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TAX

The Tax Cuts and Jobs Act One Year Later – Updates and Structuring Considerations for Private Funds and Their Managers (Part One of Two)

By Michele Gibbs Itri, *Tannenbaum Helpern Syracuse & Hirschtritt LLP*

December 22, 2018, marked the first anniversary of the signing of the Tax Cuts and Jobs Act (Tax Act). The impact of this landmark piece of legislation continues to be felt throughout the investment funds industry. This two-part series provides a brief overview of the key provisions of the Tax Act affecting private equity funds and their respective portfolio companies; hedge funds; and private fund managers, as well as updates on these provisions since the enactment of the Tax Act, including a discussion about possible tax structuring strategies and other considerations going forward for investment managers and their funds.

This first article addresses the Tax Act's impact on carried interest earned by fund managers, the self-employment tax and corporate versus pass-through structures, as well as the new limitation on the deduction of business interest. The second article will explore the effect of the elimination of miscellaneous itemized deductions; the disallowance of deductions for excess business losses; changes to net operating loss deductions; the tax treatment of gain or loss realized on the sale of a partnership interest by a foreign partner; and modifications to the controlled foreign corporation regime and other international tax rules.

For more on the Tax Act, see "Planning Strategies for Private Fund Managers Under the Tax Cuts and Jobs Act" (Jun. 7, 2018); and "New Tax Law Carries Implications for Private Funds" (Feb. 1, 2018).

Carried Interest

The Tax Act significantly modified the taxation of the carried interest earned by fund managers and other partnership interests held in connection with the performance of substantial services by the taxpayer (a so-called "applicable partnership interest"). Under new Section 1061 of the Internal Revenue Code of 1986, as amended (Code), gain allocated by a partnership with respect to carried interest will qualify as long-term capital gain only to the extent that the partnership has held the relevant assets giving rise to the gain for more than three years as of the time of disposition, rather than the one-year holding period generally required for long-term capital gain treatment. Gains that do not meet the three-year holding period are reclassified as short-term capital gain – taxable at ordinary income rates – rather than as ordinary income.

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In addition, the three-year holding period requirement also applies to gain derived from the sale of an applicable partnership interest itself. In other words, the general partner will be required to hold the partnership interest attributable to its carried interest in a fund for more than three years in order for the gain on the sale of such interest to qualify as long-term capital gain.

This provision did not modify the tax treatment of carried interest allocations of:

1. qualified dividend income, which is generally taxable at the preferential 20% rate, plus the 3.8% tax on net investment income; or
2. gains on sales of futures contracts, which are taxable under Section 1256 of the Code as 60% long-term capital gain and 40% short-term capital gain.

It also did not impact any portion of the partnership interest held by a general partner which is attributable to capital contributed to the partnership by the general partner. Additionally, foreign managers are not required to treat carried interest allocations as U.S. effectively connected income, as those rules do not treat carried interests as fees being received for services.

The modifications to the carried interest rules have clearly affected hedge fund managers more than managers of private equity and real estate funds, as the latter two types of managers generally hold assets for more than the requisite three-year holding period. Managers of hedge funds that hold positions for greater than one year but less than the newly required three-year period are most affected by the new rules.

Over the course of 2018, it had been suggested that managers of funds that do not hold assets for more than three years should consider restructuring their incentive allocations to incentive fees. The incentive allocation structure, however, still retains the benefits of:

1. exemption from New York City unincorporated business income tax, which is relevant to managers based in New York City;
2. allocations of qualified dividend income and future gains at preferential tax rates; and
3. avoidance of the suspension of deductions for advisory fees by individual limited partners in certain funds, as discussed further in the second article in this series.

Nevertheless, this strategy may be helpful for fund managers based outside of New York City that engage in high-frequency trading (so-called "trader" funds) where there is very little unrealized income and mostly short-term capital gains.

It should also be noted that the statutory language under the Tax Act provides that the new changes do not apply to carried interests held by corporations, which, for purposes of this provision, would include C corporations as well as S corporations. This had led to discussions early in 2018 about possible elections to treat existing general partner entities as S corporations to take advantage of this carve-out. On March 1, 2018, however, the U.S. Internal Revenue Service (IRS) issued Notice 2018-18 to clarify that the term "corporation" for these purposes does not include an S corporation.

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Self-Employment Tax

While an earlier version of the House bill preceding the Tax Act contained a repeal of the exemption in the Code from self-employment tax for income received by limited partners in a partnership, the final Tax Act maintained this exemption. As the Code does not specifically allow for this exemption to apply to members of a limited liability company (LLC), principals of hedge fund managers structured as LLCs may seek to restructure as limited partnerships in order to claim this exemption from self-employment tax on their allocations of the manager's management fee and other fee income.

