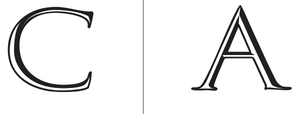

CAMBRIDGE ASSOCIATES LLC

AN INTRODUCTION TO UNRELATED BUSINESS INCOME TAX (UBIT)

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Unrelated Business Income Tax (UBIT) is an income tax that a tax-exempt organization must pay on income generated from any unrelated trade or business regularly carried on by the organization. Excluded from this definition of "income" are dividends and interest, payments in connections with securities loans, and gains and losses recognized on investment activities and from the lapse or termination of options on securities. When UBIT is generated, all income earned by the unrelated business is considered ordinary taxable income and, in keeping with IRS requirements, the organization must file a tax return. The institution is taxed at either the corporate or trust tax rate, depending on the nature of the tax-exempt institution. The organization retains its tax-exempt status, and all non-UBIT generated gains will continue to be exempt from tax.

There are a number of circumstances under which UBIT may arise and of which tax-exempt investors should be aware before making investment selections. First, we will further clarify the rules related to standard UBIT. Then, we will discuss the risks of incurring UBIT through investments in private equity, real estate, and hedge funds.

As mentioned above, tax-exempt organizations can incur UBIT from the gross income earned by any unrelated trade or business that the organization appears to be directly connected to running. The costs associated with the running of the unrelated business may also be deducted from this taxable income. An "unrelated trade or business" is one that is not substantially related to the fulfillment of the tax-exempt organization's charitable function. Random, special rules are applicable to the income generated by things like gift shops, mail order activities, advertising, hospital services, bingo, travel and tour service activities, distribution of member lists, and other activities in the murky area between related and unrelated business.

UBIT becomes an investment-related concern to non-taxable investors who are evaluating private equity, real estate, and/or hedge fund investments. Private equity limited partnership investments can generate UBIT if the partnership's investment activity appears to be in the nature of running a business rather than passively investing in a business. In this scenario, the tax-exempt organization's UBIT is calculated based on its share of the partnership's gross income (realized or unrealized). The negative impact of incurring UBIT can be significant: return may be unacceptable after the realization of taxes and any recognition of taxable income could trigger an audit of a limited partner's entire portfolio. As such, it is standard for the limited and general partners to agree that the general partners should use their "best efforts" to avoid investments that would trigger UBIT.

In the case of real estate investments, more recent modifications of the Internal Revenue Code have exempted educational organizations and qualified pension plans from rules related to debt-financed property (discussed below). However all tax-exempt organizations can incur UBIT from real estate investments in operations where income is derived from more than just rents (i.e., a building that includes

a parking garage, hotel management activity, etc). Foundations (but not educational endowments or qualified pension plans) run the additional risk of incurring UBIT through real estate investments that use leverage; income and deductions that would otherwise be excluded from the scope of UBIT are nevertheless subject to taxation if incurred with respect to debt-financed property. The Internal Revenue Code makes special provisions for the taxation of the unrelated income from property for which the acquisition is financed with debt (for example, a mortgage or similar lien) and which is held to generate income. In general, a tax-exempt organization's income from debt-financed property is subject to tax as unrelated business income in the proportion to which the property is financed by debt. Excluded from this is property that is used for purposes substantially related to the organization's charitable function as well as property income that is already taxable under standard UBIT.

Similarly, returns generated by a hedge fund that are directly attributable to "traditional leverage" may be subject to UBIT. "Traditional leverage" means that the fund must use borrowed money (a margin account) to leverage the portfolio. This does not include "non-traditional leverage" like futures, options, and other forms of derivatives that have a high level of economic leverage. Short positions that are collateralized by offsetting long holdings are also not subject to UBIT. Tax-exempt institutions can avoid UBIT by investing in offshore funds. In this case, the institution buys a share of an offshore company, and the IRS does not "look through" to the underlying portfolio.