From: Richard Kahn <[redacted]>
To: "jeffrey E." <jeevacation@gmail.com>
Subject: Fwd: Alert: The 2017 Tax Reform Act
Date: Tue, 23 Jan 2018 18:23:09 +0000

Richard Kahn
HBRK Associates Inc.
575 Lexington Avenue 4th Floor
New York, NY 10022
tel 212-971-1306
fax 212-320-0381
cell 917-414-7584

TAX ALERT JANUARY 23, 2018

The 2017 Tax Reform Act - Key Provisions Impacting Fund Managers and Their Funds

For further information about this *Alert*, please contact:

Alex Gelinas
Partner
[redacted]

Steven Etkind
Partner
[redacted]

Please feel free to discuss any aspect of this *Alert* with your regular Sadis & Goldberg contact or with any of the partners whose names and contact information can be found at the end of the *Alert*.

The Tax Cuts and Jobs Act (the "Tax Act"), which was signed into law by President Trump on December 22, 2017, contains the most sweeping federal tax law changes since 1986. Most provisions of the Tax Act take effect for taxable years beginning on or after January 1, 2018. **This Client Alert is not intended to be a comprehensive review of this massive legislation. The Alert focuses on certain provisions of the Tax Act that may have the most significant impact on asset management firms, their owners, their investment vehicles, and the investors in such funds.** Certain changes made by the Tax Act are permanent but many

others are scheduled to expire after 2025 unless extended by further Congressional legislation.

I. Carried Interest Survives in Modified Form

The Tax Act contains changes to the treatment of "carried interests", but such changes are not as negative as the prior legislative changes that had been proposed but never adopted. The granting of a "future profits only" interest in a partnership in connection with the performances of services to the partnership continues to be eligible for tax-free treatment under the new law. For certain owners of "Applicable Partnership Interests" (of the sort that would generally be issued by an investment partnership to the general partner), the Act applies a three-year holding period requirement for **capital gains** derived by the partnership (or from the disposition of the profits interest) to be eligible for the long-term capital gains tax rate (instead of the generally applicable one-year holding threshold).

The change in carried interest taxation clearly impacts managers of hedge funds more than managers of private equity funds or real estate funds, which typically have a longer than three-year holding period for investments in their portfolio companies or real estate assets. The new tax treatment applies to income realized in tax years beginning on or after January 1, 2018 and existing carried interests are not grandfathered. Thus, it appears that any unrealized capital gains which have already been allocated to a general partner on the books of the partnership would be subject to the new tax treatment at the time the partnership realizes such gains in 2018 or subsequent years.

Note, however, that the Tax Act does not change the current federal income tax treatment of carried interest allocations of "qualified dividends" to individuals, which are also taxed at long-term capital gains rates. The capital gains from the carried interest that fail to satisfy the new three-year holding period requirement are treated as "short-term capital gains" which are taxable at ordinary income rates.

The "Applicable Partnership Interest" held by the general partner or an affiliate should not include any portion of the partnership interest that is attributable to capital contributed to the partnership by the general partner. The exact manner on how such exception will apply will need to be addressed in future IRS notices or regulations to be issued. Limited partners holding capital interests in private investment funds are also not affected and therefore retain the one-year holding period requirement for long-term capital gain treatment.

Note also that the term "Applicable Partnership Interest" does not include an interest held directly or indirectly by a corporation and it currently appears that such exception includes holdings by both C corporations and S corporations. It is likely that further guidance will be issued on this question, as it may be advantageous for certain general partners to convert their existing entities that hold the carried interest to S corporations, and such general partners may have until March 15, 2018 to accomplish such conversion.

Managers of hedge funds and other partnerships that do not hold capital assets for more than three years before their sale may consider whether the carried interest incentive allocation should be replaced with an incentive fee structure. Also, the reduced after-tax value of a carried interest partnership allocation may impact the management company's executive compensation arrangements.

Although an earlier version of the tax legislation would have repealed the exemption in the Code which provides that a limited partner's income is exempt from self-employment tax, the final version of the Tax Act does not contain such change in law.

