should not be considered an act of self-dealing.

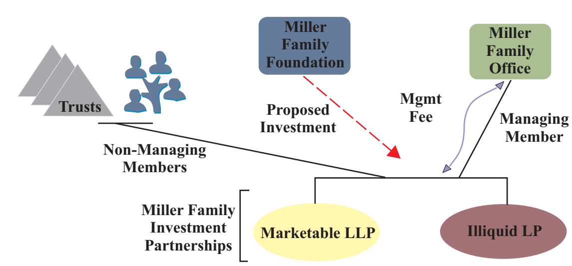
III. Co-Investment Opportunities

A. Case Study: Family Fund Structure

The Miller family had previously formed an investment partnership[37] (Marketable LP) that holds marketable, exchange-traded assets invested with separate account managers. The family is contemplating a second partnership (Illiquid LP) to serve as a fund of funds, holding various hedge fund and other illiquid investments.

MFO is the general partner for Marketable LP, and it is expected to be the general partner for Illiquid LP. The limited partners are John's various descendants and the trusts established for their benefit. As the general partner, MFO intends to charge a management fee to each partnership for the investment consulting services it provides. Exhibit 1 illustrates the family fund structure.

Figure 1. Co-Investment Example Proposed MFF Investment Into the Miller Family Investment Structure



Through its foundation manager, MFF has expressed an interest in becoming a limited partner in Marketable LP as well as in Illiquid LP. MFO is

[29]LTR 9703031.

[30]*Madden v. Commissioner*, T.C. Memo. 1997-395.

[31]Reg. section 53.4941(d)-3(c)(1) references reg. section 1.162-7.

[32]Reg. section 1.162-7(b)(3).

[33]Under section 501(c)(3).

[34]Reg. section 1.501(c)(3)-1(c)(2).

[35]Reg. section 53.4958-6(c)(2)(i).

[36]For a more in-depth discussion on leading practices for structuring those compensation arrangements, see Eric L. Johnson and Ryan E. Thomas, "Family Office Management of Private Foundation Funds," 150 *Trusts & Estates* 33 (Oct. 2011).

[37]Our references to "partnership" throughout this report are used to cover limited partnerships, limited liability partnerships, limited liability companies, Delaware business trusts, and other arrangements taxed as partnerships for federal tax purposes. Accordingly, the term "partner" is used to cover both partners and members of these entities.

excited about this prospect because the additional funds contributed by MFF will significantly increase assets under management. MFF's participation in Marketable LP will allow MFO to negotiate lower fees with the partnership's separate account managers and to pursue investment opportunities with funds that require higher investment minimums.

Why would MFF want to invest in these partnerships in the first place? There may be several different reasons. Participation in one or more of these partnerships may help MFF access different asset classes and thus diversify its investment portfolio. MFF might also gain access to investments with higher minimum investment requirements, investments that would otherwise be unavailable to MFF in maintaining its own portfolio. Moreover, MFF might benefit from economies of scale and resulting cost savings by negotiating lower investment management fees from these arrangements. These are all valid reasons for MFF to invest with the family's partnerships, but this arrangement raises potential excise tax considerations.

B. Is the Investment a Self-Dealing Violation?

Would MFF's investment in Marketable LP or Illiquid LP be self-dealing? As noted earlier, a sale or exchange between a private foundation and a disqualified person is an act of self-dealing. So we must first determine whether Marketable LP or Illiquid LP is a disqualified person.

Marketable LP is by definition a disqualified person because more than 35 percent of its profits interests are owned by the Miller family members and related trusts. Is Illiquid LP a disqualified person? Self-dealing presupposes a transaction between a private foundation and a disqualified person. However, self-dealing does not include a transaction between a private foundation and a disqualified person if the disqualified person status arises only as a result of that transaction. This is known in philanthropic circles as the "first bite" rule.[38] So in our case study, Illiquid LP is not a disqualified person, assuming MFF's initial investment is simultaneous with those of the Miller family members and trusts to initially form Illiquid LP. However, the first bite rule does not apply to any later transaction between the private foundation and the disqualified person once disqualified person status has been established.

