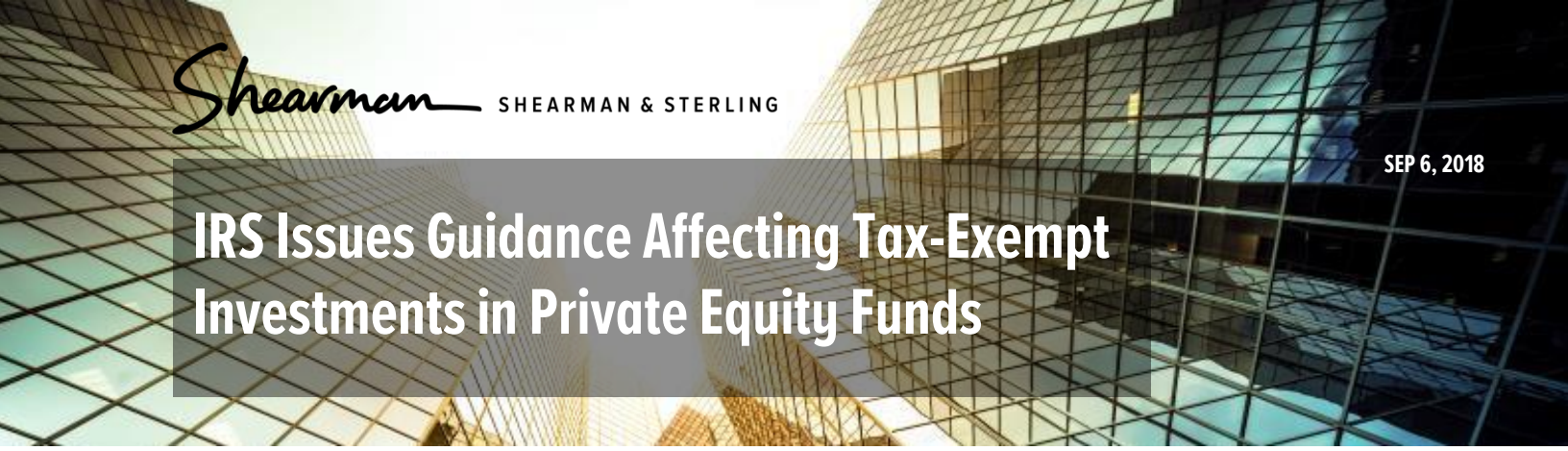

SHEARMAN & STERLING

SEP 6, 2018

IRS Issues Guidance Affecting Tax-Exempt Investments in Private Equity Funds

Under the Tax Cuts and Jobs Act (TCJA, December 22, 2017), tax-exempt investors must now calculate unrelated business taxable income (UBTI) separately with respect to each trade or business. As a result, a deduction from one unrelated trade or business for a taxable year may no longer be used to offset income from a different unrelated trade or business for the same taxable year. The TCJA does not define "trade or business" for this purpose, and thus has created anxiety for many tax-exempt investors that receive significant income from a large number of businesses conducted by private equity funds. As discussed below, the IRS issued Notice 2018-67 on August 21, 2018, providing interim guidance for aggregating income reported by tax-exempt investors with respect to separate trades or businesses under Section 512(a)(6) of the Internal Revenue Code, including welcome news pertaining to investments in private equity funds.

Separate Trades or Businesses.

Pending issuance of proposed regulations, the Notice indicates tax-exempt investors may rely on a "reasonable, good-faith interpretation" of Sections 511 through 514 of the Internal Revenue Code, considering all the facts and circumstances, when determining whether a tax-exempt investor has more than one unrelated trade or business for purposes of Section 512(a)(6) of the Internal Revenue Code. A "reasonable, good-faith interpretation" includes identifying a particular trade or business by the six-digit code assigned under the North American Industry Classification System (NAICS). In this manner, a tax-exempt investor is now permitted to aggregate items of gross income or deduction as a single trade or business to the extent they are proximately connected with a particular NAICS six-digit code.

Interests in Partnerships.

The Notice acknowledges the high administrative burden associated with requiring a tax-exempt investor to calculate UBTI separately with respect to each unrelated trade or business regularly carried on by a partnership in which the tax-exempt investor is a direct or indirect partner. In the context of a private equity fund investment, the Notice observes that it may be difficult for tax-exempt

investors to obtain sufficient information regarding the trade or business activities conducted by lower-tier partnerships in which a private equity fund may invest.

To address this situation, the Treasury Department and the IRS intend to propose regulations treating certain "investment activities" as one trade or business for purposes of Section 512(a)(6)(A) of the Internal Revenue Code. Under the anticipated guidance, tax-exempt investors could aggregate all items of gross income and deduction related to such "investment activities," *e.g.*, items of income or deduction flowing from Schedule K-1 received with respect to underlying private equity fund investments. The Treasury Department and the IRS are requesting comments about the scope of such "investment activities," including with respect to the aggregation of income from a tax-exempt investor's participation in multiple private equity investments.

Under the interim guidance provided by the Notice, a tax-exempt investor may aggregate items of UBTI from its directly held interest in a single private equity fund with multiple underlying trades or businesses, so long as the private equity investment meets either the *de minimis* test or the control test described below. Furthermore, the Notice would permit the tax-exempt investor to aggregate its UBTI from one fund investment with UBTI from other investments meeting one of these tests, which together would be treated as comprising a single trade or business for purposes of Section 512(a)(6)(A) of the Internal Revenue Code.

Under the *de minimis* test, a private equity fund investment will qualify for aggregation if the tax-exempt investor's average interest in the profits and capital of the investment partnership for the taxable period does not exceed two percent (subject to certain attribution rules). A fund investment not meeting the *de minimis* test may qualify instead under the control test if the tax-exempt investor directly holds no more than 20 percent of the capital interest and has no control or influence over the fund or its investments (as determined based on a facts and circumstances analysis). Transition relief waives the *de minimis* and control test for private equity investments subscribed for prior to August 21, 2018; provided that such relief limits aggregation to items of UBTI from a directly held interest in a private equity investment with multiple underlying trades or businesses (and does not provide relief for aggregating with other directly held private equity investments or similar partnership interests).

CONTACT

TODD LOWTHER
Partner
Houston
todd.lowther@shearman.com
T: +1 713 354 4898

LAURA FRIEDRICH
Partner
New York
laura.friedrich@shearman.com
T: +1 212 848 7411

SARAH MCLEAN
Partner
Houston
sarah.mclean@shearman.com
T: 1 713 354 4897

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069