Alternative Investments for Nonprofits and Exempt Organizations: Avoiding Unforeseen Tax Consequences

TUESDAY, DECEMBER 12, 2017, 1:00-2:50 pm Eastern

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Alternative Investments for Nonprofits and Exempt Organizations

Dec. 12, 2017

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Alternative Investments

Presented By:
Jennifer Becker Harris and Deby MacLeod
Agenda

• Alternative investment types and considerations
  • Considerations before an alternative investment is made
  • Potential liquidity issues
  • Valuation considerations

• Tax implication of alternative investments
  • Unrelated business taxable income (UBTI) (federal and state)
  • Implications for private foundations
  • Foreign reporting requirements

• Financial reporting and audit implications for alternative investments
  • Additional audit procedures
  • Enhanced disclosures
  • Coordinating audit and tax efforts

• Impact of new partnership audit regulations on exempt organizations

• Potential impacts of tax reform
Alternative Investment
Types and Considerations
What are Alternative Investments?

• It’s not traditional (cash, securities or bonds)
• Lacks liquidity
• Risk may be higher (for smaller investors)
• Complex tax consequences
• Entity structure is usually a LP, LLC or a foreign entity
• Valuation can be subjective
Other Definitions

- **Blocker** – a corporation or foreign entity that “blocks” unrelated business income from being attributable to the exempt organization.

- **Net present value** – the difference between the present values of cash inflows and outflows. Typically involves a discount for the time value of money. (NPV)

- **Program related investments** – loans and equity investments provided by foundations at favorable rates that have a direct charitable purpose. ROI is not a primary motivation. (PRI)

- **Mission related investments** – investments that have a positive social impact while contributing to the investor’s long-term financial stability and growth. (MRI)
Common Tax Entity Classifications

• Limited Partnership/Limited Liability Company – Taxed as Partnerships
• S Corporation
• Controlled Foreign Corporation (CFC)
• Passive Foreign Investment Company (PFIC)
• Foreign Partnership
Before You Invest...

• What is the purpose or objective of the investment?
• What is the investment vehicle and how will it be taxed?
• Investment policy analysis
  • Consideration of state laws and regulations such as the Uniform Prudent Management of Institutional Funds Act (UPMIFA). Many states have adopted a version.
• Cash flow analysis
  • Will debt be needed?
  • Timing of capital calls
• Cost of the investment
  • Consider not only the management fees but the additional cost of tax compliance
• Timing of Schedules K-1; who to access for questions
• Impact on financial statements
• Is the fund familiar with exempt orgs?
  • Are they prepared to provide the necessary information for the tax return and audit?
Before You Invest…

• Foreign Investments:
  • Is there a “blocker”? If so, what is the purpose?
  • What are the costs of the proposed structure? Is there potential withholding the organization may not be able to recover?
  • What type of legal entity is the organization? Has a “check-the-box” election been made for U.S. entity classification purposes?

• Private Foundations:
  • Will the investment be a co-investment with disqualified persons? Or are there other self-dealing implications?
  • Is the investment being reviewed for excess business holding purposes?
  • Have the jeopardizing investment rules been considered?
  • Will the investment be considered a program related investment?
  • How will capital calls/distributions be tracked and valuations made for determining the minimum investment return and distributable amount?
• If a private foundation considers ownership a PRI:
  • Expenditure responsibility needs to be performed
  • Specialized language needs to be in the governing documents
    • Main purpose is not a profit motive for the private foundation
    • The funds can not be used for lobbying activities
  • The investment needs to be tracked separately. Any contributions/distributions are qualifying distributions/recoveries of qualifying distributions.
  • “Trade or business” or debt-financed income is not considered UBTI
Costs of the Investment

- Management fees
- Tax Preparation/Financial Statements – additional compliance
- Additional taxes
- May hold up completion of the financial statements and/or tax returns
Tax Implications of Alternative Investments
Step 1: Understand income tax regime that applies to the organization
  - Corporation
  - Trust
  - Private Foundation vs Other Exempt Organizations

Step 2: Review of Schedules K-1

Step 3: Review of Direct Foreign Investments

Step 4: Identify the Foreign Filings

Step 5: Preparation of the Form 990-T (if applicable Form 990-PF)
Corporation

- AMT applies to large corporations
- Passive activity and at-risk rules (IRC Secs. 469 and 465) usually do not apply (based on “ownership”)
- Corporate tax rates
- Charitable contributions limited to 10% of taxable income

