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A Private Equity Fund Structure for Nonprofits

by Peter James Cline

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In this article, Cline examines nonprofits' use of blocker entities in private equity structures to avoid unrelated business taxable income, and he proposes a modified strategy involving a new partnership entity that would be formed alongside the blocker and allow a nonprofit to avoid UBTI categorization on investment income as well as the 21 percent tax rate on UBTI and C corporation income for some of the investment income.

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Introduction

A tax-exempt organization may seek to maximize portfolio appreciation by investing in alternative investment vehicles, such as private equity funds, that hold interests in portfolio companies engaged in businesses unrelated to the exempt purpose of the EO. These private equity funds are typically structured as passthrough entities for tax purposes. If the private equity fund invests in a portfolio company that is also organized as a passthrough entity for tax purposes, the EO's income from the investment generally will be unrelated business taxable income subject to tax at the corporate income tax rate, and the EO may risk loss of its exempt status.

EOs typically manage these risks by investing through a C corporation blocker. Investing through a blocker protects the EO's exempt status but does not protect the investment income from tax; the tax is simply incurred at the blocker level rather than at the EO level. However, an alternative structure may be available that both protects the EO's exempt status and relieves a portion of the investment income from tax.

UBTI and the Commerciality Doctrine

An EO's income will be included in UBTI if it is derived from a trade or business, regularly carried on, that is unrelated to the EO's exempt purpose.[1]

UBTI is subject to tax at the C corporation rate (currently 21 percent for United States federal income tax purposes).[2]

Income earned by an EO through a partnership engaged, directly or indirectly through one or more other partnerships, in a trade or business unrelated to the EO's exempt purpose is specifically included as UBTI.[3]

More importantly, under general agency principles and the aggregate theory of partnership tax, the trade or business activity of a partnership is treated as the activity of the partners.[4] Imputation of the partnership's trade or business activity to the EO partner exposes the EO to the risk of losing its exempt status under the commerciality doctrine.[5] This doctrine conditions exempt status on an EO not engaging in more than an "insubstantial" amount of activities unrelated

[1] Reg. section 1.513-1(a)-(d).

[2] Section 511(a).

[3] Section 512(c).

[4] *See* Rev. Rul. 98-15, 1998-1 C.B. 718.

[5] *See* reg. section 1.501(c)(3)-1(e)(1); IRS Publication 5833, "Exempt Organizations Technical Guide," at Section II.C.3 (rev. Feb. 1, 2024).

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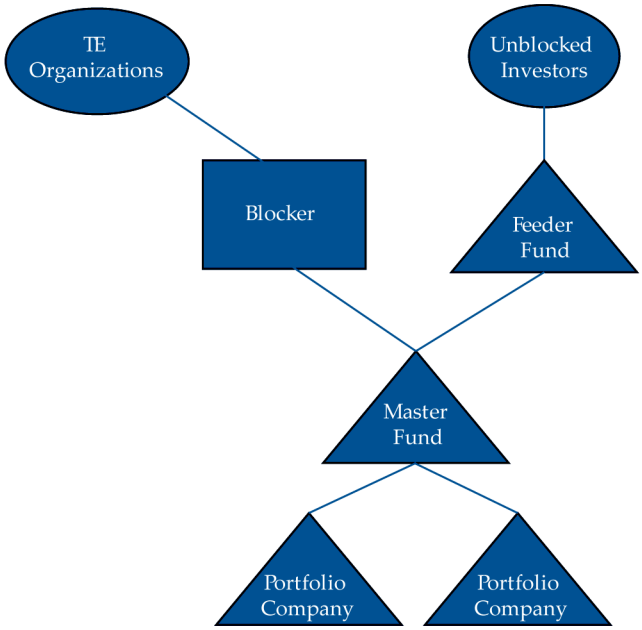
Figure 1



to its exempt purpose.[6] An EO investing in a business organized as a tax partnership must therefore weigh its share of the business's trade or business activities against the scale of its own exempt-purpose activities to determine if the business activities imputed to it are more than an insubstantial part of its total activities.

Unfortunately, given the risks involved, there is no bright-line test for what constitutes an insubstantial amount. That is why many EOs limit or do not make direct investments in private equity funds and other alternative investment vehicles organized as partnerships without a blocker somewhere in the structure.

Typical Private Equity Fund Blocker Structure

A blocker entity that protects EO investors from UBTI and the commerciality doctrine is often incorporated within a master-feeder private equity fund structure (a generalized version of which is shown in Figure 1).

