Tax Considerations for 2018

Schulte Roth & Zabel

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Partner
New York Office
+1 212.756.2124
philippe.benedict@srz.com

Practices

Tax

Real Estate Capital Markets & REITs

Philippe Benedict

Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of investment fund managers. Philippe's recent real estate transactions include advising the Related/Oxford joint venture developing Hudson Yards on closing nearly $1.4 billion in equity investments and debt financing for the center's first tower, and advising Oxford in over $5 billion in financing of three office towers, a retail center and a residential building for the project; advising Arel Capital in a number of equity investments, including operating multi-family properties with significant retail components and ground-up development projects for modern condominium buildings in Manhattan and Brooklyn; and advising Perella Weinberg Partners on the acquisition of 50-percent ownership of interests in two hotels and the structuring of a REIT joint venture with Loews Corporation.

Chambers USA, *The Legal 500 US*, *New York Super Lawyers* and *Tax Directors Handbook* have recognized Philippe as a leading lawyer. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and was interviewed on the outcome of the Bipartisan Budget Act of 2015 in *Hedge Fund Legal & Compliance Digest*'s article "Impact of New Partnership Tax Audit Rules on Hedge Funds: An Interview with Schulte Tax Partner Philippe Benedict." Philippe also speaks at prominent industry events, including PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2017 conference in New York and Goldman Sachs' 15th Annual Hedge Fund Seminar. He has also presented on topics including FATCA, customized solutions for investors and management company structuring and operations.

Philippe earned his LL.M. in taxation and his J.D. from New York University School of Law. While pursuing his J.D., he was the recipient of a Gruss Fellowship and staff member of the *Journal of International Law and Politics*. He obtained his B.S., *summa cum laude*, from Adelphi University.

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Special Counsel
New York Office
+1 212.756.2428
david.griffel@srz.com

Practices

Tax

David S. Griffel

David concentrates his practice on tax issues related to the formation and operation of onshore and offshore investment funds and their investment managers, as well as tax issues that prospective investors face with such investments, tax considerations related to employee and executive compensation, including deferred compensation programs and partnership taxation.

Recognized by *The Legal 500 US* as a leading tax lawyer, David has spoken on tax issues related to running investment management firms and their funds, as well as hedge fund tax considerations and compensation structures. He contributed to "Hedge Fund Employee Compensation," published by Practical Law, and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David regularly presents on the topic of "Hedge Funds" at PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances conferences. He is a member of the American Bar Association and the New York State Bar Association.

David holds an LL.M. in taxation and a J.D., *magna cum laude*, from New York University School of Law, where he was a Florence Allen Scholar and Order of the Coif, and an A.B., *cum laude*, from Harvard University.

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Special Counsel
New York Office
+1 212.756.2098
christine.harlow@srz.com

Practices

Tax

Real Estate Capital Markets & REITs

Christine Harlow

Christine focuses on the tax aspects of investment funds, private equity funds, joint ventures and registered investment companies. Her practice also includes providing advice to lenders and borrowers in financing transactions and advising on transactions involving sales of investment fund managers. A rising star in the industry, Christine recently co-authored "Year-End FATCA Action Items for Investment Funds That Are Sponsored Entities or Have Investors That Are Sponsored Entities," an *SRZ Client Alert*, and is a contributor to *Private Equity Funds: Formation and Operation* (Practising Law Institute).

Christine received her J.D. from Cornell Law School and her B.S. from Cornell University.

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Partner
New York Office
+1 212.756.2510
shlomo.twerski@srz.com

Practices

Tax

Blockchain Technology & Digital Assets

Hedge Funds

Investment Management

Real Estate Capital Markets & REITs

Regulated Funds

Shlomo C. Twerski

Shlomo is co-head of the Tax Group and he focuses his practice on the tax aspects of onshore and offshore investment funds, registered investment companies and business development companies, private equity partnerships, real estate and corporate transactions, restructurings and workouts, securitizations, and existing and emerging financial instruments. He also provides ongoing tax advisory services to a number of hedge fund managers regarding fund structuring and formation, distressed debt investments and other complex transactions.

Recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 US* and the *Tax Directors Handbook*, Shlomo is a member of the Tax Section of the New York State Bar Association. He regularly speaks at industry conferences and events, and his most recent presentations have addressed new partnership audit rules, hedge fund and management company structures, funds in the energy space, tax considerations for private investment funds and FATCA. In addition, he has published on a range of topics, including FATCA provisions, FIRPTA and REIT rules, and compliance requirements for hedge funds. Most recently, he co-authored "Twilight of the Deferred Fees: Planning for 2017," published in *The Hedge Fund Journal* and *Hedge Funds: Formation, Operation and Regulation*, published by ALM Law Journal Press.

Shlomo earned his J.D. from Hofstra University School of Law, where he was articles editor of *Hofstra Law Review*.

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Partner
New York Office
+1 212.756.2052
elie.zolty@srz.com

Practices

Tax

Real Estate Capital Markets & REITs

Elie Zolty

Elie focuses his practice on the tax aspects of onshore and offshore investment funds, private equity partnerships, real estate investment trusts (REITs) and real estate joint ventures. He represents investment managers in connection with the formation of funds and their ongoing operations, as well as sales of their investment management businesses. He also represents real estate sponsors in connection with operations, restructurings and workouts.

