Morgan Lewis

NAVIGATING US TAX REFORM:

WHAT BUSINESSES NEED TO KNOW

Investment Funds and their Managers

January 19, 2018

Presenters:

Richard LaFalce, *Partner*
Daniel Nelson, *Partner*
Gabriel Quihuis, *Associate*
Jason Traue, *Partner*
Richard Zarin, *Partner*
William Zimmerman, *Partner*

AGENDA

SECTION 01

CONTEXT

Context – Fundamental Changes to Corporate and Pass-Through Taxation Impact Funds and Portfolio Companies

- Certain key changes to basic corporate tax treatment
  - Reduction in corporate income tax rate from 35% to 21%
  - Limitations on deductibility of business interest
  - Limitations on use of NOLs
  - Enhanced cost recovery through "expensing" of certain assets
- Key change to basic tax treatment of income from pass-through entities -- Deduction of up to 20% for "qualified business income" allocated to non-corporate partners
  - Formula limitations on amount of deduction
  - "Specified service" businesses excluded
  - Benefit applies to certain REIT dividends and income from publicly traded partnerships conducting a qualified business
- Takeaway – choice of entity considerations have changed

SECTION 02

LIMITATION ON DEDUCTION OF BUSINESS INTEREST

New § 163(j) limits deductibility of business interest

- Generally limits the deduction for business interest to the sum of:
  - Business interest income, and
  - 30% of "adjustable taxable income."
- "Adjusted taxable income" approximates
  - For 2018-2021, EBITDA, and
  - For 2022 and later, EBIT.
- Concept of limitation based on fixed percentage of EBITDA is consistent with OECD BEPS recommendations.

Additional rules

- Businesses with average annual gross receipts of $25M or less (indexed to inflation) are generally exempt
- Disallowed business interest can be carried forward indefinitely
- Real property trades or businesses can generally elect out

Practical observations on § 163(j)

- For entities with big depreciation and amortization deductions, business interest deductions may be severely limited beginning with 2022
  - No grandfathering—this is an issue that needs to be considered as to existing instruments
  - Immediate expensing before 2022 may soften the blow
- Limitation is based on *net* interest expense
- Limitation should be considered when modeling performance
- Effect of limit may vary depending on interest rates

Immediate expensing of certain assets

- § 168(k) temporarily allows immediate 100% expensing of "qualified property"
- "Qualified property" generally includes
  - depreciable tangible property
  - NOT stock, real estate or intangibles
- Incentivizes acquisitions with eligible assets in the next decade
- Incentivizes asset purchases—actual and deemed
- 100% expensing if placed in service after 9/27/2017 and before 1/1/2023
- Percentage steps down from 2023 to 2027, as shown on next slide

Expensing schedule—based on placed-in-service date

9/27/2017-12/31/2022
100%

2023
80%

2024
60%

2025
40%

2026
20%

SECTION 03

REQUIRED WITHHOLDING ON SALES OF PARTNERSHIP INTERESTS

Foreign partners subject to withholding and tax on sale of ECI partnership interests

- Reverses a recent Tax Court case, *Grecian Magnesite*, and reflects long-standing IRS position.
- Taxable gain reflects, in general terms, portion of gain that would be viewed as tied to a US business if the partnership sold its assets.
- Significant change is addition of an obligation to withhold at 10% of the foreign seller's entire "amount realized" for a buyer of such a partnership interest, and a backstop obligation of the partnership to withhold from distributions to a buyer who does not so withhold.
- "Amount realized" for purposes of determining amount to be withheld presumably includes seller's deemed share of partnership liabilities, which is difficult to determine as of time of sale.

Foreign partners subject to withholding and tax on sale of ECI partnership interests (continued)

- IRS has temporarily suspended this withholding for publicly traded partnerships.
- Subject to regulations or other guidance, withholding applies to transfers that are otherwise tax-free.
- No stated exceptions based on limited amount of potential ECI—that is, subject to regulatory guidance, no exceptions along the lines of the 50%/90% exception to withholding provided for transfer of partnership interests reflecting in part US real property interests.

