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# Alternative Investments: Regulatory Filing Obligations Can Get Onerous

by [Mary Antonetti](#) on [October 12th, 2023](#)



The past year has been a roller coaster for the stock market. Managers at many nonprofits invested a portion of the organization's portfolio in alternative investments attempting to diversify. While this might be a sound investment strategy, these types of investments bring myriad federal, state, and foreign filing obligations.

Even one investment could generate multiple reporting requirements. When evaluating the return on investment, the organization should consider the tax implications and cost of compliance.

A tax-exempt organization generally does not pay tax on activities related to its exempt purpose. However, tax would be paid on unrelated business income (UBI), which is generally defined as income from a trade or business that is unrelated to the organization's exempt purpose. An activity might be UBI to one organization but not to another, depending on the organization's exempt purpose. Interest, dividends, capital gains, and certain types of rental income are statutorily excluded from UBI.

As long as your organization doesn't generate so much UBI that it is no longer operating primarily for its exempt purpose, it will retain its tax-exempt status. In short, it is fine to have some UBI. You just need to understand the implications and compliance burden.

Many alternative investments operate in a partnership structure. A partnership is not a tax-paying entity. Rather, the income is passed through to the partner on a Schedule K-1. This schedule shows the amount and character of income or loss that each partner should put on their tax return, though not all income will be taxable to them.

This form specifically shows your organization's income or loss generated from UBI. It also provides information on foreign and state activity.

Partnership investments usually generate UBI from operations or debt-financed income. It is UBI if the ordinary income on Schedule K-1, Line 1 is unrelated to your organization's exempt purpose. What does this mean? If you are running a school, your mission is to educate students. If you invest in a private equity fund that invests in a partnership that sells digital advertising, the income is UBI to your organization because your mission is not to sell digital advertising.

Keep in mind that this partnership might have operations in all 50 states. Since you are a partner in this investment, you are indirectly operating in 50 states. That could trigger federal and state tax liabilities based on the income the investment generates.

Alternative investments also create UBI through debt financing. Investment income, such as interest and dividends, is excluded from UBI — except if the investment is

debt-financed. In a debt-financed investment, the organization borrows money to purchase the investment. ^

For example, generally renting real property does not generate UBI.

However, for some types of organizations, if the real property is debt-financed and used in an activity unrelated to your organization's exempt purpose, it would generate UBI. The implications of UBI for debt-financed rental property vary by the type of organization.

If managers at a tax-exempt organization want to avoid UBI altogether, there is often an option to invest in a blocker. A blocker is a corporation that becomes the partner in the partnership. The tax-exempt organization purchases stock in the blocker corporation. Unfortunately, since the blocker corporation is not a tax-exempt organization, it will pay tax on all the income passing through from the partnership, not just the UBI portion.

However, since the blocker corporation is a tax-paying entity, it will bear the cost of tax compliance — and unless debt was incurred when funding the corporation, the tax-exempt organization would have no UBI. Any distributions from the blocker corporation would be treated as passive dividends, which are generally not taxable.

Your organizational leaders will need to evaluate the pros and cons of both types of investments. The blocker corporation might have a lower rate of return, but it eases your compliance burden. Alternatively, the income taxed at the corporate level may be significantly greater than the UBI taxes to the nonprofit organization. Your organization may also already have multi-state UBI, which could mitigate any extra costs of compliance.

An alternative investment might also be a foreign corporation or partnership. These types of investments need to be carefully monitored because they often trigger additional foreign reporting requirements, especially if your organization invests more than \$100,000 in a 12-month period. Your organization could also be subject to foreign reporting obligations due to indirect ownership of foreign entities through a partnership. The penalties for not filing required foreign reporting forms could be up to \$100,000 per incident, which could become costly very quickly.

Finally, in many states, owning a partnership investment operating in a particular state creates nexus in that state. Even though you may never have any activities in a state, the fact that you invested in a partnership with activity in that state could generate a filing requirement. Approximately 27 states tax unrelated business income from investments.

Managers often wonder if there is a need to file in 20 states because the partnership generated a loss. In most cases, the technical answer is “yes.” If the organization has nexus in the state, there is a filing requirement. Just because a tax return has little, no tax liability does not mean you can choose not to file.

Some managers believe the cost of compliance is too burdensome for a return with zero tax due, so they choose to set a threshold. For example, if the tax liability in a state is over a certain amount then they will file, and if not, then they believe the cost of compliance far outweighs the risk. When making this decision, consider the following:

- \* Some states are more aggressive than others about going after organizations.
- \* Is it real estate or a different type of investment? Often, if real estate is generating the UBI losses, there is still a taxable sale coming down the road. Your organization may want to file to secure the loss carryforward.
- \* Does the state have a minimum tax liability?
- \* What is the reputational risk to your organization if you do not meet all filing requirements?

For financial statement reporting, ASC740 provides guidance on uncertain tax positions. A tax position is a position a company has taken on a prior return, or a position a company expects to take. An uncertain tax position is one that, based on the merits of the position, does not have a 50% or higher likelihood of being sustained upon exam based solely on the merits of the positions. Your filing obligations will need to be evaluated under Financial Accounting Board (FASB) accounting standards codification 740 (ASC740).

If no return is filed, the statute of limitations would not close for that return. Accountants typically will record an uncertain tax position in its financial statements if it is material. You need to quantify how much, if any, tax liability exists in these states and apply an interest and penalty factor to determine if it is material to the organization.