A published author, Elie contributed to "United States Fundraising" in *The Private Equity Review*, published by Law Business Research and he co-authored "PATH Act: Recently Enacted Legislation Modifies the FIRPTA and REIT Rules," an *SRZ Client Alert*.

Elie earned his LL.M., Taxation, from New York University School of Law, his J.D. from Osgoode Hall Law School and his B.A., *with distinction*, from York University.

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Tax Considerations for 2018

I. Partnership Audits

A. 2018 will be the first taxable year subject to the new partnership audit tax regime created by the Bipartisan Budget Act of 2015. Under the new regime, tax adjustments and collections are made at the partnership level rather than at the partner level, unless the partnership elects to pass adjustments through to its partners.

B. The new partnership audit procedures generally apply to all partnerships.

C. Partnerships with 100 or fewer partners can elect out of the procedures if each of the partners is an individual, a C corporation, a foreign entity that would be treated as a C corporation if it were domestic, an estate of a deceased partner or an S corporation.

1. In the case of a partner that is an S corporation, each S corporation shareholder is counted as a partner in determining whether the partnership has 100 or fewer partners.
2. Partnerships with partners that are other partnerships, trusts, IRAs, pension plans, disregarded entities or nominees cannot elect out.
3. The election to opt out of the new rules must be made each year with a timely filed return for such taxable year, including extensions, and notice thereof needs to be provided to the partners.
4. The election must disclose the name, tax classification and taxpayer ID of each partner of the partnership, including each S corporation shareholder in the case of an S corporation partner.

D. Instead of appointing a tax matters partner, a partnership must designate a partnership representative who will have sole authority to act for and bind the partnership and all its partners in all audit and adjustment proceedings.

1. The partnership representative does not need to be a partner but must have a substantial presence in the United States. This requirement is intended to ensure that the partnership representative will be available to the Internal Revenue Service (“IRS”) in the United States when the IRS seeks to communicate or meet with the representative.
2. No notice of an audit needs to be given to the partners. In addition, no appeals process exists if a partner disagrees with the result of an audit.
3. In the absence of a designation of a partnership representative by the partnership, the IRS has the authority to select any person as the partnership representative for a partnership.

E. Following a partnership audit, the IRS will issue a Notice of Proposed Partnership Adjustment setting out the “imputed underpayment” required to be paid by the partnership.

1. An imputed underpayment is determined by netting all adjustments of similar items of income, gain, loss or deduction at the partnership level and multiplying by the highest tax rate for individuals or corporations for the year to which the tax audit rules relate (the “reviewed year”).
   - (a) If an adjustment involves reallocation of an item to another partner, only the tax increase, not the net adjustment, enters into the calculation of the imputed underpayment under the statute. This could cause the same income to be taxed twice.
   - (b) However, under Proposed Regulations issued on June 14, 2017, a determination by the IRS that an item of income should have been allocated differently among the partners may, in certain cases, not result in the partnership incurring an imputed underpayment.
2. The partnership has 270 days to demonstrate to the IRS that its tax rate should be lower and the imputed underpayment should be reduced.

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(a) An imputed underpayment may be reduced to the extent that it is allocable to a partner that is a "tax-exempt entity" that would not owe tax on the adjusted income (e.g., the U.S. government, a tax-exempt U.S. organization, a foreign person or entity, etc.), a partner that is a C corporation (in the case of ordinary income) or an individual with capital gains or qualified dividends. In the case of a modification requested with respect to an indirect partner, the IRS may require information related to the pass-through partner through which the indirect partner holds its interest.

(b) If any partner files an amended return for the reviewed year taking into account its allocable share of the adjustments and pays tax thereon, that payment can offset the partnership's imputed underpayment. Modification is allowed to the extent the amended returns are filed and any necessary payments are made within the 270-day time period.

F. As an alternative to the partnership paying the imputed underpayment, the partnership may elect, under Section 6226 of the Code, within 45 days following the mailing by the IRS of the notice of final partnership adjustment to pass the adjustment through to its partners who were partners for the reviewed year.

1. The adjustment is passed through to the partners by issuing a statement to the reviewed year partners with their share of adjustments. The reviewed year partners are required to take the adjustments into account on their returns in the year when the adjustment takes place (the "adjustment year") (rather than amend their returns for the reviewed year).

2. An imputed underpayment is collected together with the partner's tax due for the adjustment year.

3. This special election generally removes partnership-level liability for the adjustments but makes the partnership responsible for identifying the reviewed year partners and appropriately allocating the adjustment among those partners.

4. The cost of making this election is that interest on an imputed underpayment is determined at the partner level at a rate that is 2 percent higher than the normal underpayment rate (i.e., short-term AFR + 5 percent).

5. A partnership that passes the adjustment through to its non-U.S. partners may still be required to withhold under chapters three and four on any adjustment that would have been subject to withholding in the reviewed year.

6. Proposed Treasury Regulations released on Dec. 15, 2017, if finalized, would authorize the Section 6226 Election to be effected through partnership tiers, whereby each partnership in the chain generally may choose to either pay the tax directly or push it out to its own partners (e.g., from a master fund to its feeder fund, and then to the feeder fund's investors). Each upper-tier partnership would need to make such choice by the extended due date for the tax return for the adjustment year of the partnership that was audited.

