23rd Annual Health Sciences Tax Conference

Investment status: it’s complicated!

Tax considerations for pensions, VEBAs and other tax-exempt investors

December 11, 2013
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Objectives

- Review the general tax requirements that apply to exempt organization (EO) investors such as pensions, voluntary employee beneficiary associations (VEBAs), foundations and others
- Discuss federal and state tax considerations that may impact EO investors
- Discuss international tax considerations and compliance requirements
- Identify planning ideas to reduce US and foreign taxes of pension and VEBA trusts
It’s complicated

- Several factors drive complexity in the area of the taxation of exempt organization investors.
- Different unrelated business taxable income (UBTI) rules apply to different types of EOs.
- Different tax rules apply to EOs organized as nonprofit corporations versus EOs organized as trusts.
- In recent years, exempt organizations have invested in an increasingly diverse array of funds and other investment vehicles.
- Investing in international funds creates even more complexity.
Typical types of large EO investors

- Pension trusts
- VEBA trusts
- Private foundations
- Exempt corporations
- Individual retirement accounts (IRAs) and 401(k) trusts
- Others
# Pension tax filing overview

## Pension trusts

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<tr>
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<td>Rates that apply</td>
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## VEBA tax filing overview

### VEBA trusts

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# Public charity tax filing overview

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# Private foundation tax filing overview

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Alternative investment allocations

- US corporate-defined benefit pension plan assets total approximately $1 trillion.
- The average allocation to alternative asset class is 14% and is increasing.
  - The public pension plan average allocation is 20%.
- Composition of alternative asset investments:
  - Private equity 45%
  - Hedge funds 18%
  - Real estate 31%
  - Commodities 6%

UBTI

There are four general ways that an investment partnership may generate UBTI for its investors:

- Operation of a trade or business
  - Example: an oil and gas partnership
- Debt-financed investments
  - Example: a commodities fund that borrows to make investments in futures contracts
- Flow-through from other investments
  - Example: a fund of funds that invests in other partnerships
- Depreciation recapture under sections 1245 or 1250
Unrelated debt — financed income

► 514(c)(9) exception
  ► Debt-financed income from real property is excluded from UBTI for “qualified organizations”
  ► Qualified organizations
    ► Section 170(b)(1)(A)(ii) educational organizations and their section 509(a)(3) supporting organizations
    ► Section 401 qualified trusts
    ► Section 501(c)(25) real property holding organizations
UBTI information provided by partnerships

Section 6031(d) of the Internal Revenue Code (IRC) states:

“the information required … to be furnished to its partners shall include such information as is necessary to enable each partner to compute its distributive share of partnership income or loss … in accordance with section 512(a)(1).”
Schedule K-1 analysis

- Federal UBTI
- State UBTI
- Classification of UBTI
- Foreign filing requirements
- Reportable transactions
Tax consideration #1

What tax rate should be applied?
Tax consideration #1: applicable tax rates

- Different tax rate schedules apply to EOs organized as corporations versus those organized as trusts
- Corporate tax rate schedule — section 11
- Trust tax rate schedule — section 1(e)
  - Trusts are subject to the passive loss rules, but are able to take advantage of preferential rates on qualified dividends and capital gains.
### Tax consideration #1: applicable tax rates

#### 2013 tax rate schedule for corporations

If the amount on line 34 is:

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Tax consideration #1: applicable tax rates

- 2013 tax rate schedule for trusts

*If the amount on line 34 is:*

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Tax consideration #2

How do the passive loss rules apply?
Tax consideration #2: passive loss rules

- Section 469 limits the deductions and credits certain taxpayers may claim related to passive activities.
- It generally applies to individuals, trusts and closely held C corporations.
- Therefore, with respect to EO investors, these rules will generally apply to pension and VEBA trusts, but not public charities or private foundations that are not organized as trusts.
- Some question as to whether charitable trusts were intended to be covered by section 469.
Tax consideration #2: passive loss rules

- General rule: net losses from a taxpayer’s passive activities (passive activity losses, or PALs) may not be used to offset net income from the taxpayer’s non-passive activities.
  - PALs may be carried forward and used to offset passive income in future years, and may be deducted fully when taxpayers dispose of their interest in the passive activity.
Tax consideration #2: passive loss rules

- UBTI is classified into three categories:
  - Passive
  - Portfolio
  - Non-passive

- Portfolio income/loss
  - Not subject to passive activity loss rules
  - Includes debt-financed income (not derived in the ordinary course of a trade or business) from interest, ordinary dividends, annuities or royalties, gain or loss on the sale of property that produces such income or is held for investment, and related deductions
  - Consists of specific Schedule K-1 line items
What special rules apply to publicly traded partnership investments?
Tax consideration #3: publicly traded partnerships

What is a publicly traded partnership (PTP)?