Don't panic. Understanding what you need to do is the first step. Use these questions to evaluate your investment and responsibility:

- \* Does the prospectus give any indication of the amount or types of UBI the investment will generate?

\* Does the prospectus give any indication of the states of operation?

\* Does your organization already file a Form 990-T federally, and also in one or more states?

\* If you are investing in a foreign organization, what type of organization are you investing in?

\* Is it a better idea to invest in the blocker or partnership?

These factors can help you understand your compliance obligations. From there, you should consult your tax advisor on the various federal, state, and foreign compliance obligations. Keep in mind that for non-tax reasons, it could still be a great investment. You need to understand its true rate of return. Knowledge is power. Understanding the requirements is crucial for decision-making, but complex compliance requirements should not scare you away from alternative investments.

These are the general implications for most tax-exempt organizations. However, there are additional tax implications for private foundations and tax-exempt trusts such as pensions.

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### Good Vs. Not-So-Good

#### ChatGPT becoming smarter about nonprofits

By Ben Demme

**P**ersons like John Howard, if they were well-versed in the nuances of nonprofit management, would know that the current implementation of what was once a futuristic concept—the iterations were prepared with an artificial intelligence (AI) personal assistant that did most of the heavy lifting. Howard, CEO of the Great Plains Health Foundation, said that ChatGPT is what there is in the way that such the "tech" and his team have used it to create a new organizational strategy. "There are things called AI, just to all the details, and given that," Howard said, which means of the public conversation about AI has

continued for the past year, can be a fairly accurate or make such an accurate target for grant proposals, fundraising letters, and donor lists — all areas where copyright law and intellectual property rights are difficult to be of concern. Large language model-based chatbots are often misperceived because of their management by providing an unusual tool on which organizational policies centered in of employees, such as creative and health benefits, can be tracked and accounted via a single channel in a member's inbox.

Howard said, "I know that is very powerful, but I can never know for the public," she says, can be the AI tool, Howard said. "What's clear in these examples is that nothing's being generated, no data is being shared, and we're not passing sensitive information into the world."

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### NPOs Taking Steps To Deal With Q1 Cashflow Challenges

By Brian K. Litt

**W**hat the U.S. government and independent federal agencies like the U.S. Postal Service are in for during the first quarter of the calendar year, they are not taking away through increased fundraising and other means — if an estimated — pandemic-related funding and a possible government shutdown which would also be included.

These and other factors are planning on how nonprofit organizations are adjusting their cash flow during the quarter of calendar year 2024.

Kenneth P. Pridemore and Lisa A. K. Thompson, who joined the Charitable Foundation in April 2022, completed the quarter 2023 in a year when her budgeted focus on fundraising effectiveness began to show results. Pridemore has been instrumental in driving most activities and in implementing a 10% reduction in staff salaries and benefit costs. It's a bold move, considering that the organization's financial success had historically been driven by its direct staff activities.

Some of the cash flow has been driven by pandemic-era activity of raising capital. Most package companies such as paper and software became very expensive, but the upper was jumps in post-pandemic.

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### Change Management key to landing top jobs

By Ben Demme

**A**lex McCreath is heading to the Center for Family Support (CFS) this time as CEO. One of the things she will apply for the position, she might have had a slight edge on the competition, but the process was still months long.

She had been an executive director at CFS but that didn't mean the multiple conversations with the search firm before being presented as one of several candidates. "There was a lot of searching involved. I felt supported," she said. "It was really collaborative searching," she said of meeting with the search consulting team during the 6 to 8 week job for the role.

McCreath believes that change management is key and that involves trust and understanding culture "to bring about change successfully."

"With all applicants, it is an example of there not being a shortage of candidates who want to move into a top job. The list is being an executive who can articulate a vision for what's next.

"There is a changing dynamic in recruitment of the executive search process with rapid technological advancement — from video and behavioral to previous organizational culture. And yet, the pandemic has had such to do with the evolution.

"With most nonprofits continuing to operate in remote and hybrid formats, leaders are expected to manage and

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### Philly's New Leadership

By Ben Demme

**P**hiladelphia's new leadership is a mix of old and new. The city's new mayor, Kenyan Battle, is a former state legislator who has spent much of his career in public service. He is a member of the city council and has served as the city's chief of staff. Battle is a member of the city council and has served as the city's chief of staff. Battle is a member of the city council and has served as the city's chief of staff.

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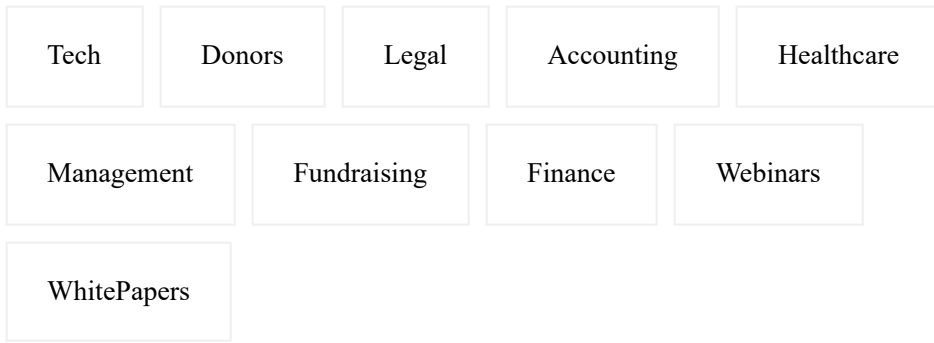
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