G. A partnership can file an administrative adjustment request in the amount of one or more items of income, gain, loss, deduction or credit of the partnership for any partnership taxable year. A partnership has three years from the later of the filing of the partnership return or the due date of the partnership return (excluding extensions) to file an administrative adjustment for that taxable year. However, a partnership may not file an administrative adjustment for a partnership taxable year after the IRS has mailed notice of an administrative proceeding with respect to such taxable year.

1. Adjustments that result in underpayments will cause tax to be due at the partnership level in the year in which the administrative adjustment is filed as described above, except that certain provisions related to modifications of such underpayment will not apply. In the alternative, such tax may be passed through to the partners under the election discussed above, except that the additional interest does not apply.

2. Adjustments that result in a refund must be passed through to the partners that were partners during the year to which the adjustment relates.

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II. Dividend Equivalent Payments: Section 871(m)

A. Introduction

1. In 2010, Section 871(m) of the Code was enacted to treat as U.S. source dividends for U.S. withholding tax purposes:

   (a) "Dividend equivalent payments" on "specified notional principal contracts" that are based on a four-factor statutory definition; and

   (b) Substitute dividend payments on securities lending or sale-repurchase transactions.

2. On Sept. 17, 2015, the Treasury issued final and temporary regulations (the "2015 Final Regulations" and "2015 Temporary Regulations," respectively, and, together, the "2015 Regulations") implementing Section 871(m) of the Code.

3. On Dec. 2, 2016, the IRS released Notice 2016-76, which indicated the Treasury's intent to phase in the applicability of the 2015 Regulations differently for transactions entered into each of: (i) calendar year 2017; and (ii) calendar year 2018 and subsequent calendar years.

4. On Jan. 19, 2017, the Treasury issued final and temporary regulations (the "Final Regulations" and "Temporary Regulations," respectively, and, together, the "2017 Regulations") that adopted, with some modifications, the 2015 Regulations.

5. On Aug. 4, 2017, the IRS released Notice 2017-42, which further extends the phase in and delays the effective dates of certain provisions of the 2017 Regulations.

B. Statutory Provision

1. Under Section 871(m) of the Code, a notional principal contract ("NPC") (generally, an equity swap) is a "Specified NPC" subject to withholding under Section 871(m) if the NPC provides for one or more amounts that may be contingent upon, or determined by reference to, U.S.-source dividends and at least one of the following four factors is present:

   (a) In connection with entering into the NPC, a long party to the NPC transfers the underlying security to a short party to the NPC (known as "crossing in");

   (b) In connection with the termination of the NPC, a short party to the NPC transfers the underlying security to a long party to the NPC (known as "crossing out");

   (c) The underlying security is not readily tradable on an established securities market; or

   (d) The underlying security is posted as collateral by a short party to the NPC with a long party to the NPC.

2. Section 871(m) of the Code authorizes the Treasury to specify other transactions as being "Specified NPCs" or otherwise substantially similar to a transaction yielding a dividend equivalent payment. The 2017 Regulations, as modified by IRS Notice 2017-42, expand the universe of transactions subject to Section 871(m) of the Code, if such transactions are entered into (or significantly modified) after 2016 or 2018, as applicable.

C. The 2017 Regulations

1. Transactions That Can Give Rise to "Dividend Equivalent Payments" ("Section 871(m) Transactions")

   (a) A "dividend equivalent" is any of:

      (i) A substitute dividend that references a U.S.-source dividend made pursuant to a securities lending or sale-repurchase transaction;

      (ii) A specified NPC;

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(iii) A payment that references a U.S.-source dividend made pursuant to a specified equity-linked instrument (a “specified ELI”); or

(iv) Another substantially similar payment.

(b) An NPC for purposes of Section 871(m) generally means an equity swap.

(c) An equity-linked instrument (“ELI”) for purposes of Section 871(m) generally means any financial transaction that references the value of one or more underlying equity securities, potentially including: forward contracts, futures contracts, swaps, options, convertible preferred stock, convertible debt instruments and debt instruments linked to underlying equity securities.

The “portfolio interest” exception to interest withholding will not apply to any dividend equivalent payment under a debt instrument.

2. Miscellaneous Issues Regarding Dividend Equivalent Amounts

(a) Any gross amount that references the payment of a U.S.-source dividend, whether actual or estimated, explicit or implicit, is treated as a dividend equivalent to the extent of the amount determined under the 2017 Regulations.

For example, the 2017 Final Regulations treat a price return swap as a transaction that provides for the payment of a dividend equivalent because the anticipated dividend payments are presumed to be taken into account in determining the other terms of the NPC.

(b) A dividend equivalent with respect to a Section 871(m) transaction is reduced by the amount of any deemed dividend arising from adjustments of convertible debt instruments and other ELIs under Section 305 of the Code, such as a change to the conversion ratio or conversion price of a convertible debt instrument. Such a deemed dividend may still be subject to withholding under other Code sections.

(c) A payment referencing a distribution on an underlying security is not a dividend equivalent subject to Section 871(m) to the extent that the distribution would not be subject to U.S. withholding if the long party owned the underlying security directly.

3. The “Delta” and “Substantial Equivalence” Tests

(a) An NPC or an ELI is a specified NPC or specified ELI subject to Section 871(m) if the instrument has a “delta” of 0.8 or greater in the case of a “simple contract,” or if a “substantial equivalence” test is satisfied in the case of a “complex contract,” which is in each case determined at the time of the instrument’s “issuance.”