II. New 21% Corporate Income Tax Rate and Reduction of the Maximum Rates Applicable to Individuals

The Tax Act reduces the 35 percent corporate rate to a flat 21 percent corporate rate. There is no special higher rate for personal service corporations (as existed under prior law). The new 21 percent rate is effective for taxable years beginning on or after January 1, 2018. The corporate alternative tax (AMT) has also been repealed. Such corporate tax changes are permanent. In contrast, the highest applicable federal income tax rate for individuals and other non-corporate taxpayers is reduced from 39.6% to 37%. In addition, the 3.8% "add-on" Medicare contributions tax on an individual's net investment income remains in effect.

1. Possible Use of a "C" Corporation as a Tax Shelter

Since the new 21% corporate tax rate is now well below the highest rate applicable to high income individuals, some investment managers may conclude that some or all of their management entities that are pass through partnerships should convert to corporate form. In addition, certain partnership funds that are engaged in trade or business, such as active loan origination or real estate activities may find it advantageous to convert to corporate form.

The advantage to the corporate form of organization is that the C corporation's net income after taxes is not taxable to its shareholders until it is distributed (e.g., either as a dividend or as a redemption of stock (i.e., as a capital gain)). Corporations that are engaged in active businesses are able to retain and reinvest their earnings. Also relevant to choice of entity decisions is the fact that the Tax Act restricts the ability of individuals to deduct more than $10,000 in state and local taxes, but corporations can continue to deduct such taxes as under prior law.

However, there are certain anti-abuse provisions that remain in the Internal Revenue Code that limit the use of a C corporation as a tax shelter. Lurking in the Code is a provision which allows the Internal Revenue Service to impose a 20 percent additional "accumulated earnings" income tax on the "accumulated taxable income" of a corporation if such taxable income is allowed to accumulate "beyond the "reasonable needs of the business". There is a $250,000 safe harbor for most corporations, while personal service corporations are allowed a safe harbor of only $150,000. There is also a 20 percent tax on the "personal holding company income" (i.e., passive investment income) of certain closely held C corporations (i.e., when five or fewer individuals own, in the aggregate, more than fifty percent of the corporation's stock and at least 60 percent of the corporation's adjusted ordinary income is personal holding company income (e.g., passive investment income)). These penalty taxes on corporations have received little attention in recent decades. However, with the enactment of the sharply lower corporate tax rate, these anti-abuse rules are likely to become a significant focus of the IRS in its audits of tax returns of privately held corporations.

2. The New Deduction for Qualified Business Income of Pass Through Entities

Congress also wanted to provide an income tax rate reduction for those businesses that are organized as partnerships or S corporations or which are owned by sole proprietors. In order to meet this goal, the Tax Act provides an income tax deduction for individuals and other non-corporate taxpayers equal to (i) 20 percent of their domestic "qualified business income"; plus (ii) 20 percent of any qualifying dividends from real estate investment trusts, qualifying income from publicly traded partnerships, and gain derived from sale of such publicly traded partnerships that would be treated as ordinary income. Therefore, such deduction results in an effective federal income tax rate of 29.6% on such qualifying income for a top bracket individual. The deduction does not apply to investment income (i.e., capital gains, dividends (other than certain ordinary income dividends paid by REITs), and most interest income). In

addition, it does not apply to reasonable compensation income and guaranteed payments paid to the taxpayer from the business.

The 20 percent of "qualified business income" deduction described in (i) above is also generally limited to the greater of either (a) 50% of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25% of the W-2 wages paid with respect to such business plus 2.5% of the unadjusted tax basis of all qualified business property of such business. Thus, if the partnership, S corporation or sole proprietorship does not pay "W-2 wages" and the second limitation is a minor amount or not applicable, the owner or pass through taxpayer's tax deduction would be a minor amount or zero.