So Marketable LP is a disqualified person, and Illiquid LP may soon become one if there are subsequent partner capital changes. Accordingly, the next question is whether specific transactions between MFF and the partnerships (contributions and redemptions) would be considered a sale or exchange under the excise tax rules. If they are, those transactions would be deemed impermissible acts of self-dealing.

The excise tax rules do not define a sale or exchange for purposes of self-dealing. And although the partnership rules use the term "exchange" when providing for nonrecognition of gain or loss on contribution,[39] the IRS seems to have disregarded that definition in defining sale or exchange for excise tax purposes.

Two lines of letter rulings appear to permit a private foundation to invest in a family-owned partnership that is deemed to be a disqualified person. One line seems to conclude that because the taxpayer has represented that the private foundation's investment in the partnership is not considered a sale or exchange under "applicable state law," there is no sale or exchange for purposes of the excise tax rules and thus no act of self-dealing.[40] Unfortunately, these letter rulings provide no analysis regarding that position, and the factual redactions make it impossible to determine the taxpayer's applicable state. The second line of rulings concludes that the private foundation's investment in the partnership, including contributions to and withdrawals from it, is simply a co-investment arrangement and not a sale or exchange for purposes of the excise tax rules.[41] However, these rulings, too, provide limited analysis regarding that position.

Accordingly, because letter rulings cannot be relied on by other taxpayers, it seems prudent for MFF to consider requesting its own ruling before making any investment in Marketable LP or Illiquid LP. It appears that the IRS will eventually provide further guidance on this matter.[42] However, before MFF makes any investment in the partnerships, it should consider a few more issues, discussed below.

C. Tangible Benefits From Co-Investment

MFO indicated that the inclusion of MFF in the fund structure and the corresponding increase in assets under management would allow MFO to negotiate lower investment management fees in

[38]Reg. section 53.4941(d)-1(a).

[39]Section 721.

[40]LTR 200043047; and LTR 200423029.

[41]LTR 200318069; LTR 200420029; and LTR 200551025.

[42]*See* Treasury and the IRS, "2015-2016 Priority Guidance Plan," at 10 (Feb. 5, 2016) (listing the following as an exempt organizations project: "guidance under section 4941 regarding a private foundation's investment in a partnership in which disqualified persons are also partners").

Marketable LP and pursue investment opportunities with higher investment minimums in Illiquid LP. If a disqualified person would benefit from the private foundation's co-investment, this may result in private inurement, another form of self-dealing.

Private inurement, although not specifically defined in the regulations, results in any transaction between a charity and a private individual (for example, a disqualified person) when the individual appears to receive a disproportionate share of the benefits of the transaction relative to the charity. There are two potential private inurement issues.

The first is the potential benefit that the disqualified person may receive from reduced asset management fees in Marketable LP. A possible solution might be to include in the partnership operating agreement a provision indicating that if the partnership achieves any cost savings as a result of the private foundation's investment and if those savings could not be achieved if the private foundation was not an investor, all the savings will inure to the private foundation. It would be important to ensure that the partnership's economic and tax allocations to the private foundation and other partners reflected that provision.

The second problem is the potential benefit that the disqualified person might receive from gaining access to more exclusive funds in Illiquid LP. One possible solution would be to conclude that this benefit is "incidental and tenuous" and therefore qualifies for an exception from self-dealing.[43] Although the Treasury regulations do not define the meaning of incidental and tenuous, the IRS concluded that in a similar arrangement, any benefits that the investment partnership and other members derived from the private foundation's participation was incidental and tenuous under the regulation.[44]

D. Profits Allocations and Incentive Fees

Recall that MFO intends to charge a management fee to each partnership for the investment consulting services it provides. In the earlier case study, we concluded that the provision of personal services by MFO to MFF qualified for an exception to the self-dealing rules. That same analysis holds true in this case study as well, with MFO providing services to partnerships in which MFF is a partner.

