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KIRKLANDPEN
Private Equity Newsletter

August 24, 2018

IRS Simplifies New UBTI Tax Rules For Tax-Exempt Investors Participating in Private Equity Funds

PENpoints

The IRS recently issued guidance that is expected to ease tax compliance and UBTI tax liability for tax-exempt investors in private equity funds.

In an August 21, 2018 notice,[1] the Internal Revenue Service issued guidance intended to ease administrative burdens for tax-exempt organizations (such as IRAs, charitable organizations, private pensions and university endowments) ("TEOs") in calculating their "unrelated business taxable income" ("UBTI") under the new UBTI computation rule enacted as part of the December 2017 Tax Cuts and Jobs Act.[2] This guidance is expected to ease the tax compliance and reporting burden and also reduce tax liability for both PE fund sponsors and their tax-exempt investors, facilitating continued investment in the sector.

In a major departure from prior law, the December 2017 legislation requires a TEO with more than one unrelated trade or business to compute UBTI separately for each trade or business, effectively prohibiting the netting of losses from one business against the income from a separate, profitable business.[3] Prior law generally permitted a TEO to compute its UBTI by netting income and losses from all trades and businesses.

This new UBTI computation rule raised significant questions for many TEOs investing in private investment funds or fund-of-funds, which may have invested (directly or through other tiers of partnerships) in more than one partnership portfolio company ("PC")[4] business, including whether a TEO is now required to separately compute its UBTI from each individual underlying PC or, alternatively, whether an aggregation concept is permissible (either at the fund level or across all of a TEO's fund investments). The August 2018 notice provides important initial guidance for TEOs permitting the new UBTI computation rule to be applied on a net basis in many cases at the TEO level or at the fund partnership level, rather than at the PC level.

Guidance for TEOs Holding Partnership Investments

The notice provides two safe harbors — an "interim rule" and a "transition rule" — permitting a TEO to net UBTI arising from certain fund partnership investments.[4]

"Qualifying Partnership Interests"

The interim rule allows a TEO to aggregate and calculate UBTI on a net basis (including UBTI arising from a fund's borrowing activities) to the extent arising from the TEO's interest in a single fund partnership with multiple PCs *and* also across multiple fund partnerships with multiple PCs, to the extent the fund partnership interests are "qualifying partnership interests."

De Minimis and Control Tests

A fund partnership interest is a "qualifying partnership interest" if it meets *either* a de minimis test *or* a control test.[5]

- **De Minimis Test:** The TEO holds directly no more than 2% of the profits interests and no more than 2% of the capital interests in the partnership. Since this test would be met only for smaller investors in a PE fund, it may not be practical for tax-exempt investors in many mid-market funds.
- **Control Test:** The TEO (a) holds directly no more than 20% of the capital interests (e.g., a tax-exempt investor representing less than 1/5 of a private equity fund's capital commitments) and (b) does not have control or influence over the partnership, considering all the facts and circumstances. A TEO has control or influence for this purpose if (i) the TEO may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the partnership's operations, (ii) the TEO has the right to appoint or remove partnership management personnel, or (iii) the TEO's management personnel have rights to participate in the partnership business's management or conduct.

  As a result, a TEO with meaningful veto rights or major decision rights (which would commonly occur in a separate account or joint venture structure) may fail the control test. We believe that the IRS should clarify that a TEO's minority participa-

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tion on a typical fund "LP advisory committee" or similar role by itself would not give the TEO sufficient "influence" or rights to "participate" in fund management as to violate the control test.

This is a powerful safe harbor which will permit many TEOs to net UBTI across separate and unrelated PE fund partnership interests. As a result, the new anti-netting rule for computing UBTI may have little impact on UBTI realized by many TEOs from investments in PE funds.

Transition Rule — Partnership Interests Acquired Prior to August 21, 2018

The notice permits a TEO to treat a partnership interest (regardless of whether either the de minimis or the control test is satisfied) that was acquired prior to August 21, 2018, as a single trade or business for purposes of the new UBTI computation rule. As a result, the transition rule eliminates the need for a TEO to look through any fund partnership interest owned prior to August 21, 2018, in calculating its UBTI.

GILTI Clarification

In addition, the notice helpfully confirms that so-called "global intangible low-taxed income" ("GILTI") received by a TEO investing in a non-U.S. corporation will be treated as dividend income, which generally is not treated as UBTI unless the TEO borrowed to invest in the non-U.S. corporation. This confirmation is important because TEOs (in order to minimize UBTI) often invest in non-U.S. feeder entities or parallel funds treated as corporations for U.S. tax purposes (which could generate income taxed to U.S. shareholders under the GILTI rules).

While it generally was believed that GILTI should not be treated as UBTI for TEOs, the notice provides welcome clarity.

