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# Nonprofit Alert: Alternative Investments
# August 15, 2008

## INTRODUCTION

During the past several years, many organizations have gone beyond traditional investments in stocks and bonds to diversify into other areas such as hedge funds, limited partnerships, fund of funds, etc. These investments were made with the hope of achieving a higher rate of return than previously realized in "traditional" investments. Collectively, these investments are referred to as alternative investments. The nature of the vocabulary has also changed. Where investors previously talked in terms of shares and corporations, today they talk about blocker corporations and tax shelters. While there is a greater potential for gain by investing in alternatives, there is also a greater risk of loss and exposure to issues not previously faced.

## UNDERSTANDING INVESTMENTS AND RELATED TAX IMPLICATIONS

Investments in alternatives are usually made through investment firms and money managers. Unfortunately, while they may understand the investment aspects, they may not be aware of the tax ramifications associated with the investment. Organizations have the ultimate responsibility of ensuring that their money is invested wisely, including the knowledge of reporting requirements and taxability responsibility.

Investment committees, or another responsible party, have to be able to analyze the investment and determine that the necessary backup will be available when the time comes to address the taxability of the investment. Exempt organizations have to prepare for the tax implications that come with some alternative investments. For instance, many generate unrelated business taxable income primarily from real estate activities. It can also result from operations in flow-through entities, such as limited partnerships, that are unrelated to the organization's exempt purpose[1]. This taxability extends well beyond the federal requirements. Investment partnerships try to avoid generating trade or business income; however it has become increasingly difficult, especially when invested in several underlying partnerships. Many states have become aggressive about taxing the business activities that are taking place locally. As a result, the various states have become more diligent in enforcing filing obligations for trade or business activity.

In addition to the greater risk of loss and exposure when an organization invests in alternative investments, there is the potential of unrelated business taxable income ("UBI") and the potential for foreign filings. As a rule, this income comes from activities that are conducted through a *trade* or *business* that is *regularly carried on* and *not related to the organization's exempt purpose.* In the traditional sense, this might be from advertising or some form of unrelated business activity. Over the past several years, with the popularity of alternative investments, other sources of unrelated income have arisen. This income is often hard to predict or plan for, but nevertheless generates unrelated business income ("UBI"). Unrelated business taxable income from alternative investments generally comes from one of two places: (1) Debt-financed income-the investee borrows money to leverage off capital contributions: and (2) Business operations-trade or business activities conducted by the investment vehicle (normally a partnership).

The complexity of the reporting arises from the nature of the investment being made. The investments will generally fall into the following categories:

- Partnership (domestic) without debt – generally presents no UBI issues or foreign filing requirements.
- Partnership (domestic) with debt – generates UBI from debt-financed income for federal and state purposes, but should not require foreign filings.
- Corporation (domestic) – generally presents little, if any, UBI issues and no foreign filings. (This assumes no debt associated with making the investment.)

- Partnership (foreign) without debt or business activities – generally no unrelated business income but potential for foreign filings.
- Partnership (foreign) with debt and/or foreign business activities – generates UBI, state taxable income (loss), extensive foreign filings and various other reporting. The partnership may or may not generate a Schedule K-1 for reporting purposes.
- Corporation (foreign) – Does not generate unrelated business income but does have the potential for foreign filings. These are commonly referred to as "blocker" corporations.

## REPORTING REQUIREMENTS

**Form 990-T Exempt Organizations Business Income Tax Return** – used to report unrelated business taxable income. This form may also be required for organizations such as churches and pension trusts that do not normally file a Form 990.

**State Filings** – income tax returns filed with the states to report their respective share of unrelated business income (loss). This is required in most cases where a Form 990-T has been filed. With the Pension Protection Act of 1986, the federal government and the state are sharing information.

**Form 926 Return by a U.S. Transferor of Property to a Foreign Corporation** – Form 926 is used to report transfers of tangible and non tangible property to a foreign corporation. This form is required but not limited to transfers of cash between an organization and a foreign corporation. Reporting is also required for a foreign partnership that effectively agrees to be treated as a corporation for this purpose. In the event that the investment is made through a partnership holding interest in multiple foreign corporations, it may be necessary to file a Form 8865 (discussed below) for the partnership and a separate Form 926 for each of the corporate interests held by the partnership. Form 926 is required for transfers to a foreign corporation during the 12-month period ending on the date of the transfer in excess of $100,000. The penalty is limited to $100,000 unless the failure to comply was due to intentional disregard.

**Form 8865 Return of U.S. Persons (*exempt organizations*) with Respect to Certain Foreign Partnerships** – Form 8865 is used to report investment activity with certain foreign partnerships. The form has to be filed by any person (exempt organization) holding an interest in the foreign partnership of at least 10%. The form also is to be filed by any person (exempt organization) that contributed property to the foreign partnership, given that the value of the property contributed (when added to the value of any other property contributed to the partnership during the 12-month period ending on the date of the transfer) exceeds $100,000. Filing requirements pass to the partner level are not an obligation of the partnership. If a foreign partnership holds an interest in multiple levels of partnership interests, the filing requirement for those partnerships passes on to the ultimate partner with respect to filing requirements. The penalty for non-filing can range from $10,000 to $100,000 per incident.

**Form 8886 Reportable Transaction Disclosure Statement** – Form 8886 is used to disclose information for each reportable transaction in which a person participates. Generally, a separate Form 8886 is required for each reportable transaction. The form is used to report the holding of an interest in any organization that participates in a "reportable transaction" and is required to file a federal income tax return. Penalties for failure to report a listed transaction can be as high as $200,000. An example where this might be applicable is a case where the IRS has determined that a "tax shelter" is abusive, meaning that it was designed to produce tax losses well in excess of the initial investment. These shelters go on a "list" held by the IRS. Investors can be held responsible, even if it is added to the list subsequent to the initial investment. While this is a somewhat limited list, there is always the potential to be added. As such, many partnerships, as a precaution, will file a "protective" Form 8886. What this actually accomplishes is telling the IRS that the partnership does not know that it is abusive, but just in case it is, they are providing the form. This form needs to be originated at the partner level in cases where advised by the partnership. In some cases, the partnership supplies the information to the investor and the investor attaches the form to the return. The penalties for participating in a tax shelter transaction

are substantial. The tax is determined by filing Form 8886-T. In some cases, the penalty can be as high as 100% of the benefit derived from the transaction.

**Form 5471 Information Return of U.S. Persons with Respect to Certain Foreign Corporations** – Form 5471 is used by U.S. citizens and residents who are officers, directors, or shareholders in foreign corporations. Stock ownership requirements are based on holdings of 10% or more. The penalty for non-filing can range from $10,000 to $50,000.

**TD F90-22.1 Report of Foreign Bank Accounts** – Foreign bank and financial account owners have to report their accounts to the government (even if the accounts do not generate any taxable income). These accounts are reported to the U.S. Department of Treasury by June 30 each calendar year. This is a significant issue for NPOs that have offshore investments. The determining factor is whether the organization has the ability to move the money in or out of the foreign account. If this is done by a money manager from an investment firm, and that manager is working on behalf of the organization then the organization would be responsible for filing the Form TD F90-22.1. This is required if the aggregate value of the financial accounts exceeds $10,000 at any time during the calendar year. Civil penalties for noncompliance are severe: (1) non-willful violations can range up to $10,000 per violation; and, (2) willful violations can range up to the greater of $100,000 or 50 percent of the amount in the account at the time of violation.

## CONCLUSION

Forms 926, 8865, 8886 and TD F90-22.1 are the ones found to be most relevant to exempt organizations. When foreign filing requirements are combined with state filing requirements, a significant amount of work will be necessary. Organizations should review their alternative investment portfolio and make sure that all filing requirements are being met. If their investment advisors are unfamiliar with these requirements or appear to be noncommittal about them, we urge such organizations to avoid these investments until they have an answer regarding the filing requirements or, if already invested in these vehicles, perform a comprehensive review of the Schedule K-1s and other relevant documents to determine what the reporting requirements are. We urge you to seek out a tax professional if there is any question about this memo.

In evaluating alternative investments, the questions attached should be considered by management and discussed with investment advisors prior to making the investment. The list of questions is not all inclusive but should provide an outline for discussion and consideration.

## ALTERNATIVE INVESTMENT QUESTIONNAIRE

### Organizational Structures: Questions to Ask

1. If the investment is structured as a Real Estate Investment Trust (REIT), has the investment manager explained the investment restrictions?
2. If the investment vehicle is structured as a domestic C corporation, has the manager explained the additional tax costs? (Entities that agree to be taxed as a corporation are taxed at the source, generally 30% unless different by treaty.)
3. If the investment is structured as a foreign corporation, has the manager considered the tax savings in comparison to the tax efficiencies that the limited partnership may provide?
4. If the investor is a general partner or member of an LLC that chooses classification as a partnership, has it addressed the exemption issue with the manager?
5. Is the investment vehicle U.S. or foreign, a corporation, partnership, LLC (taxed as a partnership or corporation) or an S Corporation?

*If the answer to any of these questions is "no," the exempt investor should hold discussions with the investment manager.*

### Unrelated Business Income Tax Concerns for Investors in Partnerships:

1. Does the agreement include a "best efforts" clause to minimize UBTI?

2. Does the agreement impose a modest limit on borrowing for ordinary and routine investments?
3. Assuming that you are investing through XXX, who is considered a qualified organization in a real estate venture, will the manager use "best efforts" to comply with the fractions rule or other exceptions to the debt-financed income rules?
4. Should the agreement include a provision requiring the manager to notify XXX or its designee of any transactions likely to generate significant tax liabilities on a quarterly basis, and include quarterly estimates of the tax liability?
5. Should the agreement or a sidebar letter include a tax liquidity clause requiring mandatory distributions to pay any anticipated taxes on the investment?
6. Should the agreement or a sidebar letter include an indemnification clause requiring the manager to indemnify the investor for penalties and interest that result from the manager improperly computing or failing to disclose tax liabilities?
7. Does the manager's history demonstrate proper management of UBTI?
8. To ensure proper leverage with the manager, does the investment consist of at least one-third exempt investors?
9. To ensure liquidation or termination options, does the agreement include a lock-up provision that is considered to be a reasonable period of time?
10. Have you established a tax contact with the manager to review the K-1?
11. When will the K-1s be issued?
12. Will the K-1 provide sufficient information related to state allocations of UBTI?
13. Will the manager apply for or schedule the appropriate documents to apply for state exemptions from withholding/tax payments?
14. Will the manager or K-1 provide the appropriate information on state withholding or tax payments made on the partner's behalf?

*If the answer to question 1, 2, or 3 is "no," can the rate of return justify the foregone benefit?*

**Filing Additional Forms:**

1. Does the agreement require the manager to provide information timely and appropriately with respect to tax shelter reportable transactions?
2. Does the agreement require the manager to provide information timely and appropriately with respect to U.S. filing requirements for foreign entities? [i.e., Forms 926, 8865, 5471, TD F90-22.1]
3. Does the agreement require the manager to minimize tax liabilities and tax filing requirements with respect to investments in foreign countries?
4. Will the K-1's specify whether income is coming from qualified or non-qualified organizations?

*With respect to these questions, the investor may include an indemnification clause.*

**FOR FURTHER INFORMATION**

If you have any questions concerning this memorandum, please contact **Michael McNee**, Partner-In-Charge of the Marks Paneth & Shron Nonprofit and Government Group at 212-503-8954 or mmcnee@markspaneth.com, or **Robert Lyons**, Managing Tax Director at 212-710-1736 or rlyons@markspaneth.com.

In addition, information on the Marks Paneth & Shron Nonprofit and Government Group can be found at www.markspaneth.com.

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[1] *Nonprofit Investment Committees: Buyer Beware,* Practical Accountant, March 2008, Michael McNee CPA, New York, New York