In a master-feeder structure, outside investors provide capital in exchange for an equity interest in a "feeder" parent entity (feeder fund). The feeder fund capital is then contributed to its subsidiary (master fund), which can use the capital to buy and grow various portfolio companies. Feeder funds are typically taxed as partnerships or C corporations depending on the types of investors involved. U.S. for-profit entities prefer to invest in feeder funds taxed as partnerships to avoid the C corporation double taxation regime. EO investors, on the other hand, will often form a separate feeder fund organized as a C corporation (the blocker)[7] to avoid the risks identified above. The blocker shields the EO investors from commerciality doctrine concerns. It also converts UBTI earned through the master fund into nontaxable dividend income,[8] but it does not reduce the tax on the EOs' investment returns because those returns are taxed at the same rate as they pass through the blocker feeder fund.

The distribution of investment returns in a master-feeder structure is governed by the waterfall section of the master fund's governing

[6]Reg. section 1.501(c)(3)-1(c)(1). Another potential concern of UBTI is the inability to offset gain from one unrelated trade or business with the losses of another unrelated trade or business. Section 512(a)(6).

[7]Blockers are also used by foreign investors to minimize their exposure to income effectively connected with a U.S. trade or business and branch profit taxes on the dividend equivalent amount. Sections 882 and 884.

[8]Section 512(b).

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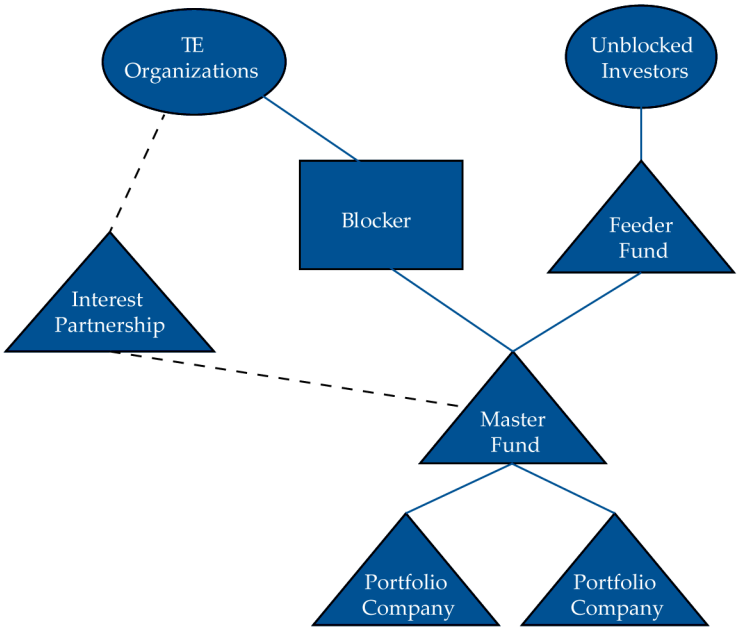
Figure 2



agreement. In general, a master fund's distribution provisions will include three tiers.[9] First, the fund will return investor capital (return of capital tier). Second, the fund will distribute profits to the investors until each investor receives a preferred return (for example, 8 percent) (preferred return tier). Third, the fund will split any remaining profits between the investors (for example, 80 percent) and management (for example, 20 percent) (residual tier).[10] Modifying the preferred return tier of the waterfall could increase returns to the EO investors without adverse consequences to management or for-profit investors and without losing the benefit of the blocker's commerciality doctrine shield.

Proposed Structure

The preferred return tier of the typical waterfall operates like a loan — in particular, a loan for which the master fund pays a fixed rate of return to its investors in exchange for their capital. If the preferred return tier payable to the EO investors were converted into an actual loan that bypassed the blocker feeder fund, the tax on this portion of the investment returns could escape taxation because interest is excluded from UBTI.[11]

This could be accomplished through adding another partnership to the structure, shown in Figure 2 (interest partnership). The EO investors would contribute a portion of their capital to the interest partnership (rather than the blocker), and the interest partnership would lend those contributions to the master fund with interest charged at the same rate as the rate under the preferred return tier. For every dollar reallocated from the blocker to the interest partnership, an additional 21 cents could be saved by the EO investors.

An interest partnership comes with benefits but also creates additional legal hurdles. For example, consideration should be given to ensure that the loan issued by the master fund to the interest partnership is treated as debt (rather than equity) for federal tax purposes. This is because if the interest partnership loan is treated as equity for federal tax purposes, then the interest partnership loan will be subject to the

[9] *See, e.g.*, Institutional Limited Partners Association, "The ILPA Model Limited Partnership Agreement (Whole-of-Fund Waterfall)," at section 14.3 (July 2020).

[10] The 20 percent distribution to management is often referred to as carried interest.

[11] Section 512(b).

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"insubstantial" amount limitation under the commerciality doctrine.

