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September 4, 2018 www.groom.com

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IRS Guidance Softens Impact of Recent UBIT Changes on Benefit Plan Investors – At Least for Now

A pension or welfare plan's investment in a private equity or real estate partnership may give rise to "unrelated business income tax" ("UBIT"). In recent years, this issue has arisen frequently as more plans have invested in such vehicles. The recent tax cut legislation made important changes in this area, creating the potential for greater UBIT liabilities. Fortunately, recent IRS Notice 2018-67 (the "Notice" (Aug. 20 *IRS Bulletin*)) may mitigate the impact of the changes for plan investors, pending the future issuance of proposed regulations.

A. Background

Under the UBIT rules, a tax-qualified retirement plan (including an IRA) or a "voluntary employees' beneficiary association" ("VEBA") may have UBIT merely by investing in a limited partnership that borrows to make one or more investments. Under Code section 514, ownership of such "debt-financed property" (or, more generally, borrowing to make investments) causes a proportionate share of the income from that investment to be subject to UBIT. A longstanding (though complex) provision exempts most debt-financed real estate investments from UBIT for pension plans. IRC § 514(c)(9). Plans have often used foreign "blocker" corporations to shelter other income from UBIT, although the costs and benefits of that approach need to be examined on a case-by-case basis. And even if no debt is used, if a limited partnership invests in an active trade or business (e.g., directly operates a hotel or participates in an operating company), the plan investor's income will be subject to UBIT. IRC § 512(c).

The calculation of UBIT allows an investor to claim its share of associated expenses against the income – and to net most gains and losses – just like any taxpayer. IRC § 512(a)(1). In the case of a trust, the net income is subject to the individual tax rates – as high as 37% in 2018 – and reported on IRS Form 990-T. IRC § 511(b). State taxes and filings also may apply.

B. What the Recent Tax Act Changed

Effective for tax years beginning after December 31, 2017, benefit plans with two or more unrelated trade or businesses will no longer be able to "net" the income and losses of the businesses in the aggregate when determining the UBIT. Instead, the UBIT for the tax year is based on the sum of the unrelated business income ("UBI") (but not less than $0) for <u>each</u> trade or business. IRC § 512(a)(6). The new law also limits the application of the carryover of net operating losses for tax years beginning after December 31, 2017 to the UBI of the same trade or business in future years. However, net operating losses from tax years beginning prior to 2018 can still be applied to any trade or business to reduce the amount of UBI subject to UBIT.

Prior to the new law, where plans had multiple investments that generated UBI, they commonly netted the gains and losses of these investments in the aggregate when determining UBIT. Many investment funds generate tax losses in early years, and with regular turnover of a plan's investments, UBIT can often be deferred for many years. Thus, the potential impact of the law could be significant.

A key area of uncertainty under the new rule is whether each investment held by the plan would be viewed as a separate "trade or business," or alternatively, whether the plan can consider all investments of the same "type" (e.g., all real estate investments or all private equity funds) as a single trade or business. (In the context of multiemployer plan withdrawal liability, a federal court has ruled that a plan's investment in a private equity fund is a trade or business. *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, 172 F.Supp.3d 447 (D. Mass. 2016); 724 F.3d 129 (1st Cir. 2013), *cert denied*, 134 S. Ct. 1492 (2014).) If each plan investment is viewed as a separate trade or business, the plan would likely have greater UBI, and possible UBIT liability, under the new rules. Among still other questions, it is unclear how this change would apply to a "fund of funds" investment program.

In view of these – and numerous other issues affecting tax-exempt organizations engaged in various fund-raising and other ancillary activities – tax-exempt groups asked IRS and Treasury to defer the application of this change until comprehensive guidance was published. As summarized below, the Notice does not defer compliance altogether, but it does provide a variety of rules that are likely to mitigate the impact of this change, at least until proposed rules are published.

C. Key Relief Rules Help Benefit Plan Investors

Reasonable, Good Faith Interpretations – The Notice states that exempt organizations "may rely on a reasonable good faith interpretation" of the UBIT rules, considering all the facts and circumstances, when determining whether the organization has more than one trade or business under the new law. This principle recognizes that the concept of a "separate trade or business" is not defined and may even vary under different Code sections.