Corporate vs. Pass-Through Structures

The Tax Act permanently reduced the corporate tax rate from 35% to 21% and repealed the corporate alternative minimum tax entirely. In contrast, the highest federal income tax rate for individuals was reduced from 39.6% to 37%. In addition, the 3.8% Medicare tax on an individual's net investment income remains in effect following the Tax Act. The effective federal tax rate for a shareholder of a domestic corporation is now 39.8%, taking into account an entity-level tax of 21% and an assumed 23.8% tax on the receipt of dividends.

Deduction for Qualified Business Income

The Tax Act introduced under new Section 199A of the Code a deduction for non-corporate taxpayers based on a non-corporate owner's qualified business income (QBI), which expires after the year 2025. This deduction generally equals 20% of a taxpayer's share of QBI from pass-through entities – *e.g.*, partnerships, S corporations, sole proprietorships, etc. – up to the greater of (1) 50% of W-2 wages of the business; or (2) 25% of W-2 wages of the business plus 2.5% of the initial cost of the tangible assets of the business. The deduction results in an effective federal income tax rate of 29.6% on QBI for an individual in the highest 37% tax bracket.

QBI is generally defined as the net amount of qualified items of income, gain, deduction and loss from any qualified business of the non-corporate owner. QBI does not include investment income and, as such, is generally not applicable to investors in hedge funds organized as partnerships. The 20% deduction is generally not available for income realized from certain businesses, including consulting and financial services; as such, it is not applicable to owners of hedge fund managers organized as pass-through entities. On August 8, 2018, the IRS released proposed regulations under Section 199A, which address in part the definition of QBI; the wage and basis limitation; and rules identifying and aggregating trade or businesses.

As the deduction is limited to a percentage of wages or wages plus asset cost, the deduction will primarily benefit businesses with large payrolls relative to profits and businesses that make large investments in depreciable property. To the extent that a private equity fund invests in those types of businesses, it would be beneficial to make those investments through pass-through entities, rather than through corporate entities, so investors can receive the benefit of the deduction.

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Conversion of Management Companies to Corporate Structures

Because the new 21% corporate tax rate is now significantly lower than the highest applicable individual rate applicable to owners of pass-through entities, some fund managers have contemplated whether it makes sense to convert their management companies from partnerships to corporate structures, especially given that investment managers cannot take advantage of the QBI deduction. The Tax Act may make it more advantageous to structure an investment management company as a corporation for certain taxpayers, even after taking into account the second level of tax on dividend distributions of corporate earnings, given the potential for a corporation to retain and reinvest its earnings prior to making dividend distributions to shareholders.

Any such analysis, however, will need to factor in the state and local tax implications at the corporation and shareholder levels; the potential impact of the 20% additional accumulated earnings tax on undistributed corporate earnings; the 20% tax on "personal holding company income" (*i.e.*, passive investment income) of certain closely held C corporations; and other benefits and detriments of the use of corporate versus pass-through structures. These factors appear to have discouraged most investment managers from converting their companies to C corporations.

New Limitation on Deduction of Business Interest

Prior to the Tax Act, business interest paid or accrued by a business was generally fully deductible, subject to certain limitations and restrictions which mainly related to interest paid to related parties under the earnings stripping rules of former Code Section 163(j). The Tax Act repealed the prior earnings stripping rules and imposed a new limitation on the deductibility of net business interest expense under a new Section 163(j).

This Section generally limits the deduction for "net business interest" for every type of business, regardless of structure, to 30% of "adjusted taxable income" or "ATI." ATI is determined at the entity level for entities treated as partnerships and S corporations and generally is earnings before interest, taxes, depreciation, amortization or depletion for tax years beginning before 2022. For 2022 and later years, ATI is more restrictive and is calculated as net earnings before deducting interest expense and taxes.

Certain taxpayers are exempt from the interest deductibility limitation, including small businesses averaging annual gross receipts of $25 million or less for the three prior taxable years, as well as real property businesses that elect out of the limitation and are thereby required to use the alternative depreciation system to depreciate property. The term business interest does not include investment interest described under Section 163(d) of the Code and, thus, does not generally impact interest expense incurred by hedge funds.

For entities treated as partnerships and S

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corporations, the interest deductibility limit is applied at the entity level rather than at the partner/shareholder level by reference to the entity's ATI and business interest. Interest deductions that are allowed by the entity decrease the net income or increase the net loss allocated by the entity to its owners. For purposes of calculating the deductibility of business interest paid directly by a partner in a partnership, the partner's ATI is determined without regard to the partner's share of income, gain, deduction or loss of the partnership. If the partnership has excess capacity for business interest deductions (*i.e.*, its business interest expense is less than 30% of its ATI), each partner's ATI will be increased by its share of the partnership's excess ATI, solely for purposes of determining the amount of business interest which that partner can deduct. Any business interest disallowed at the partnership level in a taxable year is allocated to the partners and may only be deducted by them against excess ATI allocated to them from such partnership in a future year. Unused deductions can generally be carried forward indefinitely.

On November 26, 2018, the IRS issued proposed regulations under Section 163(j) providing clarifications on the computation of ATI; expanding the definition of interest; adopting the rules of Section 162 to determine the existence of a trade or business for purposes of Section 163(j); and applying the 163(j) limitation to controlled foreign corporations, among other rules and clarifications. Along with the proposed regulations, the IRS also issued Revenue Procedure 2018-59, which provides a safe harbor to allow certain infrastructure businesses to be treated as real property businesses solely for purposes of qualifying for the exemption under Section 163(j).

The new business interest deductibility limitation imposed under the Tax Act significantly reduces the impact on debt incurred by a blocker corporate entity used by funds to invest in U.S. businesses structured as partnerships. A blocker generally does not have income other than its share of the income of the operating partnership in which it invests, and due to the partnership-level calculations, the blocker will have no ATI other than its share of any excess ATI of the operating partnership. Accordingly, unless the blocker is allocated excess ATI from the operating partnership, the blocker will not receive any current tax benefit for any interest paid or accrued on any debt incurred at the blocker level. While it is currently unclear under Section 163(j), it is possible that a blocker can carry forward its unused business interest deduction and use it against its share of gain on a future sale of its interest in the underlying operating partnership.

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TAX

The Tax Cuts and Jobs Act One Year Later – Updates and Structuring Considerations for Private Funds and Their Managers (Part Two of Two)

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The adoption of the Tax Cuts and Jobs Act (Tax Act) on December 22, 2017, marked the most significant revisions to the Internal Revenue Code (Code) since the 1986 tax reform. Several of those new or amended provisions directly affect private investment funds and their managers, and since their adoption, practitioners have been eagerly awaiting additional guidance from the U.S. Internal Revenue Service (IRS) on certain provisions. Over the past year, the IRS has issued certain regulations and clarifications of which private investment funds and their managers should be aware.

This two-part series provides a brief overview of the key provisions of the Tax Act affecting hedge funds; private equity funds and their respective portfolio companies; and private fund managers, as well as updates on these provisions since the enactment of the Tax Act, including a discussion of possible tax structuring strategies and other considerations going forward for investment managers and their funds.

This second article addresses the effect of the elimination of miscellaneous itemized deductions; the disallowance of deduction for excess business losses; changes to net operating loss deductions; the tax treatment of gain or loss realized on the sale of a partnership interest by a foreign partner; and modifications to the controlled foreign corporation (CFC) regime and other international tax rules. The first article addressed the Tax Act's impact on carried interest earned by fund managers, the self-employment tax and corporate versus pass-through structures, as well as the new limitation on the deduction of business interest.

For more on the Tax Act, see "How the Tax Cuts and Jobs Act Will Affect Private Fund Managers and Investors" (Feb. 22, 2018).

Elimination of Miscellaneous Itemized Deductions

For the 2018 through 2025 tax years, the Tax Act completely repealed miscellaneous itemized deductions previously allowed to individual investors, which were subject to 2% of the adjusted gross income floor and phase-out rule under prior law. Those deductions generally included an investor's share of the investment expenses, including management fees incurred by a fund that is not engaged

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in the active trade or business of trading securities (*i.e.*, a fund that is considered to be an "investor" rather than a "trader" of securities).

If a fund is classified as a trader rather than an investor, the fund's investment expenses are fully deductible as trade or business expenses. The determination of whether a fund is classified as a trader is based on facts and circumstances and is generally determined by the level of active trading of securities conducted by the fund. Currently, there is no clear guidance from the IRS as to what level of trading is sufficient to make a fund a trader, but this determination has become more significant given the change in tax law.

See "U.S. Tax Court Decision Highlights the Quantitative and Qualitative Factors Considered in a 'Trader' vs. 'Investor' Analysis, With Implications for the Deductibility of Fund Expenses by Hedge Fund Investors" (Dec. 12, 2013).