Trust

- Passive activity and at-risk rules likely apply
- AMT is calculated similar to individuals
- Trust tax rates (including favorable capital gains rates of 15 and 20%)
- Follow trust rules for certain deductions (i.e. Sec 179 expenses can’t be taken)
- Charitable contributions limited to 50% of adjusted income
- Lower threshold for disclosure of reportable loss transactions – Form 8886
Private Foundations

- Determine the unrelated business taxable income (Form 990-T)
- Determine net investment income and offsetting deductions
  - Interest, dividends, rents, royalties and similar items
  - Capital gains
- Excess business holdings (direct and indirect)
  - ≤ 2% safe harbor
  - > 2% must review interest combined with disqualified persons
  - > 20% combined interest may have an excess business holding unless an exception applies
  - Common exceptions: functionally integrated business (PRIs) and 95% passive income (this applies to partnerships and passive holding companies)
Valuation of alternative investments as noncharitable use assets (NCUA) for minimum investment return purposes

- What day does the private foundation value the alternative investments?
  - Typically foundations use the first or last day of the year
  - If the underlying investments in the alternative investment are marketable, the foundation may take a position to value monthly and include with the marketable securities calculation.
  - Be consistent in the methodology from year to year

- How will the values be obtained?
  - Part of the financial statement audit
  - GAAP basis capital accounts from Schedules K-1
  - Annual reports from the funds

- Capital contributions/distributions during the year are included in the NCUAs based on number of days held during the year.
### Sample Schedule K-1 Summary Sheet

<table>
<thead>
<tr>
<th>UBI Footnote</th>
<th>UBI (excl foreign tax expense, dep't, contrib &amp; credits)</th>
<th>Foreign Tax Credit (not expense)</th>
<th>Distrib in excess of basis 4940</th>
<th>Suspended losses</th>
<th>Foreign Disclosures</th>
<th>Total State UBI</th>
<th>Total State WIH</th>
<th>Controlled Entity</th>
<th>Potential EBH</th>
<th>(EBH) Passive Percentage</th>
<th>Wrong Entity Info</th>
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<td>2.17%</td>
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</tbody>
</table>
Other Exempt Organizations

• Form 990 disclosures
  • Balance Sheet - Part X, line 12 – other investments
  • Balance Sheet - Part X, line 13 - program related investments
  • Joint venture disclosures (if program related) – Part VI

• Form 990 Schedules
  • Schedule D
  • Schedule F - Part I includes foreign investments over $100K; Part IV includes foreign filing trigger questions
  • Schedule R - includes related organizations

• Form 990-T - unrelated business taxable income
### Schedule K-1 Review

<table>
<thead>
<tr>
<th>Item</th>
<th>Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>What type of Schedule K-1</td>
<td>Form 1065 (pass-thru income); Form 1120-S (100% UBTI); Direct foreign investment (EIN may start with “98”*); will need to determine if PFIC or CFC treatment</td>
</tr>
<tr>
<td>Line I1 Partner Type</td>
<td>If it doesn’t say “Exempt Organization” the applicable disclosures may not be included on the Schedule K-1</td>
</tr>
<tr>
<td>Line K – Debt</td>
<td>May trigger debt-financed income (UBTI)</td>
</tr>
<tr>
<td>Box 20V – Unrelated business income</td>
<td>UBTI disclosures for qualified (certain retirement plans and educational institutions) and nonqualified organizations</td>
</tr>
<tr>
<td>Box 1 or 10 – Trade or business income/ Sec 1231</td>
<td>If there is no UBTI and there is Box 1 income, may need to inquire further with the fund.</td>
</tr>
<tr>
<td>Basis Schedules</td>
<td>If there is no tax basis, may have suspended UBTI losses.</td>
</tr>
<tr>
<td>Final K-1</td>
<td>If it is a final K-1, were there hot assets (A/R or Inventory) as part of the K-1 liquidation? This could trigger UBTI.</td>
</tr>
<tr>
<td>Footnotes</td>
<td>Read carefully for foreign disclosures, reportable transactions or losses, additional reporting information</td>
</tr>
</tbody>
</table>

**May require inquiries with investment managers**

*IRS is moving away from international entity EINs starting with “98”.*
### Schedule K-1 Review – Private Foundations