Any partnership if:

- Interests in the partnership are traded on an established securities market
- Or
- Interests in such partnership are readily tradable on a secondary market (or substantial equivalent)
Tax consideration #3: publicly traded partnerships

- You generally cannot offset loss of a PTP against anything other than income of the same PTP.
- If there is an overall loss and less than the entire interest in the PTP was disposed of, losses are allowed only to the extent of the income, and the excess is carried forward and can be applied against future income from the PTP.
- If there is a loss carryforward and the entire interest in the PTP is disposed of, those losses are no longer limited by the passive loss rules.
Tax consideration #4

How do AMT rules apply to EO investors?
Tax consideration #4: alternative minimum tax (AMT)

- Regular taxable income adjusted for AMT adjustments and preferences (sections 56–58) to determine alternative minimum taxable income
- Taxed at 26% or 28%
- Pay higher of regular tax or AMT
- Credit for the difference between AMT and regular tax can be carried forward to future tax years
Tax consideration #4: AMT

- Common adjustments for AMT purposes:
  - Interest
  - Taxes
  - Depletion
  - Depreciation
  - Net operating loss (NOL)
  - Portfolio deductions
  - Other AMT items from alternative investments

- Calculated on Form 4626 for corporations or Schedule 1 (Form 1041) for trusts
Tax consideration #5

What is the investment interest expense limitation?
Tax consideration #5: investment interest expense limitation

- The investment interest expense deduction is limited to net investment income.
  - Includes income, unless from ordinary trade or business, from interest, ordinary dividends, annuities and royalties
  - Also included is income from a Schedule K-1 from a partnership, S corp., estate/trust and net passive activity of a PTP
- Form 4952 is used to figure the amount of investment interest expense that can be deducted for the current year and the amount to be carried forward to future years.
  - Should be prepared for both regular tax and AMT
How do the charitable deduction rules apply?
Tax consideration #6: charitable contribution expense limitation

- Contributions actually paid within the tax year to or for the use of unrelated charitable and governmental organizations described in § 170(c)
- Unused contributions carried over from prior years
- The deduction for contributions will be allowed whether or not directly connected with an unrelated trade or business
Tax consideration #6: charitable contribution expense limitation

- Limitations for corporations
  - The total amount claimed normally cannot be more than 10% of UBTI (subject to certain adjustments).
- Carryover
  - Charitable contributions in excess of the 10% limitation may be carried over to the next five years.
  - If the corporation has an NOL carryover to the tax year, the 10% limit is applied using the taxable income after the NOL.
Tax consideration #6: charitable contribution expense limitation

- Limitations for trusts
  - For contributions to organizations described in section 170(b)(1)(A), the amount claimed may not be more than 50% of the UBTI figured without this deduction.
  - For contributions to other organizations, the amount claimed may not be more than the smaller of:
    - 30% of UBTI figured without this deduction
    - The amount by which 50% of the UBTI is more than the contributions allowed in the first bullet point above
Tax consideration #7

What are the tax consequences of the disposition of an interest in an investment partnership?
Tax consideration #7: UBTI from partnership disposition

- A gain (or loss) on the disposition of an interest in a partnership investment by an exempt organization can trigger UBTI or loss to an exempt organization.

- Two types of gain
  - Ordinary — taxable to exempt organizations
  - Capital — potentially taxable to exempt organizations

- What determines the type of gain?
  - Type of assets owned by the partnership
  - Whether debt was incurred by either the exempt organization or the partnership
Tax consideration #7: UBTI from partnership disposition

- Ordinary gain is created from the sale of a partnership’s Section 751 assets (so-called “hot assets”).
- The resulting UBTI is the partner’s proportionate share of the amount of the sale that is allocated to this type of assets.
- Hot assets include:
  - Unrealized receivables
  - Certain depreciation recapture (only to the extent depreciation was allowed or allowable for calculating UBTI)
  - Certain inventory items
Tax consideration #7: UBTI from partnership disposition

- UBTI from debt-financed property
  - If the exempt organization uses debt to acquire a partnership interest, a percentage of the tax-exempt partner’s allocable share of the partnership’s portfolio income is UBTI every year until the debt is paid off.
  - If debt is incurred at the partnership level to acquire assets that will generate income for the partnership, the Internal Revenue Service (IRS) takes the position that the sale of the partnership interest is treated as the sale of debt-financed property by the tax-exempt partner (see TAM 9651001).
What additional tax considerations apply to the investment in an energy partnership?
Tax consideration #8: oil and gas considerations

- Percentage depletion limitation
- Excess intangible drilling costs
- Section 751 ordinary gain
- AMT
- Inconsistent reporting
- Trending toward large UBTI due to fracking and sale of farm/ranch land to oil companies
Tax consideration #9

How are foreign taxes paid or withheld at the investment partnership level treated?
Tax consideration #9: foreign taxes paid

- Exempt organizations are eligible to take a deduction or credit for foreign taxes paid on unrelated business income.