(i) A “simple contract” is a contract that: (i) references a fixed number of shares (that is known when the contract is issued) of one or more issuers to determine the payments under the contract; and (ii) has a single maturity or exercise date on which all amounts are required to be calculated.

(ii) A contract can still be a simple contract if it has a range of potential exercise dates (such as an option) as long as amounts due under the contract are determined by reference to a single, fixed number of shares on the exercise date.

(iii) A “complex contract” is any contract that is not a simple contract (e.g., if the number of shares of stock referenced by the contract is not fixed, but, rather, varies based on the payoff amount, time of payout or some other factor).

(b) The “delta” of a simple contract is generally a measure of how sensitive the fair market value of an instrument is to changes in the fair market value of the underlying security, generally ranging from one (completely dependent on the value of the underlying security) to zero (completely independent of the value of the underlying security).

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(c) For a complex contract, the "substantial equivalence" generally measures the correlation between the value of the contract and the value of the shares used to hedge the contract at various testing prices. If this correlation is greater than the equivalent calculations performed for a simple contract specified ELI or a specified NPC, then the complex contract is a specified ELI or a specified NPC, as applicable. The Treasury has invited comments to the "substantial equivalence" test.

4. Determining Delta/Substantial Equivalence

(a) The determination of whether an instrument is a specified ELI or a specified NPC is made only on the date the instrument is "issued."

An instrument is treated as issued when it is issued, entered into, purchased or otherwise acquired at its inception or original issuance, including an issuance that results from a deemed exchange pursuant to Section 1001 of the Code.

(b) If one of the parties to a transaction subject to Section 871(m) is a broker or dealer, that party is required to determine whether a potential Section 871(m) transaction is a Section 871(m) transaction and report the timing and amount of any dividend equivalent to the other party.

(c) If neither or both parties are dealers or brokers, then the short party must make such determination and provide such reporting.

5. Time of Withholding

Withholding is required at the later of:

(a) The time the amount of the dividend equivalent is determined, which is the later of: (i) the day prior to the ex-dividend date; and (ii) the record date; and

(b) The time a payment occurs. A payment is deemed to occur:

(i) If money or other property is paid to the long party, which includes the economic benefit to the long party of netted payments within the contract that would otherwise have been made at such time; or

(ii) The long party sells or disposes of the contract, including by virtue of termination of the contract, lapse of the contract, offsets or otherwise.

6. Baskets, Indices and Miscellaneous Situations

(a) Baskets. If a short party issues a contract that references a basket of ten or more underlying securities and hedges the contract with an exchange-traded security that references substantially the same underlying securities, then the short party may use the hedge security to determine the delta of the contract it is issuing.

(b) Combined Transactions. If a long party (or a related person) enters into two or more transactions that reference the same underlying security and the transactions were entered into in connection with each other, then the transactions are combined and treated as a single transaction for purposes of Section 871(m).

(i) If a broker does not have actual knowledge that multiple transactions were entered into in connection with each other, the broker may generally presume the transactions were not entered into in connection with each other if either: (i) the transactions were entered into two or more business days apart; or (ii) the transactions are held in different accounts.

(ii) The 2017 Final Regulations do not provide for the netting of a taxpayer's long and short positions, though the preamble to the 2015 Final Regulations leaves open the possibility of more expansive rules in the future.

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(c) Transactions Referenced to Partnership Interests. Section 871(m) only applies to payments on an NPC or ELI that references a payment on a partnership interest when the partnership: (i) is a trader or dealer in securities; (ii) holds significant investments in securities; or (iii) holds an interest in a lower-tier partnership described in (i) or (ii).

A partnership is considered to hold significant investments in securities if either 25 percent or more of the value of the partnership's assets consist of underlying securities or potential Section 871(m) transactions, or the value of the underlying securities or potential Section 871(m) transactions equals or exceeds $25 million. In this case, dividend equivalent payments are determined by looking through to such partnership's underlying assets.

This affects swaps on "master limited partnerships." Fund managers should have upfront communications with their brokers to understand how they intend to apply this set of rules, including whether they may be over-withholding on a swap if they cannot get sufficient comfort that the particular master limited partnership referenced under the swap is not a covered partnership.

(d) Indices. Transactions that reference a qualified index are generally excepted from Section 871(m). The qualified index exception is designed to provide a safe harbor for widely used passive indices that reference a diversified portfolio of long positions, and is not intended to apply to any index that: (i) is customized or reflects a trading strategy; (ii) is not generally available (i.e., the exception does not apply to over-the-counter transactions); or (iii) targets dividends. Entering into a short position that references component security of a qualified index may invalidate a qualified index Section 871(m) transaction. There is a "de minimis" safe harbor for a short position that reduces the exposure to referenced components securities of a qualified index by five percent or less of the value of the long positions in component securities in the qualified index.

(e) Anti-Abuse Rule. The IRS Commissioner may treat any payment on a transaction as a dividend equivalent if the taxpayer entered into or acquired the transaction with a principal purpose of avoiding Section 871(m). The IRS may also avail itself of general common law and statutory rules in order to challenge transactions that are designed to avoid the application of Section 871(m).

