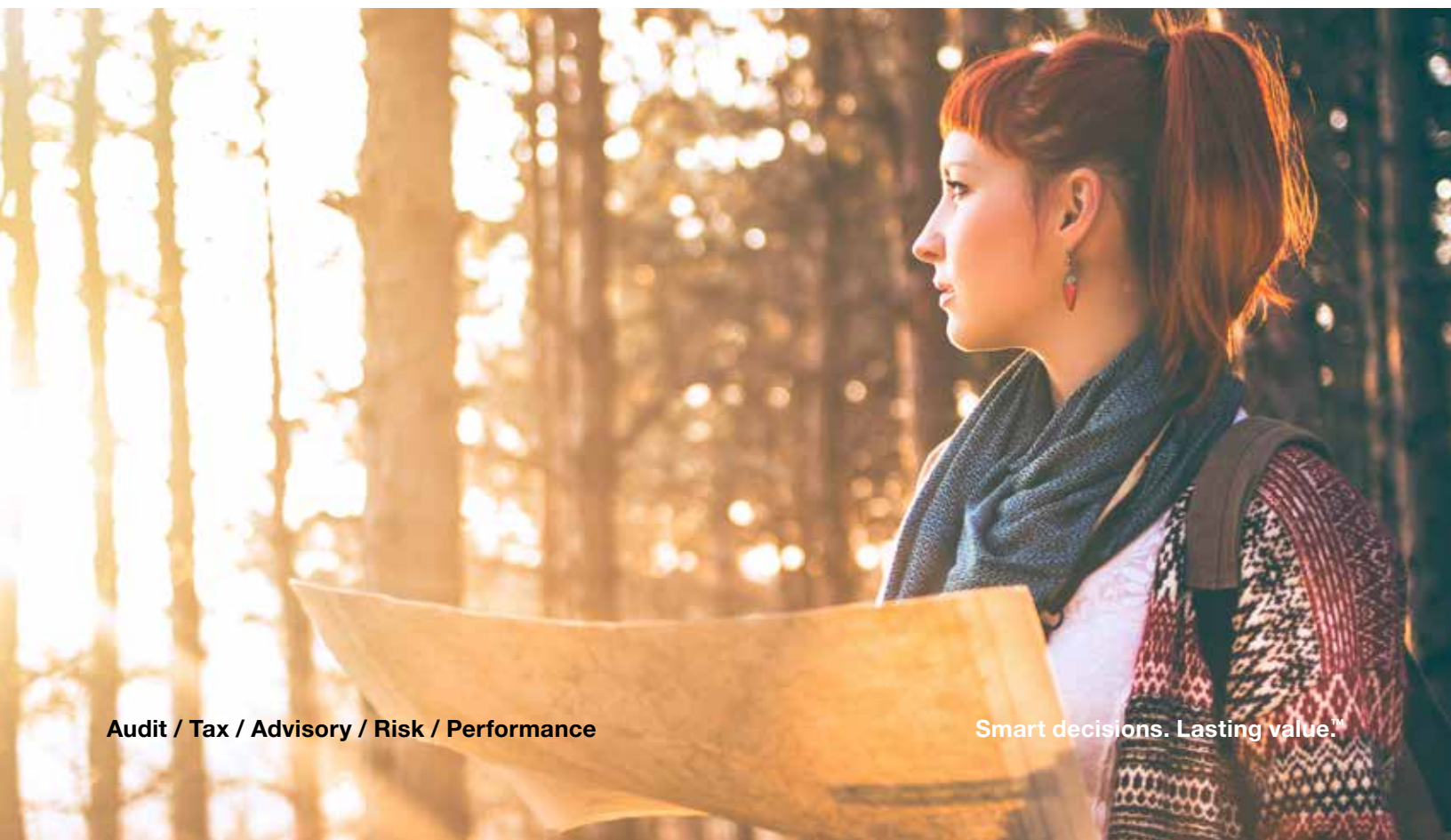


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5 Tax Planning Considerations for Alternative Investments

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Navigating through the challenging tax landscape of alternative investments – investments in assets that are not conventional (that is, they are not stocks, bonds, or cash) – can be an enormous task and a strain on internal resources for healthcare organizations.

Alternative investments can lead to both unrelated business income tax (UBIT) and significant additional filing requirements. These additional filing requirements have to be taken seriously, as there can be significant penalties involved for not filing.

