Anchin Alert

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Tax Cuts and Jobs Act: Key provisions affecting Hedge Funds, Private Equity Funds and Other Investment Funds or Fund Vehicles

The Tax Cuts and Jobs Act (the "Tax Act"), which was signed into law on December 22, 2017, enacts a broad range of changes with most provisions taking effect for tax years beginning after December 31, 2017. This alert summarizes some of the key (federal) tax provisions of the Tax Act affecting managers of hedge funds, private equity funds and other investment funds or fund vehicles.

Investment Income

The Tax Act retains the maximum 20% preferential rate applicable to long-term capital gains and qualified dividend income and the 3.8% net investment income tax continues to apply. Long term gains are taxed at rates of 0%, 15% or 20%, depending on your tax bracket, while short term gains are taxed as ordinary income. Under prior law, the 0% rate applied to the two lowest tax brackets, the 15% rate was applied to the next four and the 20% was applied to the top bracket. Under the Tax Act, the three capital gains income thresholds don't match up perfectly with the tax brackets but are applied at maximum taxable income levels, as follows:

Long-Term Capital Gains Rate	Single Taxpayers	Married Filing Jointly	Head of Household	Married Filing Separately
0%	Up to $38,600	Up to $77,200	Up to $51,700	Up to $38,600
15%	$38,600-$425,800	$77,200-$479,000	$51,700-$452,400	$38,600-$239,500
20%	Over $425,800	Over $479,000	Over $452,400	Over $239,500

Note that the Tax Act did not adopt the Senate bill's requirement that taxpayers use the first-in-first-out rule in determining which securities have been sold, thereby allowing taxpayers to continue to specifically identify which lot of securities to sell. For our prior coverage on this, please click here.

Carried Interest

Under prior law, if a non-corporate taxpayer was allocated taxable income or gain in respect of a partnership interest (regardless of whether the interest was a capital or profits interest), the character of such income or gain was determined at the partnership level. If the partner was allocated capital gain income, whether that capital gain is long-term or short-term depended on whether the partnership's holding period in the assets sold exceeded one year.

The Tax Act provides that for tax years beginning after December 31, 2017 and with respect to an "applicable partnership interest", that capital gain recognized with respect to such partnership interest will be treated as long-term capital gain only to the extent that the partnership assets producing the gain were held for more than three years (as opposed to the generally applied one-year holding period threshold).

An "applicable partnership interest" is defined as a partnership interest received by the taxpayer in connection with the taxpayer'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 interest or developing such assets.

It is important to note that an applicable partnership interest does not include any interest held by a corporation or any capital interest allowing the partner to share in partnership capital corresponding with the amount of capital contributed. Amounts not meeting the three-year holding period test would be reclassified as short-term capital gain, rather than ordinary income (as some earlier carried interest proposals had called for). The three-year holding period rule would apply regardless of whether a §83(b) election is made and would also apply to gains generated from the sale of the applicable partnership interest itself. There is no grandfathering for partnership interests received prior to January 1, 2018.

Under this new legislation, it seems clear that the treatment of carried interest will not give rise to effectively connected income ("ECI") or unrelated business taxable income ("UBTI") issues; both were concerns under earlier versions of carried interest proposals. It also appears that qualified dividend income is not impacted under the new rules and will still be taxed at the lower preferential rates discussed above. 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.

The carried interest change will impact private investment fund managers differently (depending on the type of fund) and does not totally eliminate the current treatment. Certain fund managers of real estate funds, private equity funds and (long-term) value investing funds should not be materially impacted by the change since these funds generally hold assets for greater than three years. Managers of hedge funds that have both short-term and long-term security positions with holdings periods of less than three years will be most affected by this change and could see a material amount of long-term capital gain reclassified to short-term capital gain.

A special provision provides that (subject to regulations or other guidance to be issued), this change does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third-party investors.

