Unrelated Business Taxable Income (“UBTI”)

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January 10,2017

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Overview of UBTI

- Internal Revenue Code ("IRC") Section 501 grants tax exempt status to a variety of tax-exempt and mutually beneficial organizations.
- UBTI was enacted in 1950 to ensure that tax- exempt entities do not unfairly compete with taxable companies in profit-generating activities.
- UBTI is income from a trade or business regularly carried on by an exempt organization that is not substantially related to the organization's exempt purpose

Overview of UBTI – VC / PE angle

- The Code provides that most forms of passive income will not be treated as UBTI. Passive income includes, among other:
  - ✓ Capital gains,
  - ✓ Dividends
  - ✓ interest
- Passive income that is derives from asset that is subject to acquisition indebtedness will be generally treated as UBTI.

Acquisition indebtedness is debt incurred in connection with the purchase of the property, whether the indebtedness is incurred before, after, or at the time of the acquisition.

Acquisition indebtedness –common pitfalls

- Administrative convenience
- Borrowing exclusively to pay expenses
- Defer payment of management fees

Passive income generated will be generally treated as UBTI, unless paid within a very short term. If not paid in short term, will likely to fall under acquisition indebtedness general rule.

- **General rule**: any liability, that is reasonably foreseeable at the time of asset acquisition, will fall into the acquisition indebtedness rules.

Overview of UBTI

UBTI is calculated as follows:

$$\frac{\text{Average acquisition indebtedness}}{\text{Average adjusted basis of property}} \times \textit{Gross income from property} =$$

Important :

Property considered debt-financed if acquisition indebtedness existed at any time during the tax year or the 12 months preceding the sale of the property

UBTI calculation

The Fund received $200 worth of dividend. The Fund's UBTI income is:

$$\frac{112.50}{490} \text{ X } \$200 = \$46$$

	1/1	2/1	3/1	4/1	5/1	6/1	7/1	8/1	9/1	10/1	11/1	12/1
Line of credit	100	110	100	90	80	110	150	160	120	100	110	120
Total Debt	100	110	100	90	80	110	150	160	120	100	110	120
Total Average Indebtedness	(112.50)											

	1/1	2/1	3/1	4/1	5/1	6/1	7/1	8/1	9/1	10/1	11/1	12/1
Book Cost												
Investment 1	150	150	150	150	150	150	150	150	150	150	150	150
Investment 2	120	120	120	120	120	120	120	120	120	120	120	120
Investment 3	120	120	120	120	120	120	120	120	120	120	120	120
Investment 4	120	120	120	120	120	120	120	120	120	120	-	-
Total Tax Basis	510	510	510	510	510	510	510	510	510	510	390	390
Total Average Adjusted Basis	490.00											

Avoiding UBTI – what a fund to do?

- **Guaranty of Debt**

The Fund guarantees the loan and as long as the fund is not the true borrower it may reduce UBTI issue.

- **Pre – Fund**

Allows a Fund to offer tax-exempt limited partners the ability to "pre-Fund" their capital contributions prior to a borrowing.

- **Opt - out**

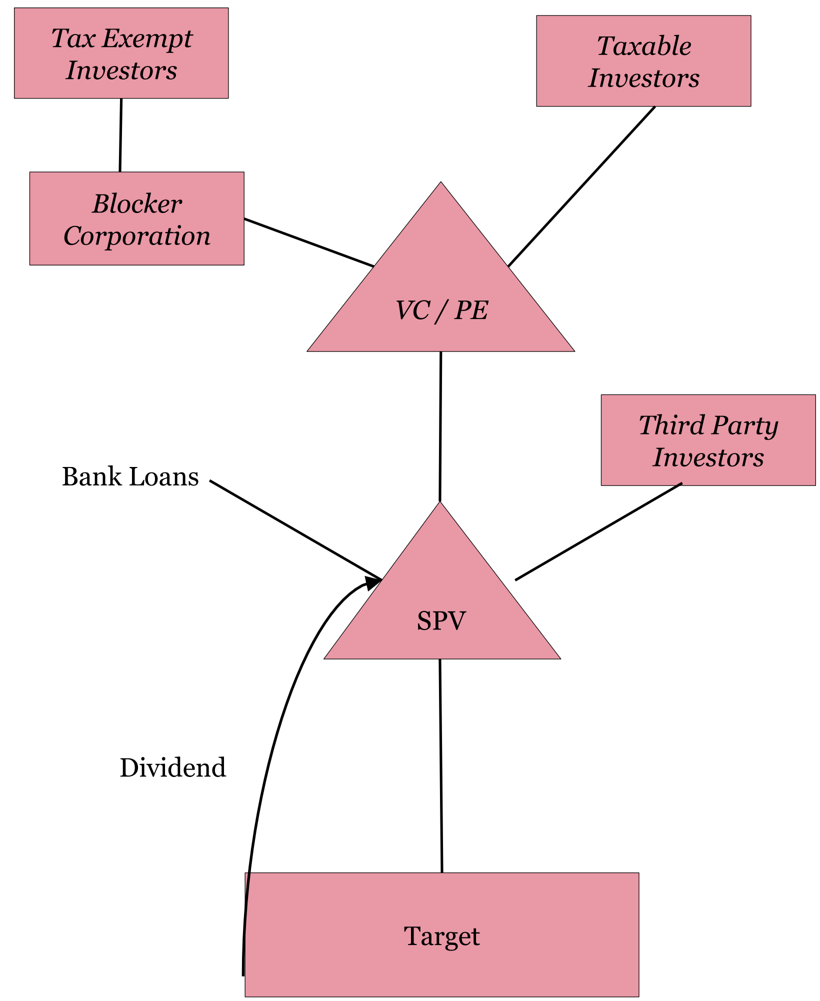
The Fund gives the exempt LPs the right to "opt-out" of the participation in the debt-financed investment.

- **Corporate and offshore blockers**

Blockers are commonly used where investments are intended to be leverage.

UBTI – Using Tax exempt blocker

- Tax exempt entities may hold their interests via a foreign corporation.
- Foreign corporation may generally be a foreign partnership elected to be treated as corporation for US income tax purposes.
- Tax exempt organizations that are shareholders of CFC / PFIC generally should not be subject to Subpart F rules (Blocker Corporation).



Fund obligation

- LPA agreement
- Side letter
- Investor relationship

Fund reporting obligation

- Identify tax investor partner – generally by obtaining W-9 form.
- Partnerships should use Schedule K-1, box 20, code V, to report UBTI information.

Thank you!

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