

# Unrelated Business Taxable Income (“UBTI”)

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*Draft for Discussion Purposes Only*

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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

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## *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.

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## *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.

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## *Overview of UBTI*

UBTI is calculated as follows:

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

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:

112.50

$$490 \quad X \quad \$200 = \$46$$

	<u>1/1</u>	<u>2/1</u>	<u>3/1</u>	<u>4/1</u>	<u>5/1</u>	<u>6/1</u>	<u>7/1</u>	<u>8/1</u>	<u>9/1</u>	<u>10/1</u>	<u>11/1</u>	<u>12/1</u>
<b>Line of credit</b>	100	110	100	90	80	110	150	160	120	100	110	120
<b>Total Debt</b>	100	110	100	90	80	110	150	160	120	100	110	120
<b>Total Average Indebtedness</b>	(112.50)											
	<u>1/1</u>	<u>2/1</u>	<u>3/1</u>	<u>4/1</u>	<u>5/1</u>	<u>6/1</u>	<u>7/1</u>	<u>8/1</u>	<u>9/1</u>	<u>10/1</u>	<u>11/1</u>	<u>12/1</u>
<b>Book Cost</b>												
<b>Investment 1</b>	150	150	150	150	150	150	150	150	150	150	150	150
<b>Investment 2</b>	120	120	120	120	120	120	120	120	120	120	120	120
<b>Investment 3</b>	120	120	120	120	120	120	120	120	120	120	120	120
<b>Investment 4</b>	120	120	120	120	120	120	120	120	120	120	-	-
<b>Total Tax Basis</b>	510	510	510	510	510	510	510	510	510	510	390	390
<b>Total Average Adjusted Basis</b>	490.00											

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## *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**

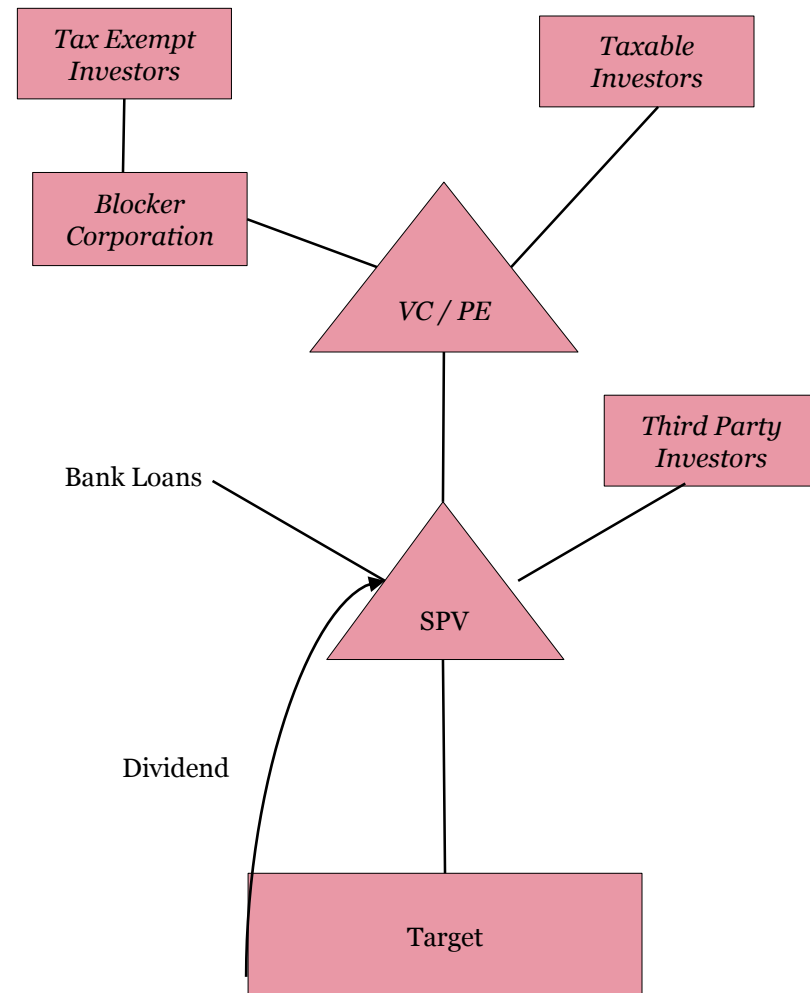
The Fund gives the exempt LPs the right to "opt-out" of the participation in the debt-financed investment.

- **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).





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## *Fund obligation*

- LPA agreement
- Side letter
- Investor relationship

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## *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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