Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Accommodating Tax-Exempt Investors: Understanding UBTI

A significant source of capital for venture capital and other private equity funds is pension plans, individual retirement accounts, foundations, and endowments. These are all tax-exempt entities under the Internal Revenue Code. Tax-exempt organizations, including "qualified" pension plans, individual retirement accounts, foundations, and endowments, are subject to "unrelated business income tax" (UBIT) on their "unrelated business taxable income," often referred to as UBTI. In connection with their investments in private investment funds, many tax-exempt investors seek to avoid or limit the funds' generation of UBTI.

Fund sponsors commonly accommodate tax-exempt entities by covenanting not to incur, or to limit or minimize, UBTI. Practically speaking, a covenant to avoid UBTI means that the fund cannot incur indebtedness and cannot invest in flow-through operating entities, except through "blocker" structures, as discussed below.

Some of the most active investors in private equity funds are governmental pension plans, such as those for states or municipalities. Most governmental plans take the position that, as governmental entities, they are not subject to tax on UBTI, although some governmental plans nevertheless seek to avoid or minimize UBTI, especially if UBTI can be avoided or minimized at little expense.

UBTI

Generally, a tax-exempt organization is exempt from U.S. federal income tax on its passive investment income. The general exemption from tax does not apply to the UBTI of the tax-exempt organization, whether realized by the organization directly or indirectly through a partnership in which it is a partner (or limited liability company of which it is a member). UBTI is defined generally as any gross income derived by a tax-exempt entity from an unrelated trade or business that it regularly carries on, less the deductions directly connected with that trade or business. The Internal Revenue Code provides that most types of passive income are not treated as UBTI. These exclusions include dividends, interest, capital gains, and certain rents from real property. An investment in a limited partnership or limited liability company is not itself viewed as passive; rather, the investor is deemed to receive its share of the income of the limited partnership or limited liability company.

Debt-Financed Property

Notwithstanding the general rule, UBTI includes a percentage of any income not otherwise treated as UBTI that is derived from property subject to "acquisition indebtedness." Very generally, the percentage of income that is treated as debt-financed is the percentage of the acquisition cost that is financed by borrowed funds. Thus, if one-half of the purchase price of an asset is borrowed, then generally speaking one-half of the income from the asset may be treated as UBTI. Acquisition indebtedness includes the amount of any indebtedness to which property is subject at the time of its acquisition, and debt incurred after the acquisition of property if the debt would not have been incurred but for the acquisition and the incurrence of the debt was reasonably foreseeable at the time of acquisition. In some circumstances where the credit is advanced based on the financial strength of the guarantor rather than the borrower, a loan guarantee by a fund can be viewed for federal income tax purposes as a borrowing by the fund.

Indebtedness incurred by a partnership or limited liability company of which a tax-exempt organization is a member can create acquisition indebtedness for the limited partner or member. However, debt incurred by a corporation is not viewed as debt incurred by a shareholder for this purpose.

Application to Investment Funds

Most of the income of most private equity and venture capital funds will consist of gains from the sale of portfolio companies and, to a lesser extent, from dividends and interest. So long as the investment fund does not borrow money in connection with the acquisition of its portfolio companies, the investment activity of the fund generally does not result in UBTI. However, certain common activities of investment funds can result in UBTI: borrowings to fund investments, investments in operating businesses structured as partnerships or limited liability companies, and provisions that credit certain types of fees earned by the general partner or its affiliates against the management fees paid by investors.

Fund-Level Borrowings

Many funds have the ability to borrow to fund investments, at least on a short-term basis, pending capital calls (bridge borrowings). There is no exception to the debt-financed property rules in the Internal Revenue Code or applicable Treasury Regulations for short-term indebtedness. However, gain from the disposition of property will not be treated as UBTI if the indebtedness was repaid more than one year before the disposition, and income from the property (e.g., dividends) is treated as UBTI based on the average amount of acquisition indebtedness during the taxable year. Thus, if there is no income from the property and the property is not sold, until one year has passed from the time the debt is repaid, the debt will not result in UBTI. In addition, tax return preparers often take the position that a very short-term borrowing (e.g., indebtedness that is outstanding for less than one month) can be ignored for purposes of determining UBTI. Because this position may be challenged by the Internal Revenue Service, some funds provide (and some tax-exempt investors may request) that the general partner will provide notice of an anticipated borrowing to bridge a capital call to the investor, and allow the investor to avoid having the fund borrow on its behalf by funding its capital contribution on abbreviated notice.

Flow-Through Operating Entities

Investment funds may invest in portfolio companies that are structured as partnerships or limited liability companies that are taxed as partnerships, thereby avoiding corporate-level income taxes. Some startup companies are formed as limited liability companies to avoid corporate-level taxes, with respect to both operating income and gain upon ultimate sale. Upon sale, an entity taxed as a partnership, unlike a corporation, can permit the buyer to step up its tax basis in the acquired assets to their market values without the seller incurring corporate-level tax. Because the income of the portfolio company typically will consist of active business income, not passive income, such income flows through to the investors as UBTI. In addition, any indebtedness incurred by the portfolio company may result in debt-financed property, resulting in UBTI upon the ultimate exit from the portfolio company.

Fee-Crediting Mechanisms

Many investment funds provide that certain fees, such as commitment, transaction, break-up, or consulting fees, earned by the general partner or its affiliates are wholly or partially applied to reduce the management fee. Because such fees are part of the benefits received by the general partner from investing the investors' capital, and any such fees diminish the assets of the portfolio companies and thereby reduce the returns to investors, limited partners often successfully argue that they should receive the benefit of a substantial portion or all of such fees. However, if the fees were earned by the fund, the fee income generally would be treated as UBTI. Instead, the earned fees are received by the general partner or its affiliates, but some or all of the fee amounts are applied to reduce the management fees payable by investors. It is not clear whether a mechanism by which some or all of such fees are credited against the management fee should be viewed as the equivalent of the fund's earning such fees, in which case UBTI would likely result. Provisions in fund documents that require the general partner to avoid generating UBTI often carve out such fee-crediting mechanisms from the UBTI prohibition.

"Blocker" Structures

Because debt incurred by a corporation (or other entity that is treated as a corporation for federal income tax purposes) is not treated as debt of its shareholders, and there is an exclusion from UBTI for dividends received from a corporation, an investment in or held through a corporation generally does not generate UBTI (unless the shares themselves are debt-financed, as described above). An investment fund may consider making an investment in a flow-through operating entity through a corporation that would act to hold the interests in the operating entity. This structure prevents the fund (and its investors) from receiving UBTI from the operating entity.

Historically, many investment funds contained restrictions requiring them to seek to avoid UBTI, and structured their investments in flow-through operating entities through blocker corporations. In addition, the terms of many investment fund agreements relieve the fund of its obligation to avoid investments resulting in UBTI if tax-exempt investors are offered the opportunity to invest through a "blocker," with other investors investing through flow-through structures. While these structures prevented UBTI from being generated, the income of the operating entity would be subject to tax in the hands of the blocker corporation at regular corporate income tax rates. A tax-exempt investor's share of the corporate tax usually will exceed the UBIT that would be paid if the blocker were not used and the investor paid UBIT. In recent years, an increasing number of tax-exempt investors have concluded that a better approach is to accept some UBTI rather than avoid it by means of blockers. As a result, private equity funds increasingly have limitations restricting the percentage of capital commitments that may be invested in UBTI-generating investments, rather than an absolute prohibition on generating UBTI. A provision permitting as much as 25% of committed capital to be invested in investments expected to generate more than an immaterial amount of UBTI is typical of these funds.

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For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

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