For funds that do not qualify for trader status, individual investors may now prefer to invest in the offshore corporate feeder fund instead of the onshore partnership fund, provided that ownership in the offshore fund by U.S. investors is not so concentrated and significant to cause the fund to be treated as a CFC, which is discussed in more detail below. As the offshore corporate fund is classified for U.S. tax purposes as a passive foreign investment company (PFIC), a U.S. investor can elect for the fund to be treated as a "qualified electing fund" (QEF Election). If a QEF Election is made by a U.S. investor, the fund reports to the investor each year its share of the fund's net long-term and short-term capital gain and net ordinary income after the deduction of all of the fund's expenses – including expenses that would otherwise be classified as miscellaneous itemized deductions – and the investor reports that net income and gain on its tax return (*i.e.*, investment expenses are deducted off the top and the investor is not subject to any limitations on the amount or types of expenses deducted).

For more on PFICs and the QEF Election, see "Hedge Fund Tax Experts Discuss Allocations of Gains and Losses, Contributions to and Distributions of Property From a Fund, Expense Pass-Throughs and K-1 Preparation (Part One of Four)" (Jan. 16, 2014).

Disallowance of Deduction for Excess Business Losses

For 2018 through 2025, the Tax Act imposed a new limitation on deductions for "excess business losses" incurred by non-corporate taxpayers. Generally, under new Section 461(l) of the Code, an "excess business loss" is the amount by which a taxpayer's aggregate deductions from trades or businesses exceed the sum of (1) the taxpayer's aggregate business income and gains; and (2) an amount equal in 2019 to $510,000 for taxpayers filing joint returns and $255,000 for other taxpayers, indexed for inflation for future years.

Losses that are disallowed under this rule are carried forward to later tax years and can then be deducted under the rules that apply to net operating losses (NOLs), subject to the limitations discussed below. In the case of a partnership or S corporation, this limitation applies at the partner or shareholder level – not the entity level. The limitation applies after the application of the currently applicable passive activity rules, which generally limit the ability of investors in private funds to deduct their share of losses and deductions

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of operating partnerships in which the funds invest.

This new limitation on excess business losses applies to net losses of actively traded trader funds, and not to net losses of funds classified as investors.

Changes to NOL Deductions

Under prior law, NOLs could be carried back two years and carried forward for twenty years. Under amendments to Code Section 172 introduced by the Tax Act, starting in 2018, NOLs cannot be carried back, can be carried forward indefinitely and are deductible only to the extent of 80% of a taxpayer's taxable income. Existing NOLs arising in taxable years ending on or prior to December 31, 2017, will continue to be carried back for two years, carried forward for twenty years and offset against 100% of income.

Effectively Connected Income on Sale of Partnership Interest

The Tax Act added Section 864(c)(8) to effectively codify the position set forth in Revenue Ruling 91-32 and thereby override the U.S. Tax Court's decision in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner of Internal Revenue*. Under this Section, gain or loss realized on the sale of a partnership interest by a foreign partner on or after November 27, 2017, is treated as U.S. effectively connected income (ECI) and subject to U.S. tax if the gain or loss from the sale of the underlying assets held by the partnership would be treated as ECI for the foreign partner.

For background on the *Grecian* ruling, see "Tax Expert Provides Insight Into Recent U.S. Tax Court Decision on Taxation of Foreign Investments in U.S. Partnerships" (Dec. 7, 2017).

New withholding rules under Section 1446(f)(1) were also added to require transferees of partnership interests to withhold 10% of the amount realized on the sale or exchange of such an interest unless the transferor certifies it is not a foreign person. Further, if the purchaser does not withhold, under Section 1446(f)(4), the partnership is required to withhold on distributions to such purchaser to cover the withholding. These new rules created additional complexity and risks for participants in secondary sales of fund partnership interests and for the funds whose interests are being transferred.

On April 2, 2018, the IRS released Notice 2018-29 to provide guidance regarding the withholding of tax under Section 1446(f)(1) and to temporarily suspend the withholding obligations of partnerships under Section 1446(f)(4). This notice provides guidance on the certifications that transferors of partnership interests can make to transferees in order to be exempt from withholding under Section 1446(f). The issuance by a non-U.S. transferor of these certifications in an affidavit to a transferee has become standard practice to avoid withholding under Section 1446.

While the suspension from withholding by a partnership under Section 1446(f)(4) is still in effect, these new rules have potential implications for a fund with a non-U.S.