It is not unusual for an institution holding a large alternative investment portfolio to receive hundreds of tax documents each year. Each of these documents must be reviewed, analyzed, and aggregated to determine the organization's share of income tax liability for federal and state purposes as well as the required disclosures for direct and indirect transfers and ownership in foreign corporations and partnerships. It is critical for institutions to have a sound process in place to verify compliance and avoid potential exposure and penalties.

Here are five planning tips healthcare organizations should incorporate into the overall tax compliance function.



1. Determine Entity Type

Understanding the type of entity in which the healthcare organization is investing is an important first step in determining the types of tax issues that may result from an alternative investment. Determining the type of legal entity structure (for example, U.S. partnership, U.S. corporation, foreign partnership, or foreign corporation) helps establish what type of tax information the investor organization can expect to receive from each particular investment. Many alternative investment funds are organized as U.S. partnerships or limited liability companies (LLCs). Thus, the partnership's or LLC's pass-through income is taxed at the organization level.

Requirements for reporting tax information to investors vary depending on the alternative investment type. For example, a U.S. partnership is required to provide its partners with an annual tax statement in the form of a Schedule K-1. Other investment structures, such as foreign partnerships and foreign corporations, may not have a U.S. filing requirement and, therefore, may not issue a Schedule K-1. However, just because a K-1 is not issued does not mean there is not a filing requirement. It often is necessary to contact the investment manager to obtain the documents needed to verify the related tax filing obligations.

Prospectus statements and offering memorandums are two examples of good sources from which to obtain an initial understanding of the potential tax obligations associated with an investment. The investment vehicle's strategies may change over time, so it is important to review them on an annual basis.



2. Understand the Underlying Activity

The underlying activity in a partnership or LLC is passed through to the institutional investor based on a distributive share of income or loss reported via a Schedule K-1. While not all income reported on a Schedule K-1 is taxable to a tax-exempt investor, some activity may be deemed and reported as unrelated business income (UBI). Here are two examples of how partnerships can generate UBI:

1. Operating a trade or business unrelated to an exempt organization investor's exempt purpose might produce ordinary income (for example, a working interest in oil and gas).
2. Investments purchased with borrowed funds can be subject to debt-financed income rules.

In addition to federal UBI, partnerships and LLCs also may report UBI sourced from states other than the tax-exempt investor's state of domicile, which may require income tax returns in multiple jurisdictions.

3. Track Transfers to Foreign Entities

Investments in foreign entities may require additional information reporting (such as Forms 926, 8865, and 5471) based on certain ownership thresholds as well as direct and indirect cash and property transfers. On an ongoing basis, organizations must monitor ownership interests and track amounts transferred to foreign partnership and corporation investments. Following up with investment managers often is necessary for confirming transfers and ownership percentages.



4. Keep Leadership Informed

Often the individuals in positions to make investment decisions – such as chief financial officers, chief investment officers, and investment committees – are focused on higher yields and not necessarily on the related tax issues. The return on investment may far outweigh any tax considerations; however, those in positions to influence investment decisions also may be interested in understanding the true rate of return, including the overall time and costs spent on tax compliance by internal resources, investment managers, and tax advisers.

An annual summary dashboard outlining a few significant tax data points will give others an understanding of the tax liabilities and associated filing requirements. Data points on the dashboard may include:

- Number of alternative investments
- Number of hours spent by internal resources
- Professional fees charged by investment advisers, investment managers, and tax advisers
- Total federal tax liability
- Total state tax liability
- Total number of state tax returns filed
- Total number of foreign disclosure forms (for example, Forms 926, 8865, and 5471) filed



5. Plan Ahead

Organizations receive tax data on investments throughout the year, making tax compliance a continuous process. Individuals in the organization responsible for tax compliance should be on alert throughout the life cycle of an alternative investment to determine what tax information the organization can expect to receive so they can plan ahead accordingly. It is important to allow sufficient time to gather and review the voluminous tax documents. Many tax professionals use alternative investment tools and calendars to help manage the receipt of information, monitor tax deadlines, and aggregate the data for tax reporting purposes.

In addition, just as the healthcare field is ever-evolving, so is the world of tax law. It is imperative for organizations to stay abreast of changing federal and state laws to minimize any risk of noncompliance.

Alternative investments can be a rewarding part of a healthcare organization's overall investment strategy. Thoughtful planning and a carefully developed understanding of the tax nuances involved with alternative investments will go a long way toward helping a healthcare organization to achieve compliance.



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