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Impact Investing by INGOs and the Law: Traps, Pitfalls and Opportunities

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Overview of Agenda

- The specific role that the INGO plays in the particular impact investment has a big impact on the applicable U.S. and foreign legal, tax and regulatory schemes
- U.S. federal income tax exemption issues are paramount, as are U.S. and foreign laws regulating investing, lending and taxation
- Unrelated Business Income Tax (UBIT) and private benefit
- Governance considerations
- Questions

The Role that the INGO Plays in the Particular Impact Investment Has a Big Impact on the Applicable U.S. and Foreign Legal, Tax and Regulatory Schemes

- INGOs can serve as **investor**, **investee** or **intermediary** in connection with impact investments
- There are different U.S. and foreign legal, tax and regulatory schemes that apply to each role
- Today's program focuses principally on the role of INGO as impact investor, either on its own directly, through some form of subsidiary or affiliate (*e.g.*, single-member or multi-member LLC), and/or in conjunction with other taxable or tax-exempt investors
- Both equity and debt investments are common in the impact investing world

U.S. Federal Income Tax Exemption Issues Are Paramount, as are U.S. and Foreign Laws Regulating Investing, Lending and Taxation

- Today's presentation is focused solely on the U.S. federal income tax exemption issues, U.S. corporate law and structuring issues, and governance issues
- It is critical to get good local legal counsel on the foreign laws and regulations relating to investing, lending and taxation to the extent the impact investments are in foreign countries, and to get good U.S. legal counsel on the U.S. laws regulating investing and lending (e.g., U.S. Securities and Exchange Commission (SEC), U.S. Foreign Account Tax Compliance Act (FACTA), U.S. Foreign Corrupt Practices Act (FCPA))

Unrelated Business Income Tax (UBIT)

- 1950 Congressional Enactment of UBIT Statute:
 - *C.F. Mueller Company* (1951 Third Circuit Decision) – New York University Law School purchased the C.F. Mueller Company pasta manufacturing company, with all profits from the company dedicated to the Law School and its tax-exempt purposes
 - The Third Circuit Court of Appeals reversed the U.S. Tax Court’s decision that had held that the Law School was no longer organized and operated exclusively for charitable purposes, relying on the then-“use-of-funds” test, thereby upholding the Law School’s position and its tax-exempt status
 - In 1950, concerned about unfair competition against taxable entities, Congress enacted the UBIT statute, eliminating the use-of-funds test and imposing today’s current UBIT regime, effective January 1, 1951; with a few exceptions, the statute has been largely unchanged since then

Unrelated Business Income Tax (UBIT) – (cont'd.)

- Internal Revenue Code Section 513 definition of an “unrelated trade or business:
 - The term “unrelated trade or business” means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of **which is not substantially related** (aside from the need of such organization for income or funds or the use it makes of the profits derived) **to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501...**
- *All three prongs must be satisfied* for unrelated business income (UBI) to exist
- The UBIT analysis is a facts-and-circumstances test

Unrelated Business Income Tax (UBIT) – (cont'd.)

- The three prongs of the UBIT test:
 - Trade or business:
 - Profit motive – but actual profit doesn't matter (except with respect to recurring losses year after year, which can be problematic)
 - Does the activity resemble those conducted by taxable commercial entities? (Commerciality Doctrine)
 - Regularly carried on:
 - Principal factors to analyze are:
 - (i) Frequency and continuity with which the activity is conducted; and
 - (ii) Manner in which the activity is pursued (especially as compared to comparable commercial activities of taxable entities)

Unrelated Business Income Tax (UBIT) – (cont'd.)

- Not substantially related to tax-exempt purposes:
 - The activity must contribute importantly to the accomplishment of one of the nonprofit's specific tax-exempt purposes (not tax-exempt purposes generally)
 - The need for income is not enough, and how the income is used is irrelevant
 - Real-life example of a wildlife conservation 501(c)(3) organization that turned an otherwise-unrelated business activity in a “related” one by accompanying the sale of office desk accessories that were imprinted with pictures of endangered species with literature about the endangered species and information about what you can do to help protect the species and support the organization
 - Has the activity become too commercial? A religious shrine's restaurant was open well before and after the hours of the shrine and extensively supported by local advertising; they went well beyond what was necessary to serve visitors to the shrine, creating UBI for the income from the additional hours (only)

Unrelated Business Income Tax (UBIT) – (cont'd.)

