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 partnershi
generated a loss. In most cases, the technical answer is “yes.” If the organization h
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 your 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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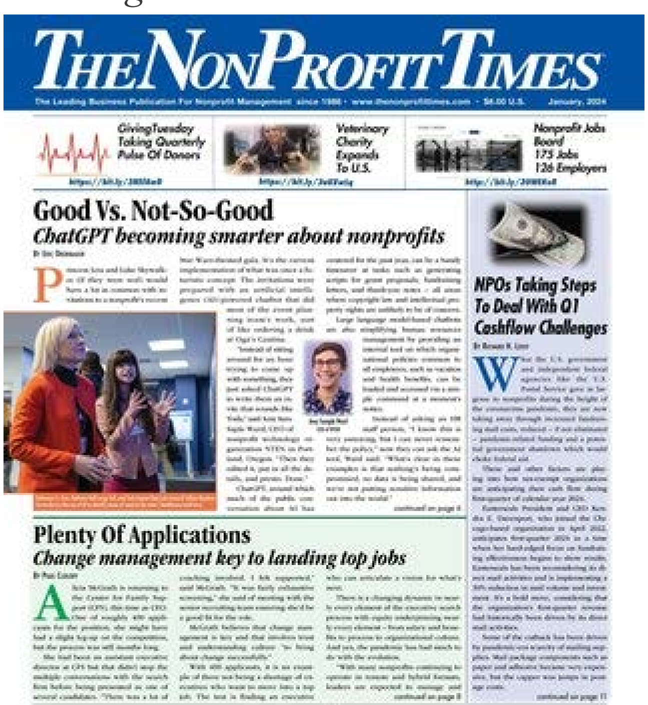

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