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IRS Issues Interim Guidance Applicable to Tax-Exempt Investors in Private Equity Funds

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On August 28, 2018, the IRS released Notice 2018-67 (the Notice), which provides interim guidance concerning the aggregation of trade or business activities for purposes of calculating the unrelated business taxable income (UBTI) of a tax-exempt organization. The Notice was issued in connection with new Code Section 512(a)(6) (the Silo Rule), which was enacted under the Tax Cuts and Jobs Act (the TCJA). The Silo Rule requires tax-exempt organizations to calculate UBTI separately with respect to each unrelated trade or business it holds, and not aggregate taxable income and losses from various unrelated trades or businesses. Tax-exempt organizations, particularly those investing in private equity funds, have welcomed the Notice as practical and helpful guidance for calculating UBTI under the Silo Rule, and see the Notice as a strong indication of the Treasury Department's approach to forthcoming proposed regulations.

The Good-Faith Standard for Identifying Separate Unrelated Trades or Businesses

A tax-exempt organization is subject to federal income tax on UBTI, which generally is taxable income derived from trade or business activities that are not substantially related to the organization's tax-exempt purpose. Certain types of income are specifically exempt from UBTI, such as dividends, interest, royalties, and certain rents, unless such income is derived from debt-financed property. Prior to enactment of the TCJA, tax-exempt organizations could aggregate taxable income and loss from multiple unrelated trades or businesses. As a result, a tax-exempt organization could utilize a net taxable loss from one unrelated trade or business to offset net taxable income from another, thereby reducing the organization's aggregate UBTI. By contrast, under the Silo Rule, a tax-exempt organization's UBTI for a taxable year generally is the sum of the organization's positive UBTI, computed separately for each unrelated trade or business. In addition, if an unrelated trade or business of a tax-exempt organization generates a net operating loss (NOL), such NOL cannot be used to offset positive UBTI from other unrelated trades or businesses but, instead, is carried forward solely to offset UBTI from the same unrelated trade or business in future years.

The Silo Rule, however, does not provide a methodology for identifying unrelated trades or businesses for which UBTI may be aggregated. Since the enactment of the TCJA, several commentators have called for a facts-and-circumstances test to identify the scope of an unrelated trade or business for purposes of the Silo Rule. The Notice takes a contrary view, pointing out that a facts-and-circumstances approach would increase the administrative burden on tax-exempt organizations by requiring them to perform fact-intensive analyses and keep detailed records to support their conclusions, and that such an approach could lead to inconsistent results among similarly-situated organizations. Instead, pending the issuance of proposed regulations, the Notice permits tax-exempt organizations to rely on a reasonable, good-faith interpretation of Code Sections 511 through 514, which define UBTI and related terms, to determine whether a tax-exempt organization holds more than one unrelated trade or business for purposes of the Silo Rule (the Good-Faith Standard). The Notice also provides that the IRS and Treasury Department are considering the North American Industry Classification System (NAICS) codes as a permissible method for identifying separate unrelated trades or businesses of a tax-exempt organization and, until proposed regulations are issued, a tax-exempt organization using the NAICS codes for purposes of the Silo Rule will satisfy the Good-Faith Standard. Accordingly, a tax-exempt investor may aggregate items of taxable income and loss as a single unrelated trade or business to the extent such items are proximately connected with a single business described in a NAICS six-digit code.

Guidance Concerning the Application of the Silo Rule to Partnership Investments

The Notice also provides guidance for tax-exempt investors owning direct or indirect interests in partnerships generating UBTI, which was not included in the TCJA. Forthcoming proposed regulations are expected to permit tax-exempt investors to aggregate all items of gross income and loss related to investment activities for purposes of the Silo Rule, including an investment in a partnership that owns interests in lower-tier partnerships with trade or business activities. The scope of investment activities for this purpose is not defined in the Notice, and the Treasury Department has asked for comments on this issue. The Notice, however, indicates that an investment activity is expected to include ownership of partnership interests with trades or businesses in which the investor does not significantly participate, which is expected to include a passive investment in a private equity fund with indirect interests in underlying portfolio businesses.

Until these proposed regulations are released, the Notice permits a tax-exempt investor to aggregate UBTI derived from a single partnership interest with multiple trades or businesses, including trades or businesses operated by lower-tier partnerships, as long as the directly-held interest meets either the *de minimis* test or the control test (referred to in the Notice as the Interim Rule). If a partnership interest satisfies the Interim Rule, the tax-exempt investor can aggregate this interest with other partnership interests held by the investor that also satisfy the Interim Rule (a Qualifying Partnership Interest) as a single trade or business for purposes of determining UBTI under the Silo Rule.

A partnership interest generally will satisfy the *de minimis* test if the tax-exempt investor directly holds no more than 2 percent of the profits interest and no more than 2 percent of the capital interest in the partnership. The tax-exempt investor may rely on the Schedule K-1 it receives from the partnership to determine its share of profits and capital for this purpose. However, if no specific profits interest is identified on Schedule K-1, the *de minimis* test cannot be met.

A partnership interest generally will satisfy the control test if the tax-exempt investor holds no more than 20 percent of the capital interest in the partnership, and the investor does not have control or influence over the partnership based on a facts-and-circumstances analysis. Although the question of whether a tax-exempt investor has control or influence over a partnership must be determined by a facts-and-circumstances analysis, the Notice provides some helpful guidance. A tax-exempt investor will be treated as having control or influence if the investor may cause the partnership to take any action, or not take any action, that significantly affects the operations or the partnership, if the investor has the power to appoint or remove any of the partnership's officers, directors, trustees or employees, or if any of the investor's officers, directors, trustees or employees have rights to participate in management or in the conduct of the partnership's business.

Finally, the Notice acknowledges that it may be difficult for a tax-exempt investor to satisfy the Interim Rule for a previously-acquired partnership interest without costly planning or restructuring. The Notice therefore permits a tax-exempt organization to treat a partnership interest acquired prior to August 21, 2018 as constituting a single unrelated trade or business for purposes of the Silo Rule, regardless of whether the partnership conducts, directly or indirectly, more than one separate trade or business (referred to in the Notice as the Transition Rule). Such a partnership interest cannot be aggregated with Qualifying Partnership Interests under the Interim Test, but may be eligible for aggregation under the Good Faith Standard.

The Taxpayer Response Has Been Positive . . . So Far

When the TCJA was enacted, tax-exempt investors were concerned that the Silo Rule would be rigidly applied to limit aggregation and generally increase investors' UBTI, without any significant opportunity for tax planning. Tax-exempt investors in private equity funds were especially concerned since, prior to the Silo Rule, the ability to aggregate taxable income and loss from portfolio businesses held by the fund often yield a significant tax benefit. As a result, tax-exempt investors have welcomed the Notice as an indication that the Silo Rule will not be rigidly applied, and investors have applauded the flexibility of the Good Faith Standard and consider the NAICS codes to be a practical approach for identifying separate unrelated trades or businesses.

Similarly, tax-exempt investors were encouraged by the inclusion of the Interim Rule in the Notice, which permits the aggregation of certain investment activities, including investments in partnerships, into a single trade or business for purposes of the Silo Rule. The general approach of the Interim Rule, if adopted in future Treasury regulations, could significantly reduce the reporting and administrative burden of tracking unrelated trades or businesses held indirectly through complex, multi-tiered partnership structures, including typical private equity funds. Such an approach would permit a tax-exempt investor to utilize taxable losses generated by one portfolio investment (for instance, an early-phase business with considerable start-up expenses or bonus depreciation) to offset taxable income from another, which appears to be the appropriate result. In the meantime, tax-exempt investors have welcomed the Transition Rule as an opportunity to avoid the application of the Interim Rule for partnership interests acquired before the scope of the *de minimis* test and the control test were provided in the Notice.

Tax-exempt organizations generally may rely on the Good-Faith Standard and may rely on the use of NAICS codes to identify separate unrelated trades or businesses until proposed regulations under the Silo Rule are published. In addition, for taxable years beginning after December 31, 2017, until proposed regulations under the Silo Rule are published, tax-exempt organizations may rely on the Interim Test and Transition Test. The Treasury Department and IRS are accepting comments to the Notice through December 3, 2018.