D. Notices 2016-76 and 2017-42

1. Transactions Entered Into During Calendar Year 2017 and 2018

(a) "Delta One" Transactions

(i) The term "delta one" was not defined in either notice. However, the language of the notices supports that only simple contracts can be "delta one" transactions.

(ii) A transaction is a Section 871(m) Transaction if it has a delta of 1.0 on the date of issuance.

(b) Combined transactions (as described above) that have a delta of 1.0 are within the scope of the Notices. However, a broker acting as a short party will only need to combine over-the-counter transactions that are priced, marketed or sold in connection with each other. Long parties would still be responsible for the substantive tax for transactions that are combined under the 2017 Regulations, even if the short party is not responsible for withholding any tax.

(c) The IRS will apply a good faith standard to determine whether long and/or short parties applied the combination, withholding and other rules during 2017 and 2018.

(d) "Qualified derivatives dealers" ("QDDs") will not be subject to tax on dividends and dividend equivalents received in 2017 and 2018 in their equity derivatives dealer capacity or withholding on dividends (including deemed dividends). QDDs must use good faith efforts to comply with the 2017 Regulations through the end of 2018.

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2. Transactions Entered Into After 2018

   (a) All other transactions entered into after 2018 (or significantly modified after 2018) that are considered Section 871(m) Transactions under the 2017 Regulations will be subject to the withholding and substantive tax provisions.

   (b) The IRS will apply a good faith standard for actions taken by taxpayers during 2019 for Section 871(m) Transactions entered into during 2019 that are not "delta one" transactions, including whether taxpayers are properly applying the "substantial equivalence" test.

E. Possible Further Changes

1. A Treasury official announced publicly in November 2017 that the government is considering whether or not to implement the 2017 Regulations for transactions that are "non-delta-one" transactions.

2. The Treasury and the IRS separately are evaluating the 2017 Regulations to "consider possible agency actions that may reduce unnecessary burdens imposed by the regulations" in accordance with Executive Order 13777.

III. Cryptocurrency

A. Characterization of Virtual Currency for U.S. Federal Tax Purposes

1. The Internal Revenue Service ("Service") provided guidance in Notice 2014-21 that virtual currency (e.g., Bitcoin, Ethereum, Litecoin, etc.) generally is treated as property for U.S. federal tax purposes and is not considered a "currency" that would trigger foreign currency gain or loss under section 988 of the Code. As property, the character of gain or loss from the sale or exchange of virtual currency generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Accordingly, taxpayers who hold virtual currency as a capital asset should recognize capital gain or loss on the disposition of such virtual currency.

2. Unlike the CFTC, the Service has not clarified whether or not virtual currencies are characterized as commodities for U.S. federal tax purposes.

3. Some virtual currency, such as Bitcoin, functions as media of exchange. Others, however, exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange. The tax treatment of such virtual currencies or other such digital assets may be characterized as equity interests in an underlying constructive joint venture or association, in which case owners of such digital assets may be taxable on their share of any items of income deemed allocated or deemed distributed from the constructive joint venture or association to them.

B. Considerations for Investment Funds Investing in Virtual Currencies

1. Publicly Traded Partnerships. Investment funds operating as partnerships for U.S. federal tax purposes generally operate in a manner so as to avoid being treated as "publicly traded partnerships" taxable as corporations ("PTPs") within the meaning of Section 7704 of the Code. Many investment funds (especially long-short equity funds) rely on the "qualifying income" exception for PTP purposes. The characterization of virtual currency as a "commodity," or otherwise, could affect an investment fund's ability to satisfy the qualifying income exception. Alternatively, virtual currency investment funds that offer frequent liquidity to their investors could restrict their investor base to fewer than 100 partners in order to satisfy the "100-partner" PTP safe harbor.

2. Mark-to-Market Elections. The mark-to-market election under Section 475(f) of the Code could apply to virtual currencies, if virtual currencies are characterized as "securities" or "commodities."

3. Effectively Connected Income and the Trading Safe Harbors. Investment Funds generally rely on the Section 864(b)(2) safe harbors to avoid treating income and gain from trading in securities and commodities as effectively connected with a U.S. trade or business. The Service has yet to provide

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guidance on whether or not virtual currencies constitute securities or commodities. Furthermore, even if virtual currencies constitute commodities, not all commodities fall under the commodities safe harbor. Only those that are "of a kind customarily dealt in on an organized commodity exchange" and even then, only if the transactions effected in such commodities are "of a kind customarily consummated at such place." The Service currently does not offer guidance on these aspects of the commodities trading safe harbor.

4. Virtual Currencies and ICOs as Deemed Equity Interests. Virtual currencies that exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange, such as certain Initial Coin Offerings ("ICOs"), may be characterized by the Service as equity interests in an underlying constructive joint venture or association for U.S. federal tax purposes. An investment in such virtual currencies or ICOs that would be treated as constructive joint ventures or associations for U.S. federal tax purposes may cause non-U.S. investors or tax-exempt U.S. investors to earn effectively connected income or unrelated business taxable income, respectively. Furthermore, if the constructive joint venture or association were regarded as a foreign corporation, U.S. investors may be subject to certain anti-deferral rules (e.g., PFIC, CFC, etc.) with respect to any income or deemed income of the constructive joint venture or association.

IV. 1 or 30 Compensation

A. General Concept. Compensation related to the investor is the greater of:

1. 1 percent of the net asset value of the interest ("NAV"); and
2. 30 percent of net capital appreciation ("NCA") for the interest for the year.

NCA would be determined without reduction for the 1 percent leg of the formula (i.e., as if the 1 percent were an advance against the 30 percent).

B. Fee vs. Allocation

1. For clients who intend to take their performance-based compensation as an allocation of profits, consider structuring the 1 percent as a fee to the investment manager and the 30 percent as an allocation of profits to the fund's general partner/managing member.
2. Given that the 1 percent is paid regardless of profits, it functions the way the typical management fee would operate. For taxpayers in New York City and other jurisdictions that have an entity level tax on business income earned by partnerships, separating the 1 percent out generally protects the 30 percent from such tax under current tax law.
3. The incentive allocation would be 30 percent of NCA minus 100 percent of the Management Fee.

C. Shortfalls

1. Example. Management Fee = 30 and NCA = 90; 100 of NCA would have been needed to achieve a performance-based profits allocation of 30, assuming no Management Fee had been paid.
2. Option 1 (investor favorable). The fund is viewed as having underperformed by 10, which would eat away at future years' 30 percent calculations.
3. Option 2 (manager favorable and more common when the carry percentage is lower than 30 percent). The excess of the 1 percent over the 30 percent is an addition to the loss recovery account. The loss recovery account ("LRA") in this example would be increased by 3.

   Note: if there is net depreciation (without giving effect to the Management Fee), the LRA typically is increased as if the Management Fee were a full advance of the carry. For example, if the Management Fee is 30 and the fund loses 70, the LRA would be increased by 170 (70 of net capital depreciation + 30/.3).

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D. Beating an Index. 1 or 30 compensation deals are often present when the performance-based compensation is based on outperforming an index. Beating an index poses a separate set of tax considerations for constructing a profits allocation, but that should not be confused with the 1 or 30 construct itself.

V. Side Letter Negotiations

A. It has become common for investors to ask for side letter provisions related to investments in both private equity funds and hedge funds. Investors are requesting broader side letter provisions, including the following.

1. Investors generally do not want to directly be subject to non-U.S. taxes or non-U.S. filing requirements (other than potential filings related to withholding taxes) in non-U.S. jurisdictions. If a manager agrees to such a representation, such manager may need to consult with counsel or other advisers in the relevant non-U.S. jurisdiction when:

   (a) making investments in non-U.S. jurisdictions;

   (b) setting up offices in non-U.S. jurisdictions; or

   (c) hiring agents or employees in non-U.S. jurisdictions.

2. However, managers may not want to promise investors that they will consult with counsel or other advisers for every investment if they are making multiple investments in the same jurisdiction or otherwise are familiar with the laws of such jurisdiction. This representation is more manageable in the private equity context where there are a smaller number of investments, but this representation may be administratively burdensome and costly when a fund has numerous investments or is investing in other managers or funds.

3. Non-U.S. investors may request representations related to income effectively connected with a U.S. trade or business (“ECI”) or income from commercial activities (“CAI”). If there is a fund specifically set up for non-U.S. investors that are sensitive to ECI or CAI, this representation is often rejected in any parallel vehicle as many managers do not want to limit investments in a fund that is majority owned by investors that are not sensitive to ECI or CAI. Further, if a fund is treated as a corporation for U.S. tax purposes, a manager may want to push back on an ECI or CAI representation at the fund level if they want to continue to make investments that generate ECI or CAI if managers believe the after-tax return provides for an attractive investment. Managers should note that the CAI rules may be broader than the ECI rules, so carve-outs for certain items (such as certain real estate holdings) may need to be included in a CAI representation.

4. Investors are increasingly concerned about disclosing non-public information about themselves or their beneficial owners. These requests may arise in non-tax provisions, but could have implications in complying with tax law or making appropriate tax filings. Given the increasing number of laws (such as FATCA and CRS) that require disclosure of investor information (including information regarding beneficial ownership and controlling persons), managers need to make sure that confidentiality provisions allow for disclosure of information: (i) to comply with law; and (ii) that is necessary or desirable to reduce or eliminate withholding or other taxes.

5. Investors are requesting provisions related to the partnership audit rules. In particular, tax-exempt and non-U.S. investors are requesting provisions that require a manager to endeavor to reduce any imputed underpayment as a result of the status of the investor, and, if there is a reduction, require the benefit of such reduction to be allocated to such investor. Prior to making such representation, managers must confirm that they have the flexibility to specially allocate such expenses or otherwise limit the provision so that it only applies to the extent permitted under the fund documents.

6. Investors are requesting more specialized reporting and tax information, in particular, in the context of an investor that is itself an entity that has promised specialized reporting to its underlying investors. If the tax reporting and information requests relate to compliance with non-U.S. laws, managers may want to consult with advisers in the local jurisdictions to determine how burdensome such reporting will be for

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the fund and the costs of complying with such requests. Managers will often require the requesting investor to bear the costs of any investor-specific reporting. Additional reporting may significantly increase the administrative burden and costs to a fund, so managers should consider if they have appropriate resources to deal with such additional reporting and information requests prior to agreeing to such provisions.

B. In order to minimize the potential for varying provisions, certain managers have built side letter terms into the fund's offering documents to provide all investors with the same terms.