But what if MFO is compensated through a more sophisticated compensation arrangement, such as a "1 and 10 carry" (that is, a 1 percent management fee and a 10 percent profits interest — a common arrangement in the financial services industry)? Is a profits allocation reasonable compensation for purposes of the personal services exception to the self-dealing rules? There appears to be no direct guidance on this matter. Interestingly, the previously mentioned example in the regulations does not specify the form of the compensation; it simply indicates that the investment counselor receives an "amount" that is determined to be not excessive.[45] One letter ruling cited earlier included a fact pattern with a profits allocation, but the taxpayer carefully structured the arrangement so the profits allocation was not taken from (nor received by) the private foundation.[46] In another letter ruling, the manager charged the partnership a performance fee for achieving returns exceeding a specified threshold, but the manager waived that fee for the private foundation partner.[47] Given the lack of direct guidance, taxpayers should proceed with extreme caution in these situations.

E. Excess Business Holdings

Could MFF's investment in Marketable LP or Illiquid LP be considered excess business holdings? Recall that in general, a private foundation and all disqualified persons, in aggregate, may not own more than 20 percent of a partnership's profits interest.[48] Because our facts indicate that MFF's investments in the partnerships will meet that test and certainly exceed the 2 percent de minimis threshold, those investments must be tested.

For Marketable LP, it's clear that one of the common exceptions applies: A business enterprise that earns at least 95 percent of its gross income from passive sources is not subject to the excess business holdings rule.[49] Because Marketable LP's portfolio consists of exchange-traded securities invested with separate account managers, MFF's investment in Marketable LP will not result in excess business holdings.

What about Illiquid LP? In one letter ruling, the IRS concluded that a partnership's only activity consisted of investments in private businesses, mainly as a limited partner in limited partnerships, and that because the partnership would not be managing the businesses of the limited partnerships, the limited partnerships represented passive investments comparable to stock and securities.[50]

[43]Reg. section 53.4941(d)-2(f)(2).
[44]LTR 200551025.

[45]Reg. section 53.4941(d)-3(c)(2), Example 2.
[46]LTR 200318069. In this ruling, the private foundation was only a co-investor in the management company that received the profit allocation, and the profits allocation was specially allocated to other partners of the management company.
[47]LTR 200551025.
[48]Section 4943(c)(3).
[49]Section 4943(d)(3)(B).
[50]LTR 199939046.

The partnership's investments were therefore passive investments, and the partnership was not a business enterprise for purposes of the excess business holdings rule. Assuming Illiquid LP remains a fund of funds partnership, it would appear that Hedge LP itself should not be construed as a business enterprise under that test.

However, to complete our analysis, we must also examine the underlying holdings of Illiquid LP to confirm that the 20 percent test will not be met on a look-through basis. Further, if Illiquid LP decides to make significant, direct investments in private equity deals or involves itself in the management of those businesses, those holdings could be problematic. So MFF's investment in Illiquid LP will need to be carefully monitored, and MFO, as investment manager, will need to be aware of these limitations when considering subsequent investments in the portfolio.

F. Jeopardizing Investments

The rules regarding jeopardizing investments were put in place to safeguard the private foundation's ability to carry out its exempt purpose.[51] In other words, private foundations cannot invest in a way that would show lack of good business judgment. The determination of whether an investment is considered jeopardizing is done at the time of the investment. It considers the portfolio as a whole and is not affected by future income or losses from the investment.

To further deter and prevent foundation managers (for example, board members, trustees, or those with similar influence) from making jeopardizing investments, a tax equal to 10 percent of the amount involved in the jeopardizing action is assessed directly on the foundation manager.[52] The tax is abatable if there is reasonable cause.[53] If the foundation manager knowingly and willingly made the investment, an additional 10 percent tax is imposed.[54] Further, if the asset is not removed from jeopardy, a 25 percent tax may be imposed on the private foundation.[55]

Could an investment by MFF in Illiquid Fund LP be deemed a jeopardizing investment? Unlikely. Although no category of investment is treated as a per se violation, there are some practical guidelines. The Treasury regulations provide that trading in securities on margin; trading in commodity futures; investments in working oil and gas wells; purchases of puts, calls, and straddles; purchases of warrants; and selling short will be ''closely scrutinized.''[56] However, this list was developed over 30 years ago, and modern portfolio theory would suggest that these investments, as part of an overall diversified portfolio, arguably provide low or negative correlation with other investments and thus may mitigate overall portfolio risk. Moreover, at least one letter ruling determined that a private foundation's investment in a hedge fund was not a jeopardizing investment.[57]