***Anchin Observation*: It is unclear if an applicable partnership interest held by an S corporation would be excluded under this new provision and if unrealized carry from incentive allocations prior to the January 1, 2018 effective date were meant to be captured as well.**

21% Corporate Tax Rate

The Tax Act reduces the corporate tax rate from 35% to 21% effective for tax years beginning after December 31, 2017, eliminates the special fixed rate of 35% for personal service corporations and repeals the corporate alternative minimum tax ("AMT") entirely. AMT credit carryforwards will be refundable up to 50% for the years 2018 through 2020 with the balance refundable in the year 2021. Under the Tax Act, the amount of dividends received that a corporation could deduct from its taxable income will be reduced to 50% (in regards to 70% deductible dividends under prior law) or 65% (in regards to 80% deductible dividends under prior law). A corporation will continue to be able to deduct 100% of dividends received from another corporation within the same affiliated group.

New deduction for pass-through businesses

Under prior law, net taxable income from pass-through business entities (such as sole proprietorships, partnerships, S corporations and LLCs) was simply passed through to their owners. It was then taxed at the owners' tax rates. In other words, no special treatment applied to pass-through income recognized by business owners.

For tax years beginning in 2018, the Tax Act establishes a new deduction based on a non-corporate owner's qualified business income (QBI). This new tax break is available to individuals, estates and trusts that own interests in partnerships, S corporations or sole proprietorships. The deduction generally equals 20% of QBI, with a cap equal to the greater of 50% of W-2 wages or 25% of W-2 wages plus 2.5% of the cost of qualified property. The deduction expires after the year 2025. Under an exception, the W-2 wage limitation does not apply until an individual owner's taxable income exceeds $157,500 ($315,000 for joint filers). Above those income levels, the W-2 wage limitation is phased in over a $50,000 range ($100,000 range for joint filers).

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, reasonable compensation income or guaranteed payments to the taxpayer from the business. The QBI deduction is not allowed in calculating the non-corporate owner's adjusted gross income (AGI), but it reduces taxable income. In effect, it's treated the same as an allowable itemized deduction.

The 20% deduction is not available for income realized from "specified service trades or businesses" such as health, law, accounting, consulting, financial services firms and other businesses where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, unless realized by a taxpayer whose taxable income falls below the thresholds described above.

Anchin Observation:* The Tax Act increases the compliance burden on pass-through entities and their owners, which become even more onerous via tiered-structures. Of greater importance is the large tax rate disparity that now exists between C corporations and pass-through entities which may prompt many businesses to reexamine their entity choice. Even with the second layer of tax on the distribution of corporate earnings as well as a potential accumulated earnings tax on undistributed corporate earnings, the lower 21% rate could be attractive for certain taxpayers. A detailed analysis of entity choice involves many factors and many moving parts and should not be undertaken without fully vetting the pros and cons with your service providers.

Gain on the Sale of a Partnership Interest by a Foreign Person

The Tax Act codifies Revenue Ruling 91-32, effectively reversing the Grecian Magnesite decision. Gain or loss on the disposition of a partnership by a foreign partner is treated as effectively connected income ("ECI") and subject to taxation in the U.S. if the gain or loss from the sale of the underlying assets held by the partnership is treated as ECI. To implement this new rule, the Tax Act requires 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. This new rule has potential implications for pass-through investments at the portfolio company, private investment fund and limited partner (including fund of fund investors) levels. The rules treating the gain or loss on a sale or exchange of a partnership interest as ECI are effective for dispositions on or after November 27, 2017 with the withholding provisions effective for dispositions after December 31, 2017. For our prior coverage on this, please click here.

New limits on business interest deductions

Under prior law, subject to some restrictions and exceptions, (business) interest paid or accrued by a business generally is fully deductible. The Tax Act significantly restricts the deductibility of interest paid or accrued by certain private investment funds that are engaged in a trade or business for tax years beginning after December 31, 2017, including interest paid on existing indebtedness. The term business interest would not, however, include investment interest (as described under §163(d)). The deduction for business interest expense 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, depreciation, amortization or depletion for tax years beginning before 2022 with no such addbacks for taxable years thereafter.

Certain taxpayers are exempted from the new 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 certain public utilities.

For S corporations, partnerships and LLCs that are treated as partnerships for tax purposes, this limit is applied at the entity level rather than at the owner level. Any business interest disallowed at the entity level in a taxable year is allocated to the shareholders or partners and may only be deducted by them against excess adjusted taxable income allocated to them from such S corporation or partnership in a future year. Amounts that cannot be deducted in the current year can generally be carried forward indefinitely.