<table>
<thead>
<tr>
<th>Item</th>
<th>Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other income/deductions</td>
<td>Interest, dividends, rents, royalties, capital gains and related deductions not subject to UBTI will be subject to net investment income.</td>
</tr>
<tr>
<td>Line J - Excess business holdings</td>
<td>If greater than 2% profits interest (partnership/LLC) or voting interest (corporations), need to review excess business holding rules. (For partnerships, look through to the income to determine if a business enterprise.) Exception: 95% passive activity</td>
</tr>
<tr>
<td>Line L – Capital account reconciliation</td>
<td>How is the capital account valued? Can it be used for minimum investment return purposes? Date used for annual valuation and adjustments for major contributions/distributions.</td>
</tr>
<tr>
<td>Foreign taxes</td>
<td>Need to take a tax position whether using a foreign tax credit on Form 990-T or foreign deduction against the net investment income (Form 990-PF).</td>
</tr>
<tr>
<td>Foreign currency gain or loss</td>
<td>The private foundation will need to take a tax position on whether the income is “similar” to net investment income.</td>
</tr>
<tr>
<td>Basis Schedules</td>
<td>If there is no basis, may have distributions in excess of basis or suspended losses that limit the net investment income losses.</td>
</tr>
</tbody>
</table>
State Returns

- 41 States (including DC) tax organizations for UBTI
- Is the organization a trust or a corporation?
  - Alaska does not tax organizations which are trusts.
- Withholding by partnerships on behalf of partners is a common area for errors. Verify if withholding is tied to the EIN of the organization.
- Most organizations report non-business direct income since apportionment often does not make sense
- Consider deducting direct expenses (preparation fees for state filings)
Review of Direct Foreign Investments

• Did the entity receive a Schedule K-1, PFIC statement or other kind of statement? (U.S. EIN may start with a “98”)

• What is the entity classification for foreign and U.S. purposes (Form 8832 entity classification may have been done)?

• How much does the organization own of the entity?
  • Less than 10% interest – can follow PFIC rules for corporations.
  • 10% or more interest
    • Need to determine if the entity is a controlled foreign corporation.
    • Subpart F income rules apply to corporations (Usually not subject to UBTI but should be subject to net investment income for PFs)

• It can be a challenge to obtain the proper information – best efforts matter.
Review of Direct Foreign Investments

- Important to keep track of income reported annually
- Track tax-basis for sales/distributions
- Private Foundations - still need to look at:
  - Excess business holdings
  - Valuation information for minimum investment return
- Often easiest to track direct foreign filings along side the domestic Schedules K-1
- Analysis of foreign filings is a must
  - There can be indirect filings so it is important to see the entity structure
  - Penalties are steep - often start at $10,000
Common Foreign Filings

• Form 926, U.S. Transferor of Property to a Foreign Corporation
• Form 5471, Foreign Corporation
• Form 8865, Foreign Partnership
• Form 8858, Disregarded Entity
Other Foreign Filings

- **Form 8938, Statement of Foreign Financial Assets** - For domestic organizations, there is an exception in the Reg 1.6038D-6(d)(1) and IRC Sec. 1473(3) that excludes “any organization exempt from taxation under section 501(a) or an individual retirement plan,“.

- **Form 8621, Passive Foreign Income Corporation** - Under Reg. 1.1291-(d) and 1.1298-(1)(c)(1), the PFIC reporting rules do not apply if the fund is not subject to UBTI. (Note, this likely would only occur if the fund is subject to debt-financing under IRC section 514.)

- **Form 3520 - Interest in a Foreign Trust** - Beneficial interest in a foreign trust
• Remember foreign entity status may not be the same as the U.S. default status. This may be overridden by Form 8832 (“check-the-box”)

• Ownership of direct/indirect interest in foreign corporation < 10%
  • Form 926 - transfer cash from a domestic entity to a foreign corporation greater than $100,000 in a 12 month period. CAUTION: May have transfers to the same foreign corporation through multiple alternative investments.
  • Form 926 - transfers of property (non-cash) typically have a filing requirement (see exceptions in the instructions)
  • Form 8621 - required if the passive foreign investment company is debt financed.
Determine Foreign Filings

• Ownership of direct/indirect interest in **foreign corporation ≥ 10%**
  • Form 926 – transfer of cash/property from a domestic entity to a foreign corporation greater than $1 in a 12 month period.
  • Form 5471 – May have a filing requirement (review categories of filers); if own greater than 50% interest, annual filing is required.
    • Ownership is defined by vote or value
    • If the foreign corporation is a controlled foreign corporation (CFC), verify subpart F income is properly picked up on the Form 990-PF
    • Verify if there are additional filings to report as part of the ownership structure
  • If the entity is not a CFC and the organization owns ≥ 10% and ≤ 50%, may have a Form 8621 filing for a PFIC – if there is UBTI on the fund.
Determine Foreign Filings

- Ownership of < 10% interest in a foreign partnership
  - Form 8865 – for transfers greater than $100,000 in a 12-month period

- Ownership of ≥ 10% interest in a foreign partnership
  - Form 8865 – Additional sections of the Form may be required
  - Form 8865 – Needed for any transfers
  - Verify there are not additional foreign filings as part of the structure
Determine Foreign Filings

- Form 8858 – required if a foreign corporation is considered a disregarded entity, include the activity with the parent.

