

Funds in Focus 2018: Private Investment Funds Annual Review Conference

Tax Reform: One Year Later

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Proskauer»



Benefits of an Opportunity Fund

- Three potential tax benefits:
 - First, a taxpayer may elect to defer tax on capital gain from the sale or exchange of property with an unrelated person by investing the gain as equity in an opportunity fund within 180 days after the sale or exchange. The deferral ends on December 31, 2026, or sooner if the taxpayer sells its interest in the opportunity fund, and at that time the taxpayer must recognize the gain (and pay tax) with respect to the original property.
 - Second, if the taxpayer holds its interest in an opportunity fund for five years, it can step up its basis in the opportunity fund by an amount equal to 10% of the deferred gain with respect to the original property and, if the taxpayer holds its interest in the opportunity fund for seven years, it can step up its basis in the opportunity fund by an amount equal to an additional 5% of the deferred gain with respect to the original property (for a total of 15%). The stepped up basis reduces the amount of gain recognized by the taxpayer at the end of the deferral period.

Benefits of an Opportunity Fund

- Three potential tax benefits: (cont'd)
 - Finally, if the taxpayer holds its interest in the opportunity fund for at least 10 years, it can step up its basis in its interest in the opportunity fund to the fair market value of the interest on the date the interest is sold (enabling the taxpayer to eliminate income tax on any post-acquisition capital gain in its opportunity fund interest, including any capital gain attributable to leverage incurred by the fund).

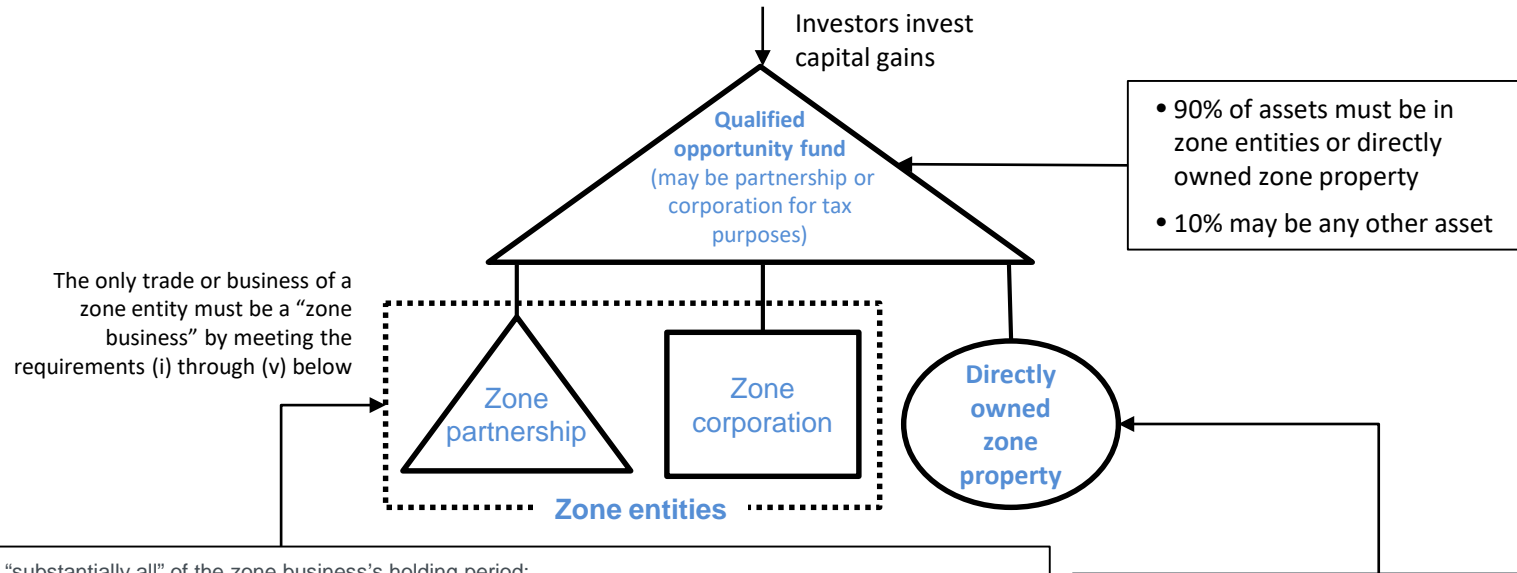
Contributing “Gain” to a Qualified Opportunity Fund

- Generally 180 days from date of the sale or exchange.
- However, if the gain is realized by a partnership and the partnership does not elect to defer the gain, then any partner can elect to defer its share of the gain. In that case, if the partnership is a calendar year partnership, the partners generally have 180 days from December 31 of the year of the sale to make the election.
- Gain is generally determined on an asset by asset basis (i.e., gains are not netted). However, there have been reports that the IRS believes that if gains are earned through a partnership and a partner elects, then only net gains can be deferred, but it is possible that if the partnership reports on an asset by asset basis, then gains are not netted.