SECTION 04

NEW RULES FOR CALCULATING UBTI AND STRUCTURING CONSIDERATIONS WITH RESPECT TO THE SAME

Unrelated Business Income Tax

- **What were the Congressional Proposals?**

  The explanation to the November 2, 2017 version of the House bill included the following:

  – Current law provides that income derived from a trade or business regularly carried on by an organization exempt from tax under Code Section 501(a) (including pension plans) that is not substantially related to the performance of the organization’s tax-exempt functions is subject to the unrelated business income tax (UBIT).

  – The explanation goes on to say that “[a] college or university that is an agency or instrumentality of a State government (or political subdivision) generally is subject to UBIT on any unrelated business taxable income. It is unclear, however, whether certain State and local entities (such as public pension plans) that are exempt under Code section 115(l) as government-sponsored entities as well as section 501(a) are subject to the UBIT rules.”

  – The draft bill would amend the provision that addresses which organizations are subject to UBTI to provide that an organization would not be exempt from tax on UBTI solely because the organization is also exempt from tax based on another provision in the Code. Thus, this reform proposal would have prevented a government pension plan (described in Section 401(a)) that is exempt from tax under Section 501(a) from claiming an exemption from tax on UBTI pursuant to Section 115 due to its status as a government entity.

  – The House bill was, however, not the first proposal to eliminate the UBTI exception for government pension plans. In 2014, then House Ways and Means Committee Chairman Dave Camp (R-Mich.) included a similar provision in his ultimately unsuccessful draft tax reform bill.

Unrelated Business Income Tax

- The Senate version of provisions affecting UBIT provided for segregation rules discussed below which were adopted:
  - Under the new law, tax-exempt entities that are subject to tax on their UBTI will be required to segregate their taxable income and loss for each unrelated trade or business activity for purposes of determining their UBIT. Under prior law, when a tax-exempt organization operates more than one unrelated trade or business activity, expenses and losses generated by one business may be used to offset income derived from another.
  - The new law will not require governmental pension plans to be subject to UBIT.

Unrelated Business Income Tax

- Under the new law, however, a tax-exempt entity subject to UBIT must calculate UBTI separately for each unrelated trade or business activity. Thus, a tax-exempt entity cannot offset expenses or losses from one trade or business with income derived from another trade or business. These changes will be effective for taxable years beginning after December 31, 2017.

- There is, however, a transition rule that permits a tax-exempt entity to carry forward net operating losses that were generated by UBTI-producing investments in a taxable year prior to January 1, 2018, against UBTI-producing investments in later years. The new segregation provision may potentially impact the decision of some tax-exempt investors on whether to invest using “blocker” corporations, which might ease the reporting and remitting of UBIT.

- We think additional guidance will be required to determine how to segregate separate unrelated trades or businesses, especially through pass-through investment vehicles.

SECTION 05

EFFECT OF NEW RULES ON US AND OFFSHORE BLOCKER STRUCTURES

Effect of new rules on US and offshore blocker structures

- US "blocker" corporations are often used to shield non-US and US tax-exempt investors from direct US tax filing and payment obligations with respect to investments in operating partnerships and LLCs.

- Such blockers may be capitalized in part with debt, as well as equity, of investors. The new tax law's restrictions on interest deductions (in general terms, to 30% of a corporation's taxable income), as well as potential for BEAT tax (in large transactions) and limits on deductions for hybrid payments, may reduce the blocker-level tax benefits of such leverage.

- Leverage may still be of interest with respect to non-US investors as a means to allow distributions without US withholding tax (subject to eligibility of investors for the portfolio interest exemption or tax treaty benefits).

Effect of new rules on US and offshore blocker structures (continued)

- The U.S. corporate tax leakage of a U.S. blocker will be reduced, going forward, because of the new 21% federal corporate tax rate (versus the prior 35% maximum rate), as well as the potential for bonus depreciation and other tax benefits.

- Offshore blocker or intermediate holding structures are often used with respect to outbound, or non-US, private equity portfolio company investments.

- Offshore feeder corporations, in master-feeder structures, are also often used by hedge funds utilizing leverage to shield non-US investors from direct US tax reporting and US tax-exempt investors from tax on debt-financed income.