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partner that wishes to transfer its partnership interest once the suspension is lifted. As the fund will have ultimate responsibility for the withholding obligation, funds will want to ensure that they are indemnified by the transferor and transferee for any withholding taxes. In addition, private equity funds with pass-through investments at the operating company level may want to consider structuring those investments on behalf of their non-U.S. investors through corporate blockers to protect against ECI generation for those investors upon a sale by the investors of their interests in the fund.

Certain International Provisions

The Tax Act introduced a "modified" territorial system of corporate income taxation under which certain income earned by certain foreign subsidiaries of U.S. corporations is not subject to U.S. tax when it is repatriated back to the U.S. Beginning in 2018, a U.S. corporation is entitled to a 100% dividend received deduction (DRD) on foreign source dividends received from a foreign corporation in which it is a 10% shareholder – other than a PFIC that is also not a CFC. The Tax Act is not a full territorial system, however, because this DRD does not apply to a 10% shareholder's inclusions of Subpart F income of a CFC or inclusions of earnings that a CFC invests in U.S. property, even if the CFC distributes the amounts back to its shareholders.

For more on CFCs, see "Tax Practitioners Discuss Taxation of Foreign Investments and Distressed Debt Investments (Part Three of Four)" (Jan. 30, 2014).

The switch to the territorial system came with a one-time mandatory repatriation tax for tax year 2017 on foreign earnings of "U.S. Shareholders" of "specified foreign corporations" under Section 965 of the Code. Accumulated earnings and profits of a specified foreign corporation through certain dates were deemed repatriated and taxed at a reduced rate.

The Tax Act made a number of changes that have increased the situations in which a foreign corporation is treated as a CFC and expanded the types of shareholders treated as U.S. Shareholders and subject to the CFC regime. A CFC is a foreign corporation more than 50% of the vote or value of stock of which is owned or deemed owned through attribution rules by U.S. Shareholders. Prior to the Tax Act, a U.S. Shareholder was a U.S. person who owned or was deemed to own 10% or more of the vote of all classes of shares of voting stock of a foreign corporation.

The Tax Act expanded this rule for 2018 and going forward (*i.e.*, the change did not apply for determinations as to whether the repatriation tax is applicable), providing that U.S. Shareholders include U.S. persons who own 10% or more of the voting power or the value of shares of a foreign corporation. In addition, the Tax Act modified the attribution rules applied in determining CFC status by removing a provision in the Code that prohibited "downward attribution" of stock ownership from foreign persons to U.S. persons. This modification is effective as of January 1, 2017; therefore, it is applicable in determining whether a foreign corporation qualifies as a CFC and thereby subjecting its U.S. Shareholders to the repatriation tax.

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U.S. Shareholders of a CFC are generally taxed currently at ordinary income rates on the CFC's Subpart F income, which generally includes passive type income of the CFC, whether or not distributed. The Tax Act introduced new Code Section 951A, which expands the categories of Subpart F income of a CFC to include "global intangible low-taxed income" (GILTI). This amendment is intended to capture a portion of a CFC's active earnings derived from low-tax jurisdictions where the CFC does not retain substantial tangible property. GILTI is generally the portion of a CFC's net income – excluding U.S. ECI and other taxable Subpart F income – that exceeds an amount equal to an implied 10% rate of return on the CFC's tangible depreciable business assets. Corporate U.S. Shareholders are permitted to deduct a portion of the GILTI inclusion so that they are taxed on this income at a reduced effective rate of 10.5%, increasing to 13.125% at the beginning of 2026. All other U.S. Shareholders include all GILTI in ordinary income each year.

It should be noted that the above international provisions of the Tax Act have created material new due diligence items for any transactions involving the purchase of stock in a foreign corporation as there are potential liabilities for the repatriation tax as well as GILTI exposure. Also, the Tax Act's reduced rates on GILTI of U.S. corporate investors, combined with the fact that the DRD described above is only available to U.S. corporate shareholders, should be considered in structuring the purchasing entity of certain foreign portfolio companies through U.S. corporate blockers.

Michele Gibbs Itri is a partner at Tannenbaum Helpern Syracuse & Hirschtritt LLP. Her practice focusses on the tax and legal aspects of investment funds, financial instruments, international transactions, corporate and real estate transactions. She works closely with clients to structure transactions to achieve the most favorable tax results. Her practice encompasses all aspects of federal, state, local and international taxation, with an emphasis on onshore and offshore investment funds; venture capital transactions; corporate acquisitions; financial instruments; and real estate acquisitions and dispositions. She also assists investment management and real estate management firms in the structuring and organization of private partnerships and limited liability companies.

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