Unfortunately, partners or owners of certain types of professional service businesses, including financial services providers, investment managers, brokers, consultants, lawyers and accountants (and others), are not permitted to claim the "qualified business income" deduction unless the taxpayer's adjusted gross income is below certain levels ($207,500 for individuals and $365,000 for married couples filing jointly). Even in such case, the benefit of the available deduction is phased out ratably as the taxpayer's income exceeds $157,500 if single, or $315,000 if filing a joint tax return. Therefore, fund managers organized as pass through entities are not likely to, and investment funds organized as partnerships will not, derive a significant benefit from this deduction.

III. ISSUES FOR PARTNERSHIP FUNDS

1. Repeal of Itemized Deductions Previously Available to Non-Corporate Taxpayers for Non-Business Investment Expenses

For 2018 through 2025, the Tax Act completely repeals the deductions previously allowed to individuals and other non-corporate taxpayers for "miscellaneous itemized deductions" (which were subject to a 2% floor and a phase-out rule under prior law). It is important to note that for individual investors in partnership funds that are not treated as engaged in a trade or business, the investor's share of the fund's investment expenses, including management fees, would now pass through as non-deductible miscellaneous itemized deductions. If the fund is properly classified as an active "trader" rather than a mere investor, then such expenses would be completely deductible as trade or business expenses. This Tax Act change obviously puts considerable strain on the fund manager and its tax advisors with respect to the trader vs. investor issue. At this time, there is a lack of clear guidance from the Internal Revenue Service on what level of trading activity is sufficient for a professionally managed fund to qualify as a "trader fund".

In cases where a partnership fund's expected activities are not likely to qualify for trader status or another trade or business, the fund's sponsor may find that US high net worth individuals may now prefer to invest in the offshore corporate feeder fund instead of the onshore partnership fund. The US income tax reason for this would be that since the offshore feeder is classified as a corporation for US tax purposes, its net income would be calculated under the rules applicable to corporations, for which there are no miscellaneous itemized deductions. Thus, assuming that the foreign feeder is a passive foreign investment company (PFIC), if the US high net worth shareholder is able to make the "qualified electing fund" election, the net income the investor would be required to report on his federal income tax return would be calculated after deducting all of the corporation's expenses, including management fees and investment expenses.

2. Non-US Partner's Gain on Sale of Partnership Interest may be Taxable as US Trade or Business Income; New Withholding Requirements apply to the Purchaser or the Fund

The Tax Act specifically provides that gains realized by a non-US partner on a sale or exchange of a partnership interest will be treated as effectively connected US trade or business income ("**ECI**") to the extent that such partner would have been allocated ECI had the partnership sold all of its assets. This provision is consistent with the IRS position in Revenue Ruling 91-32, and overrules a recent Tax Court case which had rejected the position taken in such IRS Ruling and instead held that since a partnership interest is treated as a capital asset, the foreign person's gain on its sale could escape US income taxation as a non-business capital gain.

To the extent that a partnership has any ECI-generating assets (including US real property interests), a seller of a partnership interest will have to provide a certificate that it is not a foreign person, and in the absence of such a certificate a purchaser (which could include the fund) will be required to withhold 10% of the gross purchase price. Further, the Tax Act provides that if the purchaser does not withhold, the partnership is required to withhold on distributions to such purchaser to cover the withholding. The Tax Act provides that the new withholding obligation for purchasers is effective for sales or other dispositions of partnership interests after December 31, 2017.

3. New Limitation on Deduction of Net Interest Expense

Under prior law, subject to some restrictions and limitations, business interest paid or accrued by a business was fully deductible. For taxable years beginning after December 31, 2017, the Tax Act limits the deduction for "net business interest" expense for every type of business, regardless of entity form, to 30 percent of adjusted taxable income. Business interest paid or accrued after the effective date on indebtedness, including debt that was incurred prior to the effective date of the Tax Act, is subject to this limitation.

The term business interest does not include investment interest described in Code section 163(d). Operating companies, such as management entities, and investment funds that are engaged in a business and have outstanding indebtedness could be subject to such deduction limitation. For this purpose, "adjusted taxable income" is determined at the entity level for partnerships, and is similar to EBITDA (i.e., net earnings before deducting interest expense, taxes, depreciation and amortization) for taxable years 2018 through 2021. A more restrictive 20% of EBIT limitation (net earnings before deducting interest expense and taxes) applies for 2022 and later years.