Other Relevant Changes:

Expansion of Section 179 Expensing

The Tax Act affords most taxpayers immediate expensing for up to $1 million of the cost of qualifying tangible personal property placed in service after December 31, 2017 (an increase from $500,000 cap under prior law). The Tax Act also expanded the definition of Section 179 property to include certain improvements such as roofs, heating and alarm systems, made to nonresidential real property after the property is first placed in service. The benefit under this new provision will be reduced (but not below zero) to the extent the value of qualifying property placed into service exceeds $2.5 million for the tax year (compared to $2 million under prior law).

Immediate 100% (Bonus) Depreciation

The Tax Act permits most taxpayers to expense 100% of the cost of qualified property, including certain tangible personal property, placed in service after September 27, 2017 and before January 1, 2023. The Tax Act allows immediate expensing for used as well as new eligible property. However, consistent with prior law, intangible property and real property are not eligible for immediate expensing. Beginning in 2023, the immediate expensing will be reduced to 80%, followed by 60% in 2024, 40% in 2025, 20% in 2026 and reduced to 0% for years thereafter. A special rule allows taxpayers to elect to apply 50% bonus depreciation rather than 100% bonus depreciation for the first taxable year ending after September 27, 2017.

Miscellaneous Itemized Deductions Subject to the 2% Floor Eliminated

The Tax Act repeals miscellaneous itemized deductions subject to the 2% of adjusted gross income ("AGI") floor limitation. Notable expenses include expenses incurred for the production or collection of income (such as investment management fees). The Tax Act also repeals the overall limitation on itemized deductions (commonly referred to as the "Pease" limitation), which reduced the total amount of itemized deductions for high-income taxpayers.

Excess Business Loss Limitation

A new limitation applies to deductions for "excess business losses" incurred by non-corporate taxpayers (individuals, trusts and estates). Generally, a taxpayer will have an excess business loss for a tax year if the taxpayer's deductible items from "trades or businesses" exceed the sum of (1) the taxpayer's aggregate business income and gains and (2) a threshold amount ($500,000 for taxpayers filing joint returns, $250,000 for other taxpayers). 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 NOLs (discussed below). This new provision applies after the application of the passive activity loss rules and, in the case of a partnership or S corporation, the excess business loss limitation applies at the taxpayer level and not the entity level.

Net Operating Loss ("NOL") Deduction Changes

Under prior law, 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. In addition, the maximum amount of the deduction for a NOL carryforward will be limited to 80% of a taxpayer's taxable income (determined without regard to the NOL deduction), also effective with respect to tax years

beginning after December 31, 2017. Relief is provided with respect to NOLs arising in taxable years beginning prior to December 31, 2017, which will continue to be available for the two-year carryback and the 20-year carryforward without regard to the new 80% taxable income limitation.

Mandatory Basis Adjustment to Basis of Partnership Property

The Tax Act imposes a mandatory adjustment to the basis of partnership property in connection with the transfer of a partnership interest where there is a “substantial built-in loss” – if the transferee partner would be allocated a loss exceeding $250,000 if the partnership assets were hypothetically sold for their fair market value immediately after such transfer. Under prior law, the mandatory basis adjustment was triggered only if there was a substantial built-in loss at the partnership level. For years after December 31, 2017, the Tax Act extends the substantial built-in loss test to the partner level.

Self-employment Tax for Limited Partners

Although prior versions of the House bill proposed changes to the self-employment tax treatment of pass-through entities, the Tax Act maintains the status quo for taxpayers who are limited partners in a state law limited partnership who claim the exemption from self-employment tax.

The Tax Act is the largest overhaul of the tax code in over 30 years, and we’ve covered only the highlights of certain tax provisions that we believe impact managers of hedge funds, private equity funds and other investment funds or fund vehicles. The breakneck speed at which this tax bill moved through Congress left very little time for tax planning ahead for an effective date (for the most part) that began as of January 1, 2018. Going forward, there are considerable areas of ambiguity in the Tax Act as well as many areas that create tax planning challenges and opportunities, as we wait on technical corrections and other relevant guidance. If you would like to discuss these changes, planning opportunities or have any specific questions, please contact E. George Teixeira or any member of Anchin’s Financial Services Practice. We stand ready as *Your Expert Partner* to help you plan effectively and to navigate through the various tax rules that may apply to you, your family and your fund.

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