Lowenstein Sandler

Client Alert

Tax

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Key Tax Provisions Affecting Hedge Funds, Private Equity Funds And Other Investment Vehicles

On December 20, 2017, Congress passed a statute originally named the Tax Cuts and Jobs Act (the "Act"), which enacts a broad range of tax changes. The President signed the Act on December 22. This alert briefly summarizes some of the key federal income tax provisions of the Act affecting hedge funds, private equity funds and other investment vehicles.

Carried Interest: Additional Limitation on Capital Gains Treatment

Generally, carried interest is structured as a profits interest in a partnership (the fund). Under current rules, if a person (other than a corporation) is allocated taxable income or gain in respect of a partnership interest (regardless of whether such interest is a capital interest or a profits interest), the character of such income or gain is determined at the partnership level. If the partner is allocated capital gain income, whether such capital gain income is long-term (subject to preferential tax rates) or short-term, is dependent on whether the partnership's holding period in the assets sold exceeded one year. **Generally, the Act imposes additional time-based restrictions on the recognition of long term capital gain in respect of carried interest.**

The Act provides that for tax years beginning after December 31, 2017 capital gain recognized in respect of an "applicable partnership interest" will be treated as long-term capital gain (subject to preferential tax rates) only to the extent the partnership assets producing the gain were held for more than three years (as opposed to the generally applicable one-year holding period threshold). The Act also provides that the direct or indirect transfer of an applicable partnership interest to a family member or another service provider will cause the transferor to recognize, at ordinary income tax rates, that portion of any gain attributable to capital gain assets not held for more than three years. Future guidance is expected in the form of regulations intended to prevent this new provision from applying to income or gain from any asset not held for portfolio investment on behalf of third party investors. However, we do not yet know what specific approach such guidance will take.

An "applicable partnership interest" is a partnership interest received by the taxpayer in connection with the taxpayer's (or a related person's) performance of substantial services in the trade or business of raising or returning capital and either investing in, or disposing of, securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivatives, and similar interests or developing such assets. **Accordingly, the provision is intended to apply to carried interests and other profits interests granted in respect of a portfolio or asset management business, although it is too soon to gauge the ultimate breadth of this provision's application.**

Planning Pointer: While the exact parameters of the new rules will not be known until regulations are issued, and technical corrections amending provisions of the Act to curtail perceived abuses are possible, there are a number of strategies that may minimize the effect of these changes upon carried interests that are currently held, some of which may require action before year-end. Persons holding carried interests should discuss such strategies with their tax advisor.

New Deduction for Income from Certain Partnerships

For taxable years beginning after 2017 (and before 2026), the Act provides a new 20% deduction to individuals, trusts and estates that receive income from certain S corporations, sole proprietorships and partnerships ("pass-throughs"), subject to various limitations. **The 20% deduction is generally not available to investment funds or investment managers, but could be used by partners in a real estate investment fund.** The devil is in the details. Specifically, the Act provides that partners are allowed a deduction in respect of "qualified business income" ("QBI") from a partnership that constitutes a "qualified trade or business" ("QTB") of that partner.

Qualified Business Income: QBI means the net amount of items of income, gain, deduction and loss that are effectively connected with a QTB of the taxpayer for a taxable year. Notably, QBI does not include: capital gain or capital loss, dividends, dividend equivalents, interest income (other than interest allocable to a trade or business), certain other items of passive income, qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income, among other items.

Qualified Trade or Business: A QTB is any U.S. trade or business, other than the trade or business of being an employee or a trade or business whose principal asset is the reputation or skill of one or more of its employees or owners. Such excluded service businesses include the fields of financial services, brokerage services, investing and investment management, as well as trading or dealing in securities, partnership interests or commodities. However, if a taxpayer makes less than $315,000 (for married individuals filing jointly) or $157,500 (for all other individuals) (as adjusted for inflation), all trades or businesses qualify as QTBs, with a phase-out for taxpayers making more than such threshold amounts. **If a portfolio company is structured as a pass-through for U.S. federal income tax purposes, and the portfolio company is engaged in a QTB, investors may benefit from the new 20% deduction in respect of income earned from such portfolio company.** Note, however, that structuring portfolio companies as pass-throughs may cause a fund to have effectively connected income or unrelated business taxable income.

Calculating the Deduction: Generally, the Act provides for a deduction equal to 20% of the QBI with respect to all QTBs and 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year. The 20% QBI deduction is limited by the <u>greater</u> of (i) the partner's allocable share of 50% of the W-2 wages paid with respect to such QTB and (ii) the partner's allocable share of the <u>sum</u> of 25% of the W-2 wages paid with respect to the QTB <u>and</u> the partner's allocable share of 2.5% of the unadjusted basis of the QTB's depreciable tangible property that is used in the production of QBI, and for which the depreciable period has not ended. (Notably, that computation references the basis of property at the time of its acquisition – regardless of depreciation thereafter – creating a significant benefit to partners in real estate funds.) As with the exclusions from QTB status, that limit does not apply to taxpayers with annual, inflation-adjusted earnings of up to $315,000 (for married individuals filing jointly) or $157,500 (for all other individuals), with a phase-in for taxpayers making more than such threshold amounts. The taxpayer's ability to take the 20% deduction in respect of QBI is further limited to the extent it exceeds the taxpayer's taxable income (reduced by net capital gain).