There is no single test to determine whether a loan will be categorized as debt or equity for federal tax purposes. Instead, different jurisdictions apply different sets of factors.[12] Although there is no dispositive set of factors, there are several influential court decisions that examine similar factors. In one case, *Estate of Mixon*, the Fifth Circuit evaluated and applied the following 13 factors:

> (1) the names given to the certificates evidencing the indebtedness;
>
> (2) the presence or absence of a fixed maturity date;
>
> (3) the source of payments;
>
> (4) the right to enforce payment of principal and interest;
>
> (5) participation in management flowing as a result;
>
> (6) the status of the contribution in relation to regular corporate creditors;
>
> (7) the intent of the parties;
>
> (8) "thin" or adequate capitalization;
>
> (9) identity of interest between creditor and stockholder;
>
> (10) source of interest payments;
>
> (11) the ability of the corporation to obtain loans from outside lending institutions;
>
> (12) the extent to which the advance was used to acquire capital assets; and
>
> (13) the failure of the debtor to repay on the due date or to seek a postponement.[13]

None of these factors are controlling, but certain ones are given greater weight depending on the particular facts and circumstances.[14] For example, the existence of a fixed maturity date is often an influential factor in demonstrating that a loan is debt.[15] An interest partnership could satisfy this factor by listing a fixed maturity date in its loan with the master fund that matches the anticipated liquidation date of the master fund. Further, if the lender is entitled to a sum certain from the debt, that is frequently another important factor indicating the existence of debt.[16] An interest partnership could meet this factor by matching the total principal and interest payments owed in its loan to the master fund with the anticipated distribution amount to other investors under the return of capital tier and the preferred return tier — in particular, a return of capital plus a fixed rate. Of course, any remaining factors will have to be considered when finalizing the loan between the master fund and the interest partnership to ensure that there is no inadvertent equity treatment.

Restructuring the preferred return tier as debt, and thus bypassing the blocker, also requires redrafting the master fund waterfall to allow the EOs to participate in the residual tier, but not the return of capital or the preferred return tier. This would require convincing the other investors that their tax status should not entitle them to similar debt payments. Those other investors may not agree to this alternative arrangement if the interest from the interest partnership debt cannot be deducted because of the limitations on business interest and investment interest deductions.[17] The other investors may also hesitate with their distributions (under the master fund waterfall) being subordinated to the interest partnership debt.

Conclusion

With billions of dollars at stake in private equity fund investments held by EOs, any chance to avoid additional taxes should be analyzed and,

[12] *See, e.g.*, *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972); *Indmar Products Co. v. Commissioner*, 444 F.3d 771, 777 (6th Cir. 2006); *Hardman v. United States*, 827 F.2d 1409, 1412 (9th Cir. 1987).

[13] *Estate of Mixon*, 464 F.2d at 402.

[14] *See id.* at 402.

[15] David C. Garlock et al., *Federal Income Taxation of Debt Instruments*, section 102.03[A] (2024) (quoting *United States v. South Georgia Railway Co.*, 107 F.2d 3, 5 (5th Cir. 1939) ("entire absence here of the *most significant, if not the essential feature* of a debtor and creditor as opposed to a stockholder relationship, the existence of a fixed maturity for the principal sum with the right to force payment of the sum as a debt in the event of default"(emphasis added))).

[16] Garlock et al., *supra* note 15, at section 102.03[A], n.173 (citing FSA 199940007).

[17] Sections 163(d), (j).

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depending on the situation, used. Adding the interest partnership to a master-feeder structure would come with downsides. Those downsides, however, are likely outweighed by the ability of EOs to avoid an additional 21 percent tax for preferred tier distributions. Moreover, avoidance of the 21 percent tax rate would benefit the private equity fund by attracting additional EO investment with a higher forecasted return. These mutual benefits suggest that the use of the interest partnership could be a profitable endeavor. ■

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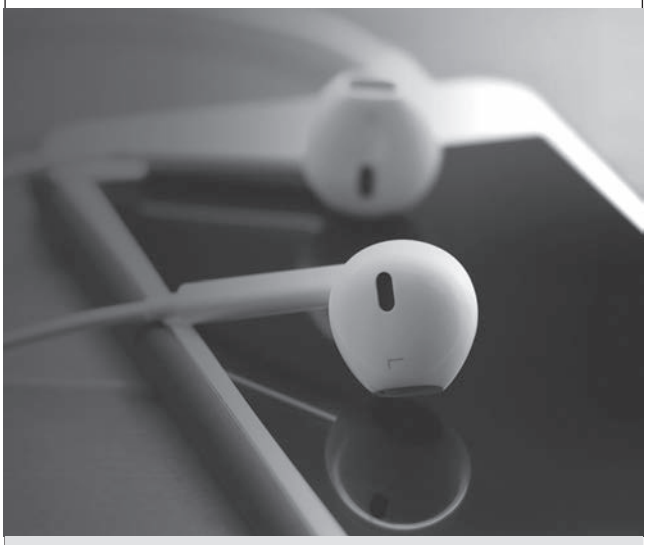

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