The Notice provides a safe harbor under which a 6-digit code described in section 3.03 of the North American Industry Classification System ("NAICS") may be considered a "trade or business" separate from an activity in another 6-digit code. Under the NAICS, "pension funds" and "health and welfare funds" each have their own 6-digit Code (525110 and 525112, respectively), which suggests that might be the end of the inquiry. That is not clear, however, as portfolio managers of pension and welfare plans are classified separately in 523920. Hopefully, future guidance will clarify this area. Meanwhile, other rules in the Notice may make it unnecessary to rely on the NAICS Codes for relief.

Relief for Investment Activities – Several provisions in the Notice should reduce situations where a benefit plan investor (including an IRA or VEBA) has UBI, such as the look-through rule for partnerships in which a tax-exempt organization invests (Code secs. 512(c), 513(a)). In light of the complexity of partnership structures, such as private equity fund of funds, Treasury and IRS intend to propose rules that allow certain investments to be treated as a single trade or business, provided that "the exempt organization does not significantly participate" in any partnership trade or business. Importantly, on an interim basis, the Notice provides a "de minimis" test, a "control" test and a grandfather rule for determining which partnership interests or holdings may be aggregated in calculating UBI. We describe these rules below.

- ***"De Minimis" Rule*** – Under this rule, an organization may aggregate its UBI from a single partnership owning multiple trades or businesses, or from "qualifying partnership interests" in the aggregate, if the organization directly holds no more than 2 percent of the profits interest and no more than 2 percent of the capital interest in those partnerships. The Schedule K-1 (which each partnership investor is required to receive) may be relied on in applying the 2 percent threshold with certain calculation rules described in the Notice, including aggregating the interests of a disqualified person or controlled entity.

- ***"Control" Test*** – Under the "control" test, if the organization directly holds no more than 20 percent of the capital interest in a partnership (again based on the K-1), and does not have "control or influence" over partnership activities based on the facts and circumstances, it may aggregate its UBI from a single partnership owning multiple trades or businesses or combine the results of such a holding with its other "qualifying partnership interests" in applying the new rules (i.e., it need not make a separate calculation of UBI with respect to each partnership interest). The Notice states that "all facts and circumstances are relevant for determining whether an exempt organization has control or influence over a partnership" and that "control or influence" includes the power of an exempt organization to require a partnership to perform, or refrain from performing, "any act that significantly affects the operations of the partnership." This leaves some important questions unanswered, such as whether a plan investor's participation in a partnership's limited partner advisory committee constitutes a position of "control or influence."

- ***Grandfather Rule*** – Finally, recognizing that it may be difficult to make the above *de minimis* and "control" determinations, the Notice generally allows each existing partnership interest as of August 21, 2018 to be treated as a single trade or business – even where one or more indirectly hold multiple lower-tier partnerships (e.g., a "fund of funds" investment arrangement). The Notice makes it clear that these special aggregation rules apply to unrelated debt-financed income (Code sec. 514) as well as the income from the partnership investment.

Treatment of Net Operating Losses ("NOLs") – The Notice also explains the Act's restriction on the use of NOLs in the case of multiple businesses, including the transition rule for pre-2018 NOLs. Guidance is requested on a number of issues.

Request for Comments – Treasury and IRS requests comments on the new rules, including the guidance in the Notice, on or before December 3.

D. What Should Plan Investors Do Now?

In light of this IRS guidance, benefit plan investors should carefully evaluate their potential tax exposure, and possible UBIT reduction strategies, including:

- identifying investments that may generate UBI,

- identifying investments that are – or are not – covered by one of the helpful interim rules,

- evaluating the structure of those investments that generate UBI and considering (or re-considering) alternatives, such as use of a "blocker" corporation to avoid UBIT, or possibly even liquidating the investment, and

- identifying net operating losses before 2018 that can be used to offset UBI in 2018 and later years.

We expect that in some cases plan investors will need to contact the investment managers in charge of their various holdings for assistance in applying the rules in the Notice. In any event, for the time being, most plan investors are unlikely to experience any increase in UBIT as a result of this change.