<u>Domestic Blockers: Subject to Lower Tax</u>

For tax years beginning after December 31, 2017, corporate income will be taxed at a flat 21% rate. A blended statutory rate based on a weighted average of the rates in place before and after the effective date will apply to fiscal year taxpayers. Accordingly, an investment into a fund through a domestic corporation results in less tax leakage than in prior years. However, deductions for dividends received from less than wholly owned domestic corporations, such as a portfolio company, are reduced to 65% (for dividends paid from a 20% or greater subsidiary) or 50% (for dividends paid from any other non-consolidated corporation). Consequently, such dividends will be subject to roughly the same effective tax rates as the maximum rates imposed under present law (i.e., 7% and 10%, respectively).

<u>Use of Leverage: Limited Interest Deductions</u>

The Act significantly restricts the deductibility of interest paid or accrued by certain investment funds that are engaged in a trade or business ("business interest") for tax years beginning after December 31, 2017 (i.e., including interest paid on existing indebtedness). The deduction for business interest is generally limited to the sum of business interest income plus 30% of adjusted taxable income. For this purpose, adjusted taxable income is determined at the entity level for partnerships and generally is earnings before interest, taxes, depreciation, and amortization (EBITDA) for tax years beginning before 2022 and earnings before interest and taxes (EBIT) for tax years thereafter.

Any business interest of a partnership that is not allowed as a deduction is allocated to its partners, reducing each partner's basis in its partnership interest (but not below zero) by the amount of such allocation. This excess business interest may be carried forward indefinitely by a partner, but is deductible only against a partner's distributive share of certain taxable income of the partnership that originally generated the carryforward. In the event a partner disposes of its partnership interest prior to deducting the full amount of its carryforward, the partner's basis in its interest will be increased, immediately before the disposition, by any such amount remaining.

The limitation does not apply to investment funds (other than tax shelters) with gross receipts not exceeding $25 million for the three prior tax years, and does not impact the deductibility of investment interest. It does, however, apply to the business interest of portfolio companies that do not meet the $25 million average gross receipts test and are not electing real estate or farming businesses, which may increase the after-tax cost of certain debt financings.

<u>Gain on the Sale of a Partnership Interest by a Foreign Person, including a Foreign Blocker</u>

The Act provides that after November 27, 2017, if a foreign person sells, exchanges or otherwise disposes of an interest in a partnership that engages in any U.S. trade or business, gain or loss on the disposition will be treated as "effectively connected income" to the extent the foreign person would have had effectively connected income had the partership sold its assets. **Accordingly, the sale of an interest in a fund by a foreign person (including a foreign feeder) will be subject to U.S. graduated income tax rates if the fund is engaged in a U.S. trade or business (e.g. a loan origination fund or certain MLPs).**

The transferee of a partnership interest subject to this new provision is required to withhold a tax equal to 10% of the amount realized on the disposition of such interest, unless the transferee receives an affidavit confirming that the transferor is not a foreign person. If the transferee fails to withhold, the partnership is required to withhold from distributions to the transferee in an amount equal to the amount the transferee failed to withhold, plus interest. These new withholding provisions go into effect for dispositions after December 31, 2017. **As a result, certain funds may have increased withholding responsibilities.**

Historically, in a much criticized 1991 ruling, the Internal Revenue Service had taken a position consistent with the new Act provision. However, in 2017, the Tax Court had found the ruling invalid. The Act resolves the uncertainty in favor of the IRS.

Miscellaneous Itemized Deductions Subject to the 2% Floor Eliminated

The Act eliminates all miscellaneous itemized deductions for expenses that previously were subject to the 2% floor. Notable examples include expenses for the production or collection of income (such as investment management fees).

This Alert provides only a simple overview of complex and nuanced tax provisions. Given the fluid fiscal and legislative environment, there may be additional changes coming. To learn more about the Act and its implications for you or your business, please contact one of the Lowenstein Sandler attorneys listed.

For more information about other provisions of the Act, please see the links below:

KEY CORPORATE & BUSINESS TAX PROVISIONS
KEY PARTNERSHIP TAX PROVISIONS
KEY INDIVIDUAL TAX PROVISIONS
KEY FOREIGN TAX PROVISIONS
KEY TAX-EXEMPT ORGANIZATION TAX PROVISIONS
KEY TRUST & ESTATE TAX PROVISIONS

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