- Ownership of > 50% interest in any entity:
  - If there are foreign bank accounts may have a FBAR (FinCEN 114) reporting if the filing threshold is met (greater than $10,000 for all accounts) – Based on calendar year information and due on October 15th.
  - Section 512(b)(13) reporting requirements
    - Schedule R of Form 990
    - Part VII-A, Line 11 of Form 990-PF
Additional Filings

• Form 8886 – Reportable Transaction Disclosure Statement
  • Certain reportable transactions
  • Loss transactions
    • Trusts: $2M in a single year or $4M in a combination of years; $50,000 in a single year for 988 transactions
    • Corporations: $10M in a single year or $20M in a combination of years.

• Form 8886-T – Disclosure by Tax-Exempt Entity Regarding Prohibited Tax Shelter Transaction
• Net unrelated business income tax from alternative investments should be included:
  • Form 990-T, Line 4 – capital gains
  • Form 990-T, Line 5 – income from partnerships and S corporations

• Indirect/direct expenses should be included:
  • Tax prep fees
  • Foreign taxes (depending on the tax position)
  • Charitable contributions to qualified organizations (domestic charities)

• Attach additional foreign filings
  • Not open to public inspection for 501(c)(3) organizations – Notices 2007-45 & 2008-49
• Form 990-PF, Part I, column (b) – Net investment income
  • Start with book income in column (a)
  • Remove all the alternative investment book income amounts (including all UBTI amounts that will be reported on Form 990-T)
  • Add the net investment income amounts from Schedule K-1 analysis
  • Add the net investment income from direct foreign investments
  • Program related investment income should be limited to expenses for items other than capital gains. (Excess expenses are qualifying distributions)

• Other disclosures – Balance Sheet (Part II, line 13); Controlled Entities (Part VII-A, line 11); Excess Business Holdings (Part VII-B, line 3); Minimum Investment Return (Part X, line 1c)
Financial Reporting
Implications of
Alternative Investments
Financial Reporting and Audit Implications

• Additional audit procedures are necessary due to the subjective nature of valuation.
  • Confirmation by a third-party confirms only the investment’s existence, not its value.
  • Because alternative investments are not typically widely traded, there may not be an active market from which to obtain valuation information.
  • A variety of audit “evidence” must be obtained. Procedures may include:
    • Obtaining GAAP basis Schedules K-1.
    • Reading the investment’s audited financial statements
    • Performing “look backs” to estimate value of your capital account based on prior year audited financial statements and percentage ownership.
    • Talking with investment managers.
    • Reviewing your policies for due diligence and monitoring practices.
Financial Reporting and Audit Implications

• Additional procedures add time, cost and complexity to the audit.
  • Increased time required by the auditor.
  • Increased internal cost related to time required to coordinate and provide information and documents.
  • Waiting for Schedules K-1 can significantly postpone audit completion.
  • Note that all investments must be valued on the last day of the year for audit purposes.

• There are additional required disclosures for audited financial statements.

• Careful monitoring of percentage ownership is necessary because GAAP treatment differs. Certain levels of ownership may result in “equity method” accounting, which adds additional complexity.

• Coordination between your external auditor and tax professional is highly desired, as much of the financial and tax reporting information is required by both.
Other Matters
Partnership Audit Regime

IRS request for comment

• All exempt organizations should check Schedules K-1 to ensure their status is properly reported as “Exempt Organization” rather than Corporation or Trust (although also technically accurate)

• Write a letter to the Partnership Representative advising
  1. Do not withhold taxes at either the federal or state level on your behalf (unless you want them to)
  2. Do not settle any tax audits which result in paying income tax liabilities from prior periods, when “you” were not a member, using current partnership/LLC assets, as it may result in a private benefit transaction, private inurement or in a worst case scenario self-dealing when there is co-ownership with disqualified persons
Tax Reform*

- UBTI taxed based on EACH trade or business separately (Senate)
- Single corporate rate is 20% (most organizations are currently taxed at 15%)
- Eliminate the net operating loss (NOL) carrybacks, carryforward indefinitely
- Limit NOL deduction to 90% of taxable income
- Various accounting method changes
- Various basis modifications for sales of partnerships/LLCs

*Assumes the exempt organization is a nonprofit corporation and there are variations on the rules
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