G. UBTI

The concept of unrelated business taxable income has been around for decades. Before 1950 a charitable organization could conduct commercial-type activities that did not relate to its exempt purpose and shield any net income from that activity from income tax. The rules at that time looked at the use of the funds generated rather than the activity itself when determining whether the income was subject to taxation. As a result, many tax-exempt organizations were engaging in all sorts of activities that were not related to their exempt purpose and directly competed with for-profit business enterprises. After much scrutiny and debate, Congress included in the Revenue Act of 1950 provisions that subjected income from an activity that was not related to an organization's overall tax-exempt purpose to income tax at the corporate or trust income tax rates. Those rules still apply.

All tax-exempt organizations, including private foundations, may be subject to income tax on UBTI.[58] UBTI can be generated through activities in which the private foundation directly engaged or through its investment in a passthrough entity, such as a partnership or S corporation.[59] For partnership entities, the private foundation would look through to the activities of the entity and evaluate whether they were tax exempt in nature. For most operating entities, the activities conducted are considered UBTI by a private foundation investor. Generally speaking, however, UBTI does not include passive types of income such as dividends, interest, rents, and royalties,[60] unless the asset generating that

[51]Section 4944.
[52]Section 4944(a)(1).
[53]Section 4962(a).
[54]Section 4944(a)(2).
[55]Section 4944(b)(1).

[56]Reg. section 53.4944-1(a)(2)(i).
[57]LTR 200318069. Although the investment was made through the hedge fund's general partner, the IRS viewed it as an indirect investment in the hedge fund's underlying investments. Even though the private foundation's investment involved most of the foundation's assets, the IRS determined that the hedge fund was sufficiently diversified and accordingly was not a jeopardizing investment.
[58]Section 511.
[59]Under section 512(e), 100 percent of an exempt organization's share of S corporation income is treated as UBTI.
[60]Section 512(b).

income is debt-financed.[61] Therefore, careful analysis of the Schedule K-1 received from a passthrough entity is required to evaluate potential UBTI impact.

UBTI from all sources is totaled and reported on Form 990-T, "Exempt Organization Business Income Tax Return." Keep in mind that in addition to federal UBTI, most states also impose a tax and require filings concerning state-sourced UBTI. Accordingly, although Marketable LP will likely generate the passive types of income previously mentioned, Illiquid Fund LP will likely generate revenue from operations that would be considered UBTI. Therefore, before investing in Illiquid Fund LP, MFF should carefully analyze the tax impact of potential federal and state UBTI.

H. Co-Investment Planning Considerations

Assuming MFF continues to pursue an investment within Illiquid Fund LP, it appears that specific provisions could be included in the partnership agreement to limit the exposure from the above concerns. Several of the favorable letter rulings on this topic have provided a nonexclusive list of these potential provisions.

For example, the partnership agreement in LTR 199939046 prohibited the partnership from:

- making any investments that would result in excess business holdings for the private foundation's partners and its disqualified persons;
- holding a more than 20 percent interest in any limited partnership;
- directly engaging in an operating business;
- making any jeopardizing investments that would subject any of the private foundation partners to tax;
- engaging in property or credit transactions with any disqualified persons of the private foundation partners that would constitute self-dealing; and
- purchasing or selling investments in an attempt to provide an advantage to a disqualified person.

The partnership agreement in LTR 200420029 contained the following provisions:

- the right for the private foundation to withdraw from the partnership, in whole or in part, as of the end of any period (perhaps drafted as a put right);
- the right for the private foundation to receive an in-kind distribution of its interest (that is, a pro rata share) if it elects to withdraw;
- a veto right provided to the private foundation for specifically defined decisions;
- a special provision indicating that if any cost, fee, or expense is incurred by the partnership and is based on a percentage of the partnership assets, the private foundation will pay the lowest possible percentage of fees and the other investors will bear the burden of and pay the remainder of those fees (for example, investment manager fees);
- a special provision indicating that if the partnership achieves any savings on costs, fees, or expenses because the amount of the investment exceeds the minimum asset amount thresholds, and if those savings could not be achieved if the private foundation was not an investor, all the savings will inure to the private foundation; and
- a provision that the manager or managers of the partnership may receive a manager's fee not in excess of the usual and customary money management fees assessed by professional fiduciaries of the community.