- Income that is usually automatically treated as taxable UBI:
 - Rental income received from debt-financed property
 - Gains derived from the disposition of debt-financed property
 - Payments from certain “controlled” entities (e.g., rents or royalties from majority-owned or -controlled subsidiaries)
- More than “insubstantial” total UBI can jeopardize an organization’s overall tax-exempt status (perhaps over 15-20% of total gross revenue), but alternatives such as taxable subsidiaries are available
- Even if the three prongs of the UBIT test are satisfied, there are numerous specific exceptions from UBI that may apply: e.g., dividends, interest, annuities, royalties, certain capital gains, certain non-debt-financed rent from real property, qualified corporate sponsorship income, income from the sale of donated goods, certain research income

Unrelated Business Income Tax (UBIT) – (cont'd.)

- Other UBIT specifics of note (including changes instituted by the enactment of the federal Tax Cuts and Jobs Act of 2017):
 - There is a \$1,000 corporate income tax deduction for UBIT
 - UBI is now taxed at the new, flat corporate income tax rate of 21% (previously, the tax rates were graduated, with a top rate of 35%)
 - There is a tax deduction against UBI for directly connected expenses incurred to generate the UBI
 - Net operating losses (NOLs) are generally permitted unless recurring for a number of years, which suggests no profit motive
 - Tax-exempt organizations can no longer offset losses from one unrelated business activity against gains from another unrelated business activity (profits and losses are determined per activity; known as the “silo” rule)
 - Tax-exempt organizations now have to pay UBIT on certain employee fringe benefits, including parking, transportation benefits, and on-premises athletic facilities (but this UBIT is not subject to the “silo” rule)
 - Quarterly estimated tax payments must be made at the federal and state levels for UBIT, and an IRS Form 990-T must be filed each year (comparable state tax filings as well)

Unrelated Business Income Tax (UBIT) – (cont'd.)

- Use of Taxable Subsidiaries and Disregarded Entities (today we are just focusing on LLCs and C corporations, but other options such as partnerships are available):
 - Single-member LLCs can be disregarded for federal income tax purposes, providing liability protection for the sole member from the LLC's activities but enabling the LLC to take advantage of the single member's tax-exempt status; for federal income tax purposes, the LLC does not exist – its activities get rolled up into the parent's for IRS reporting purposes and the like
 - Multi-member LLCs can be treated as partnerships for federal income tax purposes, providing liability protection for the members from the LLC's activities but enabling the LLC to take advantage of the tax-exempt status of one or more of the members (if one or more members are tax-exempt); multi-member LLCs allow for a tax-exempt member to bring in one or more tax-exempt or taxable investors to be members of the LLC

Unrelated Business Income Tax (UBIT) – (cont'd.)

- For both single- and multi-member LLCs, when the LLC engages in a trade or business, its members are treated for tax purposes as if they conducted the activity themselves; as a result, if an LLC generates income from a regularly carried on trade or business activity that is unrelated to the tax-exempt member's purposes, that member must treat its share of the income as UBI
- In other words, the character of the income earned by the LLC from particular investments and activities – it is the nature of the underlying revenue-generating activity that matters – gets passed through to the member(s), and then for tax-exempt members, is analyzed under the three-prong UBIT test

Unrelated Business Income Tax (UBIT) – (cont'd.)

- Use of Taxable Subsidiaries and Disregarded Entities (today we are just focusing on LLCs and C corporations, but other options such as partnerships are available)(cont'd):
 - **Debt-Financed Income:** If a tax-exempt entity – either directly or through its membership interest in an LLC – took out a loan to make an investment, all of the income produced by that investment is subject to UBIT, including any gain when the investment is sold
 - The debt-financed income exception also applies if the LLC used debt to finance the purchase of an income-producing asset (such as a rental property) that passes income back through the LLC to the tax-exempt member

Unrelated Business Income Tax (UBIT) – (cont'd.)

- A C corporation is fully taxable on its net income, however, earnings can be distributed to its tax-exempt parent/shareholder in the form of dividends, which are all tax-free (from UBIT) to the parent and can be earned on an unlimited basis (dividends are not tax deductible to the C corporation); of course, the C corporation also provides liability protection to the parent
 - C corporations are not subject to the new “silo” rule, so losses from one unrelated business activity can be used to offset gains from another – this can be a valuable tax-planning technique
 - Using a C corporation as a “blocker” entity allows the tax-exempt parent to keep the UBI off of its IRS Form 990, which may be desirable
 - May be easier to sell the stock as an exit strategy (compared to an LLC)
 - Of course, the C corporation is not able to take advantage of the parent’s tax-exempt status
- Careful planning up front in this area is critical for tax-exempt entities in order to create the most appropriate corporate structure from the tax, liability protection, regulatory, and governance perspectives

UBIT and Private Benefit

- Ancillary Joint Ventures, Private Benefit, and UBIT:
 - An “ancillary” joint venture is a partnership between a tax-exempt entity and one or more taxable or tax-exempt entities where the activity being conducted by the partnership is not a substantial part of the tax-exempt’s total activities; the partnership often takes the legal form of an LLC, although it does not have to
 - 501(c)(3) tax-exempt entities are subject to the “private benefit” doctrine; if impermissible private benefit arises, it can jeopardize the tax-exempt status of the organization
 - Private benefit is *permissible* if the private benefit – both *quantitatively* (balancing test) and *qualitatively* (the private benefit is no greater than necessary to achieve the tax-exempt purposes) – does not outweigh the public benefit of the activity
 - In a multi-member LLC – particularly where the members other than the 501(c)(3) entity are taxable entities or individuals – a certain amount of private benefit is inherently conferred those non-tax-exempt members, but any amount of private benefit that is more than incidental may jeopardize the 501(c)(3)’s tax-exempt status

UBIT and Private Benefit (cont'd.)

- Ancillary Joint Ventures, Private Benefit, and UBIT (cont'd):
 - The leading guidance from the IRS in this area states that a 501(c)(3) entity can participate in an ancillary joint venture (including through an LLC) with one or more taxable entities without creating *impermissible private benefit* or *triggering UBIT* on its share of the income from the venture so long as:
 - (i) participation furthers the 501(c)(3)'s tax-exempt purposes (the LLC's operating agreement should mandate this), and
 - (ii) the 501(c)(3) maintains majority decision-making control over those aspects of the venture that relate to its tax-exempt purposes
 - Other safeguards to include in the LLC's operating agreement:
 - Proportionate allocations (between the LLC's members)
 - Fair market value paid for all goods, services and property
 - For both IRS Form 990 and federal tax-exemption compliance purposes, it is very important for tax-exempt organizations that engage in joint ventures with taxable entities – including through multi-member LLCs and otherwise – to have a written, board-adopted joint venture policy that spells out when and how the entity will engage in such joint ventures and that codifies the above-referenced IRS guidance (I have supplied such a model policy for your use)

UBIT and Private Benefit (cont'd.)

- Presuming there are tax-exempt activities of the multi-member LLC, then generally, if the 501(c)(3) entity retains majority control over the LLC's tax-exempt functions, there should be no *impermissible private benefit* and thus no *jeopardy to the 501(c)(3)'s tax-exempt status*; unfortunately, the law remains unsettled in this area and the IRS has refused to provide further guidance
- Similarly, presuming there are tax-exempt activities of the multi-member LLC, then generally, if the 501(c)(3) entity retains majority control over the LLC's tax-exempt functions, if the revenue is coming from the tax-exempt activities, there should be no *UBI* generated from the LLC (with the possible exception of debt-financed activities); unfortunately, the law remains unsettled in this area and the IRS has refused to provide further guidance (and won't even issue Private Letter Rulings on proposed nonprofit joint ventures), and some cases and rulings suggest that control is not relevant for UBIT analysis purposes

Unrelated Business Income Tax (UBIT)

- Potential IRS and State Filing Obligations:
 - IRS Form 990-T for UBIT
 - IRS Form 926 for certain investments in foreign corporations
 - IRS Form 8865 for investments in foreign partnerships
 - IRS Form 8886 for transactions with the potential for tax evasion
 - IRS Form 990-W for quarterly estimated UBIT payments
 - 39 states tax UBI and 13 require that an IRS Form 990-T be filed with the state

Governance Considerations

- Don't forget about governance and its critical importance
- While governance may be driven, in part, by legal, tax and/or regulatory considerations, the success of your tax-exempt organization's impact investment strategy will be very much informed by a healthy, efficient, and flexible governance structure
- In general, wherever possible, for wholly owned or controlled subsidiaries or affiliates of your tax-exempt organization, you are going to want to minimize robust, independent governance structures to the greatest extent possible:
 - For controlled tax-exempt affiliates, try to minimize the size of the board of directors and maximize appointment and removal authority for the "parent," and keep board oversight and direction of the investment activities of the affiliate to that which is legally required and appropriate
 - For wholly owned subsidiaries such as disregarded single-member LLCs, make them manager-managed (not member-managed)
 - For multi-member LLCs of which the tax-exempt entity is one of the members, wherever possible, retain majority control by the tax-exempt member over the tax-exempt activities of the LLC (if any) – *i.e.*, by management, not volunteer leaders – and don't create a governance and decision-making structure that is too cumbersome or inefficient

Questions?

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