- Expansion of rules regarding determination of whether a foreign corporation is a controlled foreign corporation, or CFC, may result in treatment of these and other foreign corporations, even without significant US direct or indirect ownership, being CFCs and require US tax reporting by US "constructive" owners (e.g., in some circumstances, sister US partnerships or corporations).

SECTION 06

CARRIED INTEREST AND HOLDING PERIOD REQUIREMENTS EFFECT ON US MANAGERS

Carried interest and holding period requirements effect on US managers

- Soft attack on carried interest
  - For certain partnership profits interests, a 3-year holding period is required for capital gains "with respect to" the partnership to qualify for long term capital gain rates (prior law: 1 year holding period)
    - If not met, carry would be taxed as short term capital gain (at a top marginal rate of 37%)
    - 3 year holding period does not apply with respect to capital interest in the partnership giving the manager the right to share in partnership capital commensurate with the amount of capital contributed (as of the time the interest was received).
  - Does not recharacterize "qualified dividend income"
  - For many carried interests in PE and VC funds, holding period will not be a material limitation since investment horizon tends to be longer than 3 years for such funds
  - May affect partnership interests other than the carry, such as profits interests granted to management in connection with fee waiver mechanisms, as well as profits interests granted to management of portfolio companies (subject to specific facts and certain exceptions)
  - Transfers to "related parties" are also covered
    - Not clear whether regulations are intended to make this provision applicable notwithstanding any non-recognition rules in the Code

SECTION 07

CONSIDERATIONS FOR RICS, REITS AND PTPS

New Section 199A: 20 % Deduction as Applied to Income From REITs and PTPs

- The new 20% deduction is available for "**Qualified REIT Dividends**" and "**Qualified Publicly Traded Partnership Income**" received by taxpayers <u>other than</u> corporations

- Section 199A(c)(1) makes it clear that Qualified REIT Dividends and Qualified Publicly Traded Partnership Income is not "Qualified Business Income"
  - Primary significance: the wage and income thresholds do not apply

New Section 199A: 20 % Deduction as Applied to Income From REITs and PTPs

- “Qualified REIT Dividends” includes ordinary REIT dividends, but excludes:
  - Capital gain dividends, and
  - Dividends designated as “qualified dividend income”

- “Qualified Publicly Traded Partnership Income” means with respect to any qualified trade or business of a taxpayer, the sum of:
  - Certain Income for PTPs within the meaning of Section 7704(a)
    - Same sources of “qualified business income” discussed in slide 4
    - Excludes most passive sources of income
    - Reasonable compensation and guaranteed payments
  - Gain realized from the disposition of a PTP interest to the extent of Section 751(a) Property (unrealized receivables & inventory items)

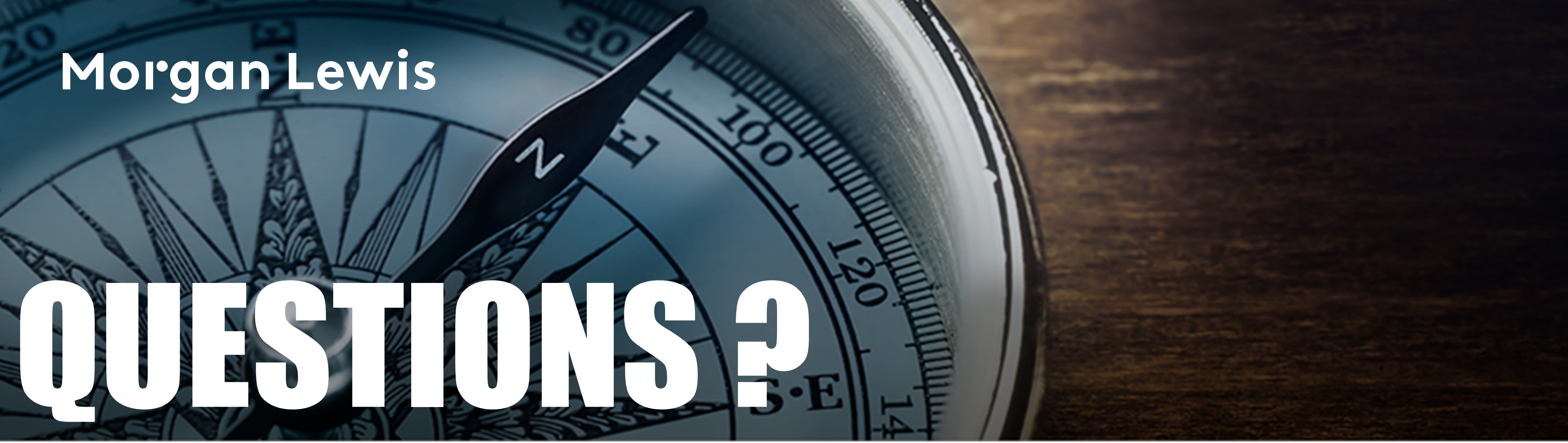
- Why include “qualified trade or business of a taxpayer” in the above QPTP Income definition?