The real challenge with any co-investment arrangement is not in establishing the arrangement but in the necessary monitoring of partner capital changes, partnership investment selection, fees charged by the manager or outside providers, and potential transactions between partners. Absent the establishment of formal procedures to continually monitor these arrangements, even good intentions can lead to unintended consequences. In our case study, the better route may be to have MFF not co-invest in the partnerships but rather maintain a separate investment portfolio. MFO could manage MFF's investment portfolio under an administrative services agreement structured to meet the personal services exception.

IV. Cohabitation Situations

A. Case Study: Sharing Space and Personnel

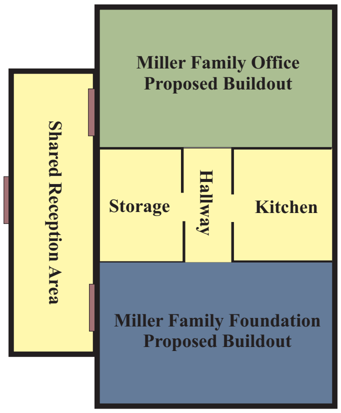
MFO has built out new office space to accommodate the increasing technology needs of the office. The space is excellent, and the MFF board has decided to move its operations there also. The family is excited about this opportunity because having both MFO and MFF in the same location should increase efficiency and provide economies of scale through the sharing of personnel, technology, vendors, and supplies.

As Exhibit 2 illustrates, the buildout will have a shared reception area but separate office space for MFO and MFF. The offices are connected by a hallway, and MFO and MFF will share a storage area and kitchen.

Also, although MFO and MFF maintain separate payrolls, there is an agreement to share specific employees: An administrative assistant will service the shared reception area, and an MFF employee

[61] Section 514.

Figure 2. Cohabitation Example
MFO and MFF Proposed Buildout



who prepares the foundation's annual report is needed in the MFO office to revamp the MFO investor reports.

In practice, it is common for families to house their private foundation in close proximity to their family office. While this can certainly provide economies of scale and other valuable benefits, there are many issues that are important to address upfront. Several seemingly "good" transactions end up problematic after the IRS rules are applied. These transactions commonly include sharing of office space, sharing of supplies and equipment, and sharing of personnel.

B. Sharing Office Space

The sharing of office space between a private foundation and the family office (when considered a disqualified person) has been the topic of many letter rulings.[62] The general rule is that if a private foundation reimburses a disqualified person for its portion of the lease, an act of self-dealing has occurred.[63] This is true even if the private foundation reimburses the disqualified person at less than FMV for the rental payment. If an act of self-dealing has occurred, the transaction must be unwound, and excise taxes will be assessed. Remember, the 10 percent excise tax (assessed on the amount of the transaction) for acts of self-dealing cannot be abated, even if there is reasonable cause.[64]

What's the solution for the Miller family? Because MFO owns the building, including the new addition, MFF cannot make lease payments to MFO for its share of the building. However, it would be permissible for MFF to sign a sublease agreement with MFO at $0 to establish the terms regarding the free use of the space.

What if MFO and MFF occupy a building owned by a third party? In that case, if MFO and MFF enter into separate lease agreements with the lessor (which cannot be a disqualified person) and if MFO receives no benefit (for example, reduced rent) from its rental of the space, the transaction will not be considered an act of self-dealing.[65] In this situation, it is permissible for MFO and MFF to agree on the allocation of the cost based on space used by each entity (including the shared reception area, kitchen, and bathrooms) before signing the lease. Note that if MFF did not originally sign the lease, it should not make payments to the third-party lessor until it has signed the lease, which will likely be the next time the lease is up for renewal.[66]

C. Sharing Supplies and Equipment

Often, family offices and private foundations share not only space but also supplies and equipment. There are two viable ways to mitigate a self-dealing argument: (1) have the family office provide the supplies and equipment at no cost to the private foundation, or (2) have the family office and private foundation enter into separate contracts with the third-party vendor that is providing the supplies and equipment.