Certain taxpayers are exempted for the new interest deductibility limitation, including small businesses with average annual gross receipts of $25 million or less for the three prior taxable years, as well as real estate businesses that elect out of such limitation. The Conference Committee Report on the Tax Act clarified that interest paid on shareholder loans by a blocker corporation is "business interest" that is subject to this new limitation. Blocker corporations for a lending business would have business interest income, which reduces the effect of this new limitation on **net** business interest expense (i.e., deductible business interest expense in excess of business interest income).

4. Deemed Repatriation Tax

One of the major tax raising provisions in the Tax Act is a one-time tax imposed on the accumulated earnings held in foreign subsidiaries of US companies. This provision is broader that it may first appear. Under the Tax Act, **any** 10% US shareholder of a foreign corporation (determined on December 31, 2017) will be required to include in income, for the taxable year 2017, its proportionate share of the foreign corporation's undistributed earnings, if the foreign corporation is either a controlled foreign corporation (CFC) or has at least one 10% US shareholder that is a corporation.

This law change could generate significant phantom income with respect to 10%-or-greater owned foreign portfolio companies both (i) for US taxable investors (including the general partner and its owners) in partnership funds organized in the United States and/or for US sponsors of non-US funds. The Tax Act provides for reduced tax rates on such income for corporate investors of 8% (for earnings invested in tangible business assets) and 15.5% (for cash and cash equivalents), and 9.05% and 17.54% for investors taxed as individuals.

5. Tax-Free Section 1031 Like Kind Exchanges Eliminated Except for Real Property Transactions

The Tax Act eliminates the ability to qualify for tax-free exchange treatment under Code section 1031 if the property being exchanged is **personal property**. Consequently, for transactions occurring after December 31, 2017, exchanges of artwork, equipment, vehicles or other personal property held for investment or for use in a business, including Bitcoin or other cryptocurrencies, for like kind property will not eligible for Section 1031 tax treatment. Exchanges of real property continue to be eligible for Section 1031 exchange treatment.

6. Certain Tax Accounting Rules Have Been Revised

Under prior law, net operating losses (NOLs) could be carried back two years and carried forward for twenty years. Under the Tax Act, NOLs arising in tax years ending after December 31, 2017 generally cannot be carried back, but can be carried forward indefinitely. However, only 80% of a company's taxable income is permitted to be offset by NOLs. The remainder of the unused NOLs will carry forward.

The Tax Act also expands the category of corporations and partnerships that are eligible to use the cash method of accounting. Certain businesses may derive a tax benefit by switching from the accrual method to the cash method of accounting.

7. Deferred Compensation

The Tax Act generally leaves the current tax rules for deferred compensation intact. However, the Act also includes a new deferral provision for certain types of broad-based employee equity, which may apply to certain private companies.

8. Estate and Gift Tax Changes

In 2017, an individual could give or transfer at death up to $5,490,000 without paying gift or estate taxes. The Tax Act doubles the federal estate and gift tax unified exemption amount for estates of decedents dying and gifts made after December 31, 2017, and inflation adjustments will continue to apply. Therefore, in 2018, an individual has approximately an $11.2 million exemption, and a married couple has approximately $22.4 million of available shelter from federal gift and estate taxation. Note that the large exemption which applies to gifts may be useful in federal income tax planning. For example, large lifetime gifts of appreciated securities, artwork and other personal property (including possibly, a carried interest) to relatives who are in lower income tax brackets, or who reside in states with lower, or no state income taxes could save the family substantial federal income and/or state income taxes when such property is sold by the recipient of the gift.

Please feel free to discuss any aspect of this *Alert* with your regular Sadis & Goldberg contact whose names and contact information are provided below.

If you would like copies of our other Alerts, please visit our website at www.sglawyers.com and choose "Library."

Sadis & Goldberg LLP | 551 Fifth Avenue, 21st Floor | New York, NY 10176 | 212.947.3793