Tax Reform and RICs

- Tax Reform generally did not change the special rules applicable RICs
  - However, new subsection 451(b) requires income inclusion not later than revenue is taken into account on a financial statement. May cause additional instances in which RICs are required to recognize income without a corresponding cash distribution, putting pressure on a RIC's distribution requirement.
  - **Section 199A Deduction**: As currently drafted 199A does <u>not</u> provide an ability for RICs to pass-through the character of income it receives from REITs and PTPs to the RIC's shareholders
  - Shareholders of RICs that primarily invest in REITs and PTPs are effectively worse-off than direct holdings in the REITs and PTPs that generate income
    - Was this intentional or a technical oversight?
    - Technical correction?

Structuring with REITs Post Tax Reform

- Generally, a real property trade or business (should include most equity REITs) can elect out of the new rules limiting interest deductibility provided the business uses certain depreciation schedules
  - This exclusion may make REITs a more desirable investment vehicle for the real estate portion of transactions:
    - For inbound investments, may tip the scale over traditional blockers
      - Compare, however, U.S. C corp blockers are now capped at a 21% drag (see slides 19-20)
    - Operating companies may consider segregating their real estate assets into REITs because REITs would not be included in their consolidated returns
  - Private REITs may be more desirable when structuring to include U.S. taxable investors
    - Although private REITs still trap losses, equity REITs will now effectively pass along the new 20% deduction without the wage and income limits
    - Compare to a traditional real estate fund without a REIT; can pass-through losses but wage and income limits as well as guarantee payments/reasonable compensation limits would apply to the new 20% qualified business income deduction



A recording of this presentation will be made available on our **Tax Reform resource page**, a centralized, cross-practice resource for tax reform-related thought leadership and programs, including webinars, LawFlashes, blog posts, and more.

THANK YOU

Biography

Richard C. LaFalce
Washington, D.C.
T +1.202.739.5506
F +1.202.739.3001

Richard C. LaFalce counsels clients on the creation and taxation of private and pooled investment vehicles such as mutual funds, REITs, ETFs, hedge funds, and other investment-related entities. He frequently advises clients on the taxation of financial products, general corporate and international tax matters, and UBIT. Before joining Morgan Lewis, Rich was an assistant branch chief in the Internal Revenue Service Office of Chief Counsel, Financial Institutions and Products.

Biography

Daniel A. Nelson
Boston
T +1.617.341.7830
F +1.617.341.7701

Daniel A. Nelson advises clients on the US and international tax and commercial considerations related to the efficient structuring of transactions and business relationships. He counsels global institutional investors—including investment managers for some of the world's largest pension funds, sovereign wealth funds, and insurance companies—in connection with investments in real estate, infrastructure projects, and other real assets. Dan also advises sponsors regarding the formation and operation of customized investment platforms, private investment funds, and joint ventures involving pension funds, sovereign wealth funds, insurance companies, and other institutional investors.

