UBTI Considerations for Tax-Exempt Funds Investing in Private Equity

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Asset managers understand that delivering consistent annual growth within the investment portfolios they oversee is one of their most important responsibilities – whether or not it’s included in their actual job description. The ability to find the right opportunities that can stay well ahead of the cost of living stands as a dividing line of success for most asset managers.

As more Baby Boomers have begun drawing from the resources within pension and retirement funds and as some endowments have encountered a smaller pool of major donors, private equity and its broad range of investment options continues to gain more acceptance among tax-exempt asset managers seeking to meet specific growth goals.

Private equity funds involving pension and retirement funds, endowments and other tax-exempt platforms as limited partners typically require more consideration than assessing the risk taken with a given investment. Fund managers and their clients in these tax-exempt vehicles must factor the impact of the possibility for Unrelated Business Taxable Income (UBTI) resulting from an investment offered through private equity.

Weighing Private Equity Investments and the Expense of Incurring UBTI

Traditionally, the types of asset managers for entities holding a tax-exempt status have been hesitant to incur a tax expense as part of a portfolio growth strategy. Yet, with the array of opportunities and potential yields found within private equity, fund managers and their investors have increasingly begun to find instances in which the returns on the investment outweigh UBTI and its associated costs.

While there are an infinite amount of possibilities (depending on how the investments are specifically organized), there are two main ways that a fund can create UBTI.

1. The first trigger involves generating unrelated trade or business income that is carried on regularly. Under this category, there are a couple scenarios that can result in tax liability:

   - **Investments are made in a partnership conducting a trade or business.** In this instance, the income from the trade or business from a pass-through perspective flows into the fund and, therefore, flows out to its investors. When the fund has taxable income from a trade or business, a tax liability is created.

   - **The fund provides services to any of its portfolio companies.** Under this scenario, the fund may receive an administrative fee and that fee could be classified as UBTI.

2. The second trigger deals with debt-financed property. In this scenario, the fund basically does some form of borrowing in order to purchase various assets.

   - **Assets are purchased with borrowed capital.** If borrowed capital is used to purchase
investments, earnings on those investments will create UBTI because the transactions involve
debt-financed property.

**Mitigating Tax Expenses Related to UBTI**

In planning strategies that involve tax exempts investing in private equity, a fund manager should consult tax advisors and legal counsel well-versed in issues related to UBTI. One of the most effective strategies for mitigating cost exposures associated with UBTI involves establishing a “blocker” corporation, which can take a couple of forms. A blocker creates separation between the investment and the fund, which would be called a below-the-fund blocker, or between the tax exempt vehicle and the fund, which is called an above-the-fund blocker.

Consider the following example of a manufacturing company that is partially owned by a private equity fund. As an investor in the fund, the tax-exempt entity stands to be a beneficiary of profits from a trade or business that is not within its primary business. In this example, let’s say the manufacturing company produces $1,000 of taxable income in one day of operation.

If that income goes directly to the private equity fund as a result of a direct investment from the fund, then the $1,000 is going to be allocated to all the respective partners in the fund, including any tax-exempt entity participating as an investor. Under this structure, the $1,000 would generate UBTI for the fund’s investors. However, with the implementation of a below-the-fund blocker, the corporation serving as the blocker will pay taxes on that income. The fund will realize any profits from the investment once it liquidates the blocker. This scenario would limit the potential for triggering UBTI.

With the above-the-fund blocker, it’s the same basic concept as the below-the-fund blocker, but there are slightly different tax implications. In this scenario, the blocker is actually the partner in the fund. In the above-the-fund blocker, the tax exempts, or a group of tax exempts, actually own the blocker entirely. In this structure, the fund is going to allocate to the blocker the income that would have been subject to UBTI. Income allocated to the blocker will also include the capital gain on liquidation of the portfolio investment, which will increase the income tax liability of the blocker. This is a key difference in comparison to the below-the-fund blocker structure, where capital gain will be incurred at the fund level. Nonetheless, the tax exempts sitting above the fund would limit their exposure to UBTI.

Any strategy involving the use of blockers does not completely eliminate tax exposure for the tax-exempt entities. Even though the tax exempt is not paying UBTI, the blocker may pay income tax if it is a U.S. corporation. One of the chief benefits of employing a blocker strategy can be found in the possibility of alleviating the U.S. filing obligation by some of these entities – providing a position which is highly valued by many tax-exempt investors.

The implementation of blockers provides a number of planning opportunities, but there are other options to consider as well. Private equity funds can allow opt-out provisions to tax-exempt entities for specific investments, utilize convertible debt structures to limit equity ownership, and permit
contribution of additional capital by tax-exempt partners to self-fund debt acquisition property. It is imperative that fund managers weigh the pros and cons of each strategy and work with their trusted advisors to create a structure that meets the needs of their limited partners.

**We Can Help**

Elliott Davis Decosimo’s Investment Companies Team specializes in planning and compliance work for private fund managers. Our tax advisors work with multiple funds – all with different strategies. By amassing this kind of expertise, we are able to help clients employ the best strategies for their unique situation. To learn more about UBTI and the scope of services our Investment Companies Team can offer, please contact your Elliott Davis Decosimo advisor or John Quinones via email by clicking here.