Letter rulings have supported both these arrangements. In one ruling, a private foundation and a disqualified person were sharing office equipment, telephone systems, and supplies.[67] The IRS ruled favorably because the taxpayer represented that the private foundation would either use the equipment or supplies at no cost or keep detailed records supporting its use and pay only its share of the cost directly to the third-party vendor.

The storage area shared by MFO and MFF may become problematic under the separate contract approach because it may be difficult to prove proper segregation of ownership of the supplies. The better approach may be to have MFO purchase all supplies and allow MFF to use them free of charge. If the separate contract approach is desired, a different supply storage method is warranted.

In recent years, technology infrastructure and buildout has become a significant cost for family offices. Often the technology platform is intended for use by both the family office and the private foundation, and there is no practical way to separate its use. In those situations, it will be important

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[62] For example, LTR 200421010; LTR 200116047; LTR 9238027; LTR 9238028; and LTR 9019064.

[63] Section 4941(d)(1)(A).

[64] Section 4962(b).

[65] LTR 8331082; LTR 9307026; and LTR 9312022.

[66] LTR 9019064.

[67] LTR 9312022.

to have the family office own the technology and allow the private foundation to use it at no charge.

D. Sharing Personnel

It is entirely possible for the family office and the private foundation to share employees, but the devil is in the details — that is, the form of the arrangement is important to reduce self-dealing concerns. In our case study, MFO and MFF maintain separate payroll, but there is a formal agreement to share two specific employees. We will look separately at the administrative assistant, who will manage the shared reception area, and the MFF employee, who is needed in the MFO office to revamp the MFO investor reports.

As discussed earlier, the provision of personal services does not constitute an act of self-dealing. Are secretarial services considered personal services? The answer was complicated by the Tax Court's decision in *Madden*.[68] In that case, the court concluded that personal services should be construed narrowly, and it defined them as services that are "essentially professional and managerial in nature." Following *Madden*, some letter ruling requests appear to have curtailed the range of proposed services, explicitly excluding secretarial services.[69] Accordingly, it would be prudent for the administrative assistant to be an employee of MFO, with any allocable share of services provided to MFF performed at no cost.

The arrangement regarding the MFF employee who is needed to revamp the MFO investor reports is clearly problematic. MFF employees cannot provide services to disqualified persons (that is, MFO). What is the likely solution? MFO should hire this employee separately. That is, the employee would be formally employed by both MFO and MFF, receive wages separately from both organizations, and receive separate Forms W-2.

Finally, although our case study indicates that MFO and MFF have separate payrolls, many families like to use a master payroll for all employees, whether they serve in the family office or private foundation. To reduce self-dealing concerns when a single payroll is desired, it is important for the family office to employ all those professionals and charge the private foundation an amount that would be deemed not excessive. A reimbursement at cost designed as an hourly charge might be appropriate.

V. Conclusion

Careful planning is required when family office activities intersect with the family's philanthropic endeavors. This report covered three of the most common intersections: (1) the provision of personal services by the family office to the private foundation; (2) co-investment opportunities between the family office, family members, and the private foundation; and (3) cohabitation arrangements between the family office and private foundation. At first blush, it may seem that the private foundation rules were put into place to prevent those family interactions, but that is not the case. The rules contemplate that these interactions will occur, and they attempt to provide a framework for structuring the arrangements in a manner to protect the interests of the private foundation.

Unfortunately, many of these rules were enacted over 30 years ago, and although well-intended, they do not adequately cover common arrangements in today's world, particularly in the co-investment area. Subsequent guidance provided in letter rulings has generally trended positive and been instructive, but it cannot be relied on by other taxpayers. Further guidance, particularly on co-investment, is welcome and appears to be forthcoming from the IRS. All three of the intersections covered in the report can be successfully navigated, but good intentions, thoughtful foresight, and an appreciation of the private foundation rules are necessary to secure a desirable outcome. ■

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[68] T.C. Memo. 1997-395.

[69] *E.g.*, LTR 200217056; and LTR 200238053.