- Generally, if an exempt organization takes the credit for any eligible foreign taxes, it cannot, in the same tax year, take a deduction for other foreign taxes.
  - There are a few specific exceptions (e.g., foreign taxes not allowed as credit due to boycotting restrictions).

- The election to take foreign taxes paid as a deduction or credit can be changed each year.
Tax consideration #9: foreign taxes paid

- **Foreign tax credit**
  - The exempt organization must have paid or accrued foreign taxes and must have a tax liability in the current year to use the credit.
  - The foreign tax credit can be carried forward 10 years and carried back 1 year.
  - Exempt trusts use Form 1116 to claim the credit.
  - Exempt corporations use Form 1118 to claim the credit.

- **Foreign tax deduction**
  - Foreign taxes paid can be directly deducted as an expense on the exempt organization’s tax return if they are not taken as a credit in the same tax year.
Tax consideration #10

How are the controlled group rules applied?
Tax consideration #10: controlled group rules

- Exempt corporations are subject to the controlled group rules under section 1561.
- Section 1561 provides that members of a particular controlled group must divide tax benefits among themselves as though they were a single corporate taxpayer for the tax years in which they were a member of such controlled group.
  - Tax brackets — $50,000; $25,000; $9,925,000
  - Additional 3% (income over $100,000) and additional 5% (income over $15 million) taxes are also apportioned to group members
- A controlled group includes the parent-subsidiary group, brother-sister group and combined group relationships.
Tax consideration #10: controlled group rules

- Schedule O (Form 1120) is used to report the apportionment of taxable income, income tax and certain tax items among all members of the controlled group.
- An exempt corporation must file Schedule O with its tax return for any year that it is a member of a controlled group, or the parent organization of a consolidated group may file Schedule O on behalf of the members of the controlled group with its consolidated tax return.
- Corporate members of a controlled group must check the box on Line 35 of the 990-T and complete Lines 35a and 35b.
Tax consideration #11

Can losses be carried forward or back?
Tax consideration #11: NOL carryback

- A net operating loss generally may be carried back 2 years or forward 20 years.
- A taxpayer may choose not to carry back its NOL: to make this choice, the taxpayer must attach a statement to its return stating that it is choosing to waive the carryback period under Section 172(b)(3).
- If such statement is not attached to the originally filed return or a return amended within six months of the originally filed return, the carryback period cannot be waived.
Tax consideration #11: NOL carryback

- Once the taxpayer chooses to waive the carryback period for an NOL generated in a particular tax year, the waiver is generally irrevocable for that NOL year.
- If the taxpayer wishes to waive the carryback period for more than one NOL, the taxpayer must make a separate choice and attach a separate statement for each NOL year.
- Form 990-T filers cannot use Forms 1045 or 1139 (Application for Tentative Refund) to claim the NOL carryback deduction.
  - They must file an amended Form 990-T.
What forms must be filed with a Form 990-T to report foreign investments or activities?
Tax consideration #12: international forms

- Investments in foreign corporations, partnerships or trusts may trigger additional US filing requirements for exempt organizations.

- The forms most commonly filed by exempt organizations include:
  - **Form 926** — generally used to report transfers over $100,000 to foreign corporations; penalty for failure to file is 10% of the fair market value (FMV) of the property transferred, up to $100,000 unless failure to file is due to willful neglect
  
  - **Form 8865** — generally used to report transfers over $100,000 to foreign partnerships or 10% ownership interest; penalty for failure to file is 10% of the FMV of the property transferred, up to $100,000 unless failure to file is due to willful neglect
Tax consideration #12: international forms

- **Form 5471** — generally used to report ownership of 10% or more in a foreign corporation; penalty for failure to file is $10,000 for each filing
- **Form 8621** — generally filed when distributions from passive foreign investment companies (PFICs) are considered to be UBTI; currently no penalty for failure to file
Tax consideration #13

How should reportable transaction disclosures noted on Schedule K-1 be reported?
Five categories of reportable transactions

- Listed transactions
- Confidential transactions
- Contractual protection transactions
- Loss transactions
- Transactions of interest

Reported on Form 8886
Tax consideration #13: reportable transactions

- Loss transactions — section 165 losses
- Reporting thresholds
  - Corporations — $10 million in any single tax year; $20 million in any combination of tax years
  - Trusts — $2 million in any single tax year; $4 million in any combination of tax years
  - **Exception** — Section 988 foreign currency losses — $50,000 threshold for any single tax year
- If there is no UBTI from the reportable transaction, Form 8886 generally is not required to be filed with Form 990-T.
Tax consideration #14

In what circumstances should a Report of Foreign Bank and Financial Accounts (FBAR) be filed?
Tax consideration #14: FBAR reporting

- An FBAR is used to report a financial interest in or signature authority over foreign financial accounts holding more than $10,000 on any day in a calendar year.
- Exempt organizations may be subject to FBAR filing due to financial interests in foreign mutual funds or other similar pooled funds.
- Filing obligations may apply even if the account produces no taxable income.
Tax consideration #14: FBAR reporting

► Who must file an FBAR?
  ► A United States person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeded $10,000 at any time during the calendar year.

► What is the United States?
  ► For FBAR purposes, the United States includes the 50 states, the District of Columbia, all United States territories and island possessions.
  ► This is a broader definition than in the IRC.
Tax consideration #14: FBAR reporting

► What are the penalties for failing to file a proper FBAR?
   ► Non-willful civil penalty up to $10,000 per account per year
   ► Willful civil penalty — minimum of $100,000 or 50% of the balance in each account at the time of the violation
   ► Willful violations may result in criminal penalties
Tax consideration #15

When should blockers be used for partnership investments?
Tax consideration #15: structuring

- Many funds offer EO investors the option to invest through a blocker corporation.
  - This structure will generally prevent the investor from recognizing UBTI from the investment.
  - Another benefit is that any nexus created by the fund will not affect the investor.
- However, the fund may incur tax withholding in foreign jurisdictions that could have been avoided if the blocker structure was not used.
- The EO investor generally will not get a Schedule K-1 from the fund but may need to report its contributions and/or ownership in the foreign blocker corporation.
Tax consideration #16

When must returns be filed in foreign jurisdictions?
Tax consideration #16: international filing

- Certain foreign jurisdictions have tax registration and tax filing requirements for nonresident investors.
  - Generally related to **direct investment** in the markets of the foreign jurisdiction
    - Taxes generally imposed on capital gains
    - Additional requirements may be triggered by real estate holdings
  - Requirements are more common in emerging markets (e.g., India, Bangladesh, Pakistan, Taiwan).
  - Tax filings are not typically filed by custodians.
  - Often, repatriation of funds is dependent on certification of taxes being current by a tax service provider.
In which states must returns be filed to report UBTI?
Tax consideration #17: state UBTI

- Many states also tax UBTI.
- Investment partnerships may operate in one or more states and thereby create state tax nexus (and filing requirements).
- An EO investor should also consider its state of domicile to determine if it has additional state tax filing requirements.
  - For example, a partnership with income allocated to states that do not tax UBTI or tax UBTI at low rates
  - For example, a partnership that operates in foreign jurisdictions
- Investors should be aware of throwback versus throwout rules.
**Tax consideration #17: state UBTI — pension trusts**

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**Difference in tax treatment between pension trusts and corporations**
**Tax consideration #17: state UBTI — corporations**

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</tbody>
</table>

** Difference in tax treatment between pension trusts and corporations
There are a few states that currently have high UBTI due to fracking:
- North Dakota
- Oklahoma
- Colorado
- West Virginia
- Virginia
The UBTI may result from both the fracking itself and the sale of farm and ranch land to oil companies.
What special UBTI rules apply to VEBA trusts?
Tax consideration #18: VEBA UBTI considerations

- VEBAs have a unique set of Unrelated Business Income (UBI) rules in addition to the standard UBI rules that apply to all exempt organizations.
- In the 1980s, Congress sought to limit employer deductions to VEBAs and limit tax-free income in such trusts.
- There are special rules for collectively bargained plan trusts.
- Overfunding results when employers attempt to pre-fund benefits for future years instead of only funding current benefits (with special rules for postretirement medical plans).
- If a trust is deemed to be overfunded, then the investment income of the trust is subject to taxation at the normal trust tax rates (or capital gain rates, if applicable).
Questions?