VI. Tax Reform

A. Carried Interest/Incentive Allocation

1. Changes to Taxation of Carried Interest/Incentive Allocation

(a) If an "Applicable Partnership Interest" is held by a taxpayer, then the taxpayer's long-term capital gain with respect to such interest necessitates a holding period exceeding three years.

(b) An "Applicable Partnership Interest" is a partnership interest transferred to a taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in an "Applicable Trade or Business."

(c) An "Applicable Trade or Business" is an activity conducted on a regular, continuous and substantial basis which consists of: (i) raising or returning capital; and (ii) either investing, disposing, identifying or developing "Specified Assets."

(d) "Specified Assets" are securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the foregoing, and an interest in a partnership to the extent of the proportionate interest in any of the foregoing.

(e) An Applicable Partnership Interest does not include: (i) an interest held by a corporation; or (ii) a capital interest which provides the taxpayer with a right to share in partnership capital commensurate with (x) the amount of capital contributed (determined at the time of receipt of such interest) or (y) the value of such interest subject to tax under Section 83 upon the receipt or vesting of such interest.

2. Switching From an Incentive Allocation to an Incentive Fee

(a) Fund Tax Considerations

(i) Offshore fund generally is indifferent and may benefit in an intermediate fund structure if the intermediate fund entity is eliminated as a result.

(ii) Onshore fund appears to have only downside risk. If the fund is an "investor" or has investments that are treated as investment activities, rather than trading activities, non-corporate taxable investors would not be able to deduct the incentive fee.

(b) Benefits to Manager

(i) If the manager is a limited partnership, the manager's profits allocations to its active limited partners are currently not subject to the 3.8 percent Medicare tax or the 3.8 percent tax on net investment income (i.e., Obamacare tax). An incentive allocation remains subject to the 3.8 percent net investment income tax.

(ii) Cash method managers may get a year of deferral since the fee is typically paid in the following January, while allocation reflects income realized as of Dec. 31.

(iii) If the manager earns carry based on annual outperformance of an index, there should be no tax-based limitations on paying the fee as it is earned.

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(c) Potential Problems for the Manager

(i) Side pockets and multi-year fees are generally subject to Section 457A of the Code, including potential additional taxes of 20 percent and premium interest, whereas incentive allocations are generally not subject to those rules.

(ii) Long-term capital gains treatment still exists for "qualified dividends" and 60 percent of the mark-to-market income on "Section 1256 contracts."

(iii) Fees are generally subject to state and local taxes, if any, where the manager is based (e.g., the New York City Unincorporated Business Tax).

(iv) For investments held longer term, the fee may accelerate taxation.

(v) In the case of an offshore fund, U.S. withholding tax may reduce the profits on which the incentive fee is based, whereas such tax may be recoverable by the manager earning an incentive allocation.

B. Sale of Partnership Interests by Foreign Partners

1. The IRS held in a 1991 Revenue Ruling[1] that gain on the sale of a partnership interest by a foreign partner was subject to tax in the U.S. to the extent of such partner's share of unrealized net gain in any ECI assets held by the partnership.

2. In 2017, the Tax Court held in *Grecian Magnesite*[2] that a foreign partner was not subject to U.S. federal income tax on gain from the sale of a partnership interest in a partnership conducting business in the U.S., except for gain attributable to the partnership's USRPIs. The IRS has appealed the decision of the Tax Court.

3. The Act effectively reverses *Grecian Magnesite* by revising Code Section 864(c) to provide that gain or loss realized by a foreign partner from the sale or exchange of a partnership interest occurring on or after Nov. 27, 2017 is treated as effectively connected with a U.S. trade or business to the extent that the seller of such interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of the sale or exchange.

4. The Act adds a new Code Section 1446(f), which requires the buyer of a partnership interest to withhold 10 percent tax on the amount realized by the seller on the sale or exchange of a partnership interest occurring after Dec. 31, 2017 if any portion of the seller's gain on the sale of the interest would be effectively connected income under revised Code Section 864(c), unless the seller certifies that the seller is non-foreign. In the event the buyer fails to withhold the correct amount of tax, the partnership shall deduct and withhold from distributions to the buyer an amount equal to the tax that the buyer failed to withhold from the seller.

5. The IRS issued Notice 2018-08 on Dec. 29, 2017, which suspends withholding under Code Section 1446(f) on the transfer of any interest in a PTP as defined in Code Section 7704(b) until regulations or other guidance have been issued under Code Section 1446(f).

C. Deductibility Issues

1. Limitation on Deductibility of Business Interest Expense

(a) Section 163(j) of the Code limits the deduction of business interest expense attributable to a trade or business generally to the sum of the taxpayer's (x) business interest income and (y) 30 percent of adjusted taxable income relating to a trade or business (calculated by excluding business interest expense and business interest income). For these purposes, business interest expense and business

[1] Rev. Rul. 91-32

[2] *Grecian Magnesite Mining* v. *Commissioner*, 149 T.C. No. 3 (July 13, 2017).

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interest income do not include “investment interest” or “investment income,” respectively, within the meaning of Section 163(d) of the Code.

(b) Any business interest expense not deductible pursuant to the foregoing limitation is treated as business interest expense of an eligible taxpayer that carries forward to succeeding taxable years, subject to the same limitation.

(c) The limitation on the deductibility of business interest expense does not apply to interest attributable to an electing real property trade or business and certain other businesses.

(d) In the case of a partnership, the limitation is determined at the partnership level. To the extent the limitation applies at the partnership level to reduce the business interest expense deductible for a year, such excess shall carry forward to succeeding years and, subject to certain limitations, may be deducted by an eligible partner to the extent the partnership has sufficient excess taxable income that was not offset by business interest expense in such year. Any amount not utilized will form part of the investor’s adjusted basis in its interest in the partnership only at the time such investor disposes of its interest.

2. Limitation on Deductibility of Excess Business Losses; Changes to Rules on NOLs

(a) Under a new provision (Section 461(l) of the Code) applying to noncorporate taxpayers, if a trade or business activity generates losses in excess of a taxpayer’s trade or business income, a maximum of $250,000 ($500,000 if filing a joint return) of the losses can be used to offset investment income for the year.

(i) Any excess business losses that are disallowed by this provision cannot be used to offset tax liability on investment income, but rather will be carried forward as net operating losses (“NOLs”) that can be used in subsequent years.

(ii) This provision is not permanent; it applies only for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

(b) For losses arising in taxable years beginning after Dec. 31, 2017, a deduction for NOLs is limited to 80 percent of taxable income.

(i) Any unused NOLs can be carried forward indefinitely.

(ii) NOLs can no longer be carried back (except for certain losses incurred in a farming trade or business).

(iii) NOLs carried forward from taxable years beginning before Jan. 1, 2018 are not subject to this new 80 percent limitation.

3. Suspension of Miscellaneous Itemized Deductions

Miscellaneous itemized deductions for individuals under Section 67 of the Code are suspended for any taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2026.

4. Reduction in Corporate Tax Rate and Limitation on Deductibility of State and Local Taxes

(a) The corporate income tax rate is reduced from 35 percent to 21 percent for taxable years beginning after Dec. 31, 2017.

(b) For individual taxpayers, the amount of state and local taxes (including income and property taxes) permitted to be deducted is limited to $10,000 (aggregated).

The $10,000 aggregate limitation is scheduled to sunset in 2026; it applies only to tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

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5. Deduction for Qualified Business Income of Pass-Thru Entities

   (a) Twenty percent deduction for taxpayers other than "C" corporations for Qualified Business Income ("QBI") and certain other income.

   (b) QBI deduction means the sum of the:

      (i) Lesser of either the taxpayer's "Combined QBI" amount or 20 percent of the taxpayer's ordinary income (excluding capital gains and qualified cooperative dividends); plus

      (ii) Lesser of either 20 percent of the taxpayer's qualified cooperative dividends or taxpayer's ordinary income (excluding capital gains).

   (c) Combined QBI means the sum of the:

      (i) Lesser of either taxpayer's QBI from a qualified trade or business, or a combination of a percentage of W-2 wages and/or basis of depreciable property; plus

      (ii) Twenty percent of the total "qualified REIT dividends" and "qualified PTP income."

   (d) Investment management and most investing funds are not "qualified trades or businesses." Funds whose trade or business does qualify (e.g., certain lending funds) generally do not pay W-2 wages.

      (i) For most investment funds and investment managers, the first clause of Combined QBI will be $0.

      (ii) Funds can still benefit from the QBI deduction from "qualified REIT dividends" and "qualified PTP income."

D. Controlled Foreign Corporations ("CFCs")

   1. Modification of definition of United States Shareholder.

      The definition of "United States Shareholder" of a CFC is amended to include U.S. persons that own 10 percent or more of the total value of shares of all classes of stock of a foreign corporation.

   2. Elimination of requirement that corporation must be controlled for 30 days before Subpart F inclusions apply.

      Amendment eliminates requirement that 10 percent U.S. shareholders of a foreign corporation must only include their pro rata share of Subpart F income of a foreign corporation that was a CFC for an uninterrupted period of 30 days or more during any taxable year. 10 percent U.S. shareholders must now include their allocable share of Subpart F income if the foreign corporation has been a CFC at any time during any taxable year.

   3. Both CFC amendments effective for taxable years of foreign corporations beginning after Dec. 31, 2017, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

E. New Excise Tax on Certain Private Colleges and Universities; UBTI

   1. Excise Tax Based on Investment Income of Private Colleges and Universities

      Net investment income of certain private colleges and universities is subject to a 1.4 percent tax. Such income is calculated in the same manner in which private foundations calculate their net investment income. Effective for taxable years beginning after Dec. 31, 2017.

   2. UBTI

      Under a new provision (Section 512(a)(6) of the Code), UBTI must be calculated separately with respect to each separate trade or business with losses usable only against the applicable related trade or business and not against all UBTI generally.

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F. Accounting Methods – Certain Special Rules for Taxable Year of Inclusion

1. New Section 451(b) provides that accrual basis taxpayers must include certain types of income in gross income when an item of income (or portion thereof) is taken into account as revenue in an "applicable financial statement" of the taxpayer. Does not apply with respect to items of gross income for which a taxpayer uses a "special method of accounting" (other than one in Sections 1271 through 1288). The period for taking into account any Section 481 adjustments with respect to income from a debt instrument with OID is six years.
2. New Section 451(c) provides that accrual method taxpayers can elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income is also deferred for financial statement purposes.
3. Effective for taxable years beginning after Dec. 31, 2017 (Dec. 31, 2018 for instruments with OID).

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