Next Steps

The notice marks an easing of a strict rule for private equity fund managers, who worried about the cost and time involved in separately reporting the UBTI from each of their underlying investments (a problem only magnified for a fund-of-funds), as well as the UBTI tax cost if TEOs are unable to utilize losses to offset gains. However, many uncertainties still remain regarding reporting and computation for private equity funds and their investors, at least until the IRS publishes further guidance. TEOs generally may rely on the notice until proposed regulations are published.

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1 IRS Notice 2018-67.

2 P.L. 115-97.

3 Internal Revenue Code Section 512(a)(6). See additional discussion of the new UBTI rule and the Tax Cuts and Jobs Act generally in our prior *KirklandPEN* and *Kirkland Alert*.

4 A partnership portfolio company includes a partnership or limited liability company taxed as a partnership for U.S. federal income tax purposes.

5 Where neither safe harbor applies, the notice directs TEOs with partnership investments to use a "reasonable, good-faith interpretation" of the rules for computing UBTI, considering all the facts and circumstances, when identifying separate trades or businesses, thereby providing little comfort for a TEO falling outside the two safe harbors.

6 For purposes of these two tests, a TEO's percentage interest in a partnership's capital or profits is its applicable percentage interest reported by the partnership on IRS Schedule K-1 (averaging its ownership interest in capital or profits, as applicable, at the beginning and end of year), and the TEO must aggregate certain interests of related persons in determining its percentage interest.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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PENbriefs

California Court of Appeals Holds that Settlement Terms "Approved as to Form and Content" Are Not Enforceable Against Counsel

Settlement agreements often contain terms requiring the parties to keep the terms of the agreement confidential. One might expect that a confidentiality clause applicable to "the parties and their attorneys" would bind an opposing counsel who signs off on the agreement as "approved as to form and content." A recent decision from the California Court of Appeal, however, holds that an attorney's approval "as to form and content" does not actually create any obligations on the attorney under a settlement agreement. To learn more, see our recent *Alert.*

Federal Circuit Says Portion of Wind Farms Purchase Price May be Allocable to Intangibles

The Federal Circuit recently ruled that a portion of the owners' tax bases in six new wind farms that were purchased at a premium above the seller's cost could be allocable to goodwill and other intangible assets, and thus ineligible for cash grant payments that the owners received under section 1603 of the American Recovery and Reinvestment Act of 2009. The decision, which reverses a 2016 U.S. Court of Federal claims ruling, could have significant implications for cash grant and investment tax credit calculations in the renewable project finance industry. To learn more, see our recent *Alert.*

The Always Evolving Tactics of Shareholder Activists

Activist investor tactics are evolving and becoming more creative, with new approaches being deployed by first-time and infrequent activists who do not always operate from the typical playbook. Companies should be aware of these evolving strategies and ensure they are prepared for new approaches. To learn more, see our recent *M&A Update.*

PENnotes

Client Call: CFIUS Reform Becomes Reality
September 6, 2018, at 11:00 a.m. ET

On August 13, 2018, President Trump signed the Foreign Investment Risk Review Modernization Act (FIRRMA) into law. FIRRMA is the most significant reform of the Committee on Foreign Investment in the United States (CFIUS) in its history. Join Mario Mancuso, leader of Kirkland's International Trade and National Security Practice, for an interactive discussion of FIRRMA and its impacts on dealmaking. Click here for more information or to register.

Thomson Reuters Annual Loan and CLO Conference
New York, NY, September 12, 2018

Kirkland is a sponsor of this event, which has a comprehensive program exclusively devoted to the latest trends across the credit markets with a focus on the global loan market. Kirkland partner Eric Wedel will moderate a panel on the "Private Equity Perspective: Sponsored Leveraged Finance in 2018." Click here for more information.

Kirkland Registered Adviser Seminar & CCO Summit
New York, NY, September 25, 2018
Boston, MA, September 27, 2018
Chicago, IL, October 2, 2018
Houston, TX, October 9, 2018
San Francisco, CA, October 18, 2018
Los Angeles, CA, November 13, 2018

Designed specifically for private fund manager CCOs, general counsel and other senior executives, this annual event enables firms to navigate the evolving regulatory landscape and get timely updates about SEC policy and enforcement developments affecting private fund managers. Click here for more information.

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Kirkland & Ellis' nearly 500 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and fund formations on behalf of more than 400 private equity firms and hedge funds around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in each of the last seven years by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. U.S. News Media Group and Best Lawyers have ranked Kirkland as a Tier 1 law firm for Leveraged Buyouts and Private Equity Law for seven consecutive years and as a top-tier firm for Private Funds/Hedge Funds Law since 2012. The Firm was recognized as the #1 law firm for private equity in the 2018 Vault 100 rankings, and, in 2016, Private Equity International named the Firm "Law Firm of the Year in North America: Fund Formation" for the third year in a row.

In 2012-2017, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011-2017*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite," having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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