Biography

Gabriel A. Quihuis
Boston
T +1.617.341.7736
F +1.617.341.7701

Gabriel A. Quihuis advises fund sponsors on tax matters relating to fund structuring and operations, and provides tax advice to institutional investors in connection with domestic and offshore private fund investments. Gabriel regularly advises clients on issues relating to the Foreign Account Tax Compliance Act (FATCA). Gabriel also assists clients on various corporate tax issues related to domestic and cross-border mergers, acquisitions, financings, and restructurings.

Biography

Jason P. Traue
Boston
T +1.617.951.8964
F +1.617.428.6410

Jason P. Traue's practice focuses on federal tax matters. He works extensively with tax issues related to the formation and operation of registered and private investment funds. Jason also assists with merger and acquisition transactions, capital markets transactions, general corporate and partnership tax issues, and international tax issues. Jason has helped clients obtain numerous administrative rulings from the Internal Revenue Service and has assisted in federal and state tax controversy matters.

Biography

Richard S. Zarin
New York
T +1.212.309.6879
F +1.212.309.6001

Richard S. Zarin provides tax advice to sponsors of and investors in a wide range of onshore and offshore investment funds. In addition, working with businesses in industries such as financial services, aviation, education, media and shipping, Richard S. Zarin counsels clients on tax matters involving international and US transactions. He also advises clients on ongoing tax planning.

Biography

William P. Zimmerman
Philadelphia
T +1.215.963.5023
F +1.215.963.5001

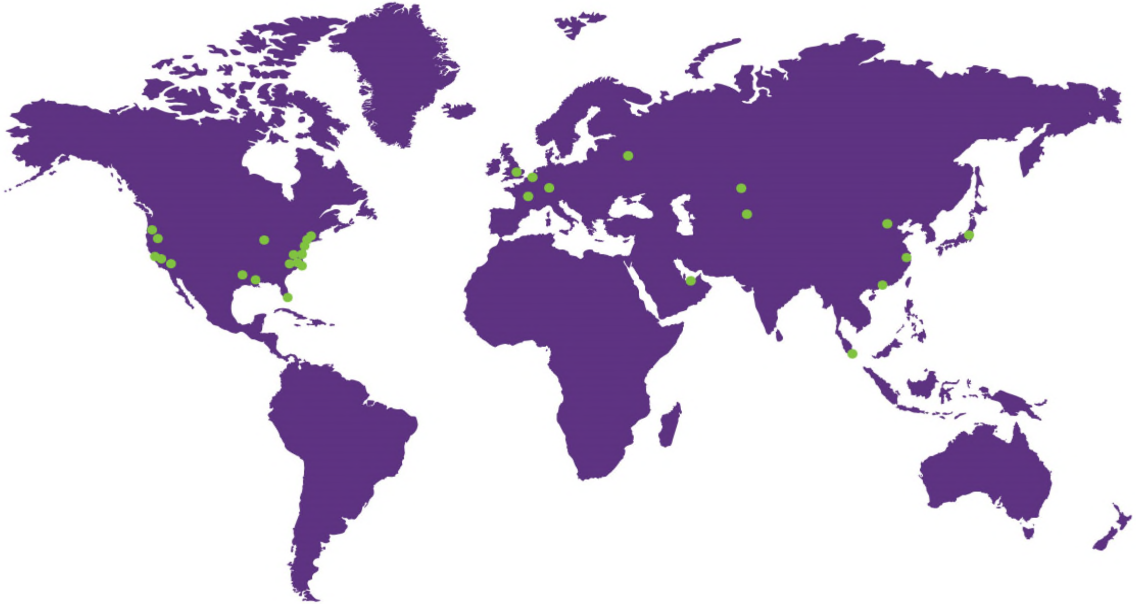
William P. Zimmerman guides clients on the creation and operation of private and pooled investment vehicles, such as mutual funds, hedge funds, real estate investment trusts, and other investment-related vehicles. He also advises clients on general corporate and individual tax planning matters, including reorganizations, mergers, acquisitions, spinoffs, recapitalizations, and workouts. Additionally, Bill provides partnerships and limited liability companies with planning and operational guidance on tax-related issues.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty
Astana
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



Morgan Lewis

*Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners.