UBTI: The Hidden Tax for the Tax-Exempt

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As the old adage goes, "it's not what you make, but what you keep that matters." The saying can also be broadly applied to the tax impact on investments, which is often an overlooked area of investment management and asset allocation, especially for taxable investors. One of the most common and misunderstood issues that can effect "what you keep" is that of Unrelated Business Taxable Income ("UBTI"). Because UBTI is applicable to a multitude of investors, accounts, and investments applying a "general" set of rules regarding its tax treatment is somewhat daunting. This whitepaper focuses on some of the most common scenarios an individual investor may encounter to help understand how UBTI and asset location may affect you and your investments. The ultimate purpose is to introduce the concept and consequences of UBTI to help ensure that your asset allocation is executed in the most tax-efficient manner by minimizing your tax bill and maximizing after-tax returns.

Definitions

UBTI in its most pure and simple form can be defined as: net income derived from any unrelated trade or business that is regularly conducted by any tax-exempt organization or tax-advantaged accounts.[1] While this definition seems rather short and straightforward, each word is integral to distinguishing what income is considered UBTI.

First, it is important to remember that UBTI applies to tax-exempt or tax-advantaged organizations and entities. Second, in order for net income to qualify as UBTI it must meet all three conditions mentioned in the definition above: 1) unrelated 2) in connection with a trade or business and 3) regularly conducted.[2] The IRS defines each one of these conditions for clarification.

1. An activity is unrelated if it does not contribute importantly to accomplishing the organization's purpose (other than the production of funds).[3]
2. A trade or business is defined as any activity conducted for the production of income from selling goods or providing a service.[4]
3. An activity is regularly conducted if it shows a frequency and continuity and is pursued in a manner similar to comparable non-exempt organizations.[5]

[1] IRC § 512(a)(1). Pursuant to IRC § 511, applicable accounts include 501(c) entities (i.e., charitable entities, foundations), accounts under IRC § 401 (i.e. pensions, 401(k)s), and accounts under IRC § 408 (IRAs).
[2] CFR § 1.513-1(a).
[3] IRC § 513(a).
[4] CFR § 1.513-1(b).
[5] CFR § 1.513-1(c)(1).

While UBTI is commonly thought of as a situation only found in charitable tax-exempt entities, it is just as applicable to an individual investor with a retirement account. When applying these definitions to the average individual investor, UBTI is most commonly generated through two types of investments:

1. **Any pass-through income from an unrelated business.** This typically is generated through direct investment in limited partnerships ("LPs") or limited liability companies ("LLCs") that pass through pre-tax income. The important distinction is to remember how the underlying entity or investment is structured and if income is passed through pre-tax or after-tax. If the income is passed through without being taxed, chances are it will trigger UBTI in your tax-exempt account.
2. **Any debt-financed income.** Financing investments with debt in a tax-exempt or tax-deferred account creates an issue because taxes are not paid on this levered money. A common example is that of debt-financed property (e.g., real estate financed with a mortgage loan) held within a tax-exempt account. If this property generates any income, the proportion of income considered UBTI is equivalent to the average debt over the average property value for the year. This is commonly referred to as "acquisition indebtedness."[6]

As with most tax laws, there are multiple exclusions from UBTI that include, but are not limited to:[7]

1. **Passive income.** This is probably the most common exclusion and includes stock dividends, interest payments (e.g., coupon payment from a corporate bond), annuities and other investment income.
2. **Royalties.** Royalties are also exempt and include things such as payments from drug patents or a royalty from a registered trademark.
3. **Rent from real properties and gains or losses from sale of a property.** Rental income from real property such as an office building is typically excluded from UBTI along with any profits from the sale of a real property. However, remember that any income or gain that is derived through the use of debt generates UBTI.

IMPACT OF UBTI TO INDIVIDUAL INVESTORS

IRAs

As mentioned above, any individual with a qualified retirement account is at risk of generating UBTI, making it the most common tax-advantaged account where an average investor would encounter UBTI. If an IRA generates gross UBTI of $1,000 or more during a year, the investor will receive a notice from their custodian regarding the existence on UBTI in their account and the individual must file a Form 990-T.[8] The UBTI generated during that year is taxed at the individual's marginal tax rate. Not only is this an unwelcome and surprising tax bill for an account that an investor believed to be tax-advantaged,

[6] IRC § 514(a)-(c).
[7] IRC § 512(b)(1)-(5).
[8] IRC § 512(b)(12).

but if the account is a traditional IRA, the investor will be taxed again on the investment when funds are withdrawn, resulting in the double taxation of an investment that would ideally be taxed only once.

BEST PRACTICE: It is recommended that UBTI generating investments be left out of tax-advantaged retirement accounts. If a UBTI-generating investment is held in a taxable account, the tax treatment is limited to a single tax at the individual's marginal tax rate resulting in a larger after-tax income distribution for the investor.

CHARITABLE REMAINDER TRUSTS

A charitable remainder trust ("CRT") is an irrevocable trust typically funded with a highly appreciated asset.[9] The CRT provides a specified distribution to a beneficiary ("lifetime beneficiary") at least annually for a specified amount of time. Following the distribution period, the remaining value of the trust is distributed to at least one charitable beneficiary ("charitable remainder beneficiary"). The benefit of setting up a CRT is the immediate gift tax deduction of the present value of the designated value for the charitable remainder beneficiary and the ability to sell an appreciated asset within the CRT with no immediate tax burden - the proceeds of which can be then be invested in a more diversified portfolio.[10]

In comparison to an IRA, the inclusion of UBTI has a much more punitive and material impact on the returns and taxes generated from the CRT. If any income is derived from an unrelated business activity within the CRT in any given year, the subject income is taxed at 100%, eliminating any potential distribution.[11]

BEST PRACTICE: While the tax-exempt status of the CRT is maintained and other income and realized gains that do not fall under UBTI are distributed pre-tax, the inclusion of UBTI producing investments in a CRT is not recommended as it eliminates any potential income from that investment. A UBTI generating investment would be more efficiently located in a taxable account where the distribution is taxed at the investor's marginal tax rate rather than at 100%.

COMMON INVESTMENTS THAT TRIGGER UBTI

MASTER LIMITED PARTNERSHIPS ("MLPS")

A common type of investment that individual investors hold that would most likely generate UBTI is a Master Limited Partnership ("MLP"). Shares of these public partnerships can be purchased much like a public stock and are often tied to activity used to produce or transport oil, natural gas or coal. The

[9] IRC § 664(d).

[10] The details related to the future tax burden in a CRT are beyond the scope of this whitepaper.

[11] IRC § 664(c)(2).

partnership structure of MLPs allows for distributions to be passed through to the individual or entity holding the shares of the LP and taxed at his/her marginal tax rate, rather than at the partnership level.

Given the popularity of MLPs, there are multiple structures that allow investors to gain exposure to MLPs within tax-exempt accounts without triggering UBTI. The most tax-efficient way is through a derivative contract like a total return swap, usually structured as an Exchange Traded Note ("ETN"). While these are subject to counterparty risk, they do not trigger UBTI because the actual MLP interests are not held by the holder of the swap, but by the bank that issues the ETN. The ETN returns merely mimic that of the underlying MLPs. Additionally, an open or closed-end fund (mutual fund, ETF, CEF) with more than 25% of assets invested in MLPs ("pure-play strategies") can be used because taxes are paid at the fund level (corporate level) before making distributions.[12]

Private Equity

Private equity is another common investment that has the potential to generate UBTI. Because private equity funds are typically structured as LPs they can pass-through unrelated business income from their underlying investments. If a private equity fund invests in private companies structured as LPs or LLCs any income distributed by these companies to the private equity fund will generate UBTI in applicable tax-exempt accounts. The same is also true for any income that is generated from an investment which is debt-financed by the private equity fund.

Due to the frequent occurrence of UBTI in private equity investments, private equity funds have established various solutions for investors to avoid or eliminate the receipt of UBTI. While a full description of these solutions are not within the scope of this whitepaper, the three main options that private equity funds will employ for tax-exempt investors include: the option to elect out of UBTI investments (either on a deal by deal basis or possibly through investment in a Parallel Fund), investment through an Offshore Feeder Fund, or the establishment of a Blocker Corporation.

Hedge Funds

Similar to private equity funds and MLPs, hedge funds are typically structured as limited partnerships and thus are able to pass-through income in order to avoid paying tax at the partnership level, making tax-advantaged investors susceptible to UBTI. It is almost impossible to apply generalizations to hedge funds given the vast amount of hedge fund styles and strategies, but there are a few techniques that hedge funds typically utilize that would trigger UBTI.

1. **Leverage**: The use of margin to increase the gross portfolio exposure is the main trigger of UBTI in hedge fund investments. Margin is a form of debt-financing and any income that results from its use will be considered UBTI and subject to tax.

[12] Mutual funds, CEFs, and ETFs with less than 25% of assets invested in MLPs can remain a Registered Investment Company (RIC), which is a special type of pass-through entity that is generally not subject to UBTI. If a mutual fund, CEF or ETF holds more than 25% of assets in MLPs, they must be registered as a C-Corp, which subjects them to taxation at the fund level with no deductions. (IRC § 851)

2. **Investment in an LP:** Hedge funds that investment in LP structures, such as MLPs, could also trigger UBTI. Due to the pass-through nature of hedge funds, any investment in a pass-through business that makes frequent distributions will result in unrelated business income for the end investor.

SPECIAL CONSIDERATIONS

REAL ESTATE INVESTMENT TRUSTS ("REITS") &BUSINESS DEVELOPMENT COMPANIES ("BDCS")

REITs and BDCs are investments that at first glance would appear to be subject to UBTI, but in reality the majority of REITs and BDCs are excluded from the UBTI rule. Both REITs and BDCs are pass-through entities that use debt to finance investments, but they are structured as taxable entities that are eligible for deductions. As long as they meet certain income, distribution and diversification requirements, REITs and BDCs can avoid taxes at the corporate level through these deductions. This typically results in no income tax paid by the REITs or BDCs at the corporate (fund) level, allowing for more money to be distributed to shareholders. REITs and BDCs are granted this special deduction privilege and avoid double taxation because they promote public policy by encouraging public investment in real estate and small businesses.

SHORT SALES

Short exposure does not create UBTI if fully collateralized by long positions or cash. Even though shorts are "borrowed," as long as they are fully collateralized by the long book or cash (i.e., no margin was acquired to put on shorts), then there is no UBTI.[13]

CONCLUSION

When dealing with tax-exempt and tax-deferred accounts, there are two important considerations. Firstly, investors, in addition to investment advisors, should always consider the most tax-efficient approach to asset allocation. This does not just mean selecting the most tax-efficient investments, but determining the location of assets across a variety of accounts an individual may hold to minimize the tax burden. Additionally, in order to locate assets efficiently, an investor must be knowledgeable of the underlying investments in their accounts. Specifically, investors should be aware of the organizational structure of their investments and the tax status of the distributions they receive from these investments so they understand the potential tax implications. UBTI can have a significant impact on an investor's total return if it is not fully understood and taken into consideration when incorporating a new investment in a tax-exempt account.

[13] Rev Rule 95-8.

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