Contributing “Gain” to a Qualified Opportunity Fund

- If a taxpayer has “substantially diminished” her risk of loss with respect to personal property **at any time**, even if the property is not actively-traded, then gain from the sale of the property is not eligible for deferral.
 - Thus, if appreciated personal property was a position in a straddle for one day ten years ago, capital gain realized upon disposition of the property is not eligible for deferral.
 - If the taxpayer had entered into a contract to sell her business ten years ago, but the sale ultimately never went through, and the taxpayer sells the business in 2018, arguably the gain is not eligible for deferral because the 10 year old sales contract substantially diminished the taxpayer’s risk of loss.

Opportunity Zone Program



For "substantially all" of the zone business's holding period:

- (i) At least 70% of the tangible property owned or leased by the zone business must be zone business property,
- (ii) At least 50% of the gross income of the entity must be from the active conduct of the zone business,
- (iii) A "substantial portion" of the intangible property of the zone entity must be used in the active conduct of the zone business,
- (iv) Less than 5% of the average of the aggregate unadjusted bases of the zone entity's property may be attributable to "nonqualified financial property" (stock, debt, etc.) unless it qualifies for the "working capital safe harbor", and
- (v) The zone entity cannot operate a "sin business".

Tangible property that ceases to be zone business property remains zone business property for five years.

Directly owned zone property must be "zone business property":

- (i) it must be tangible property used in a trade or business,
- (ii) it must be acquired from an unrelated person after December 31, 2017,
- (iii) either the original use of the property in the zone must begin with the fund or the fund must invest at least the amount of the purchase price to improve the property, and
- (iv) during substantially all of the holding period for the property, "substantially all" of the use of the property is in the zone as part of a trade or business.

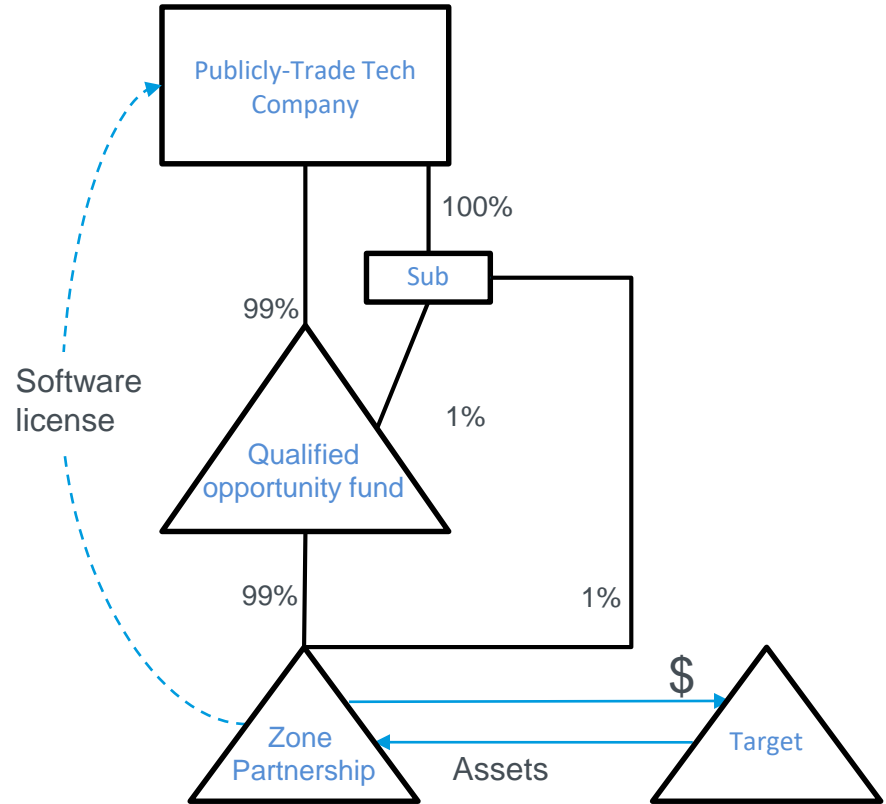
Software Company Acquisition

Tech Company contributes cash to the fund, which contributes the cash to the zone partnership, which uses most of the cash to buy target, and the rest to lease and renovate space in the zone, where the programmers sit.

The zone partnership licenses software to Tech Company.

In 10 years, Tech Company sells the QOF for \$1 billion.

- Taxable or tax-free?
- Is at least 50% of the gross income of the partnership derived from the active conduct of a trade or business in the opportunity zone?
- Is licensing software to Tech Company the “active conduct of a trade or business”? Is the business “in” the zone?



Special Rules for Land and Improvements on Land

- Revenue Ruling 2018-29.
- If an opportunity fund purchases a property located wholly within an opportunity zone for \$800, and \$480 of the purchase price is attributable to the land and \$320 is attributable to a building, then the opportunity fund need invest only \$320 to improve the building, and the full \$800 purchase price plus the \$320 of improvements to the building can all qualify as zone business property.
- If the property is purchased for \$1,000,100,000 and \$1 billion is attributable to the land and \$100,000 is attributable to a shack, then only \$100,000 needs to be spent to improve the shack, and the full \$1.001 billion plus \$100,000 can all qualify as zone business property.
- Treatment of vacant land is unclear.
 - Can \$1 billion of vacant land be purchased, paved, and used for an “active” parking lot (without any improvements)?



Overview

Overview: Section 1061

- Applies to an “applicable partnership interest” – an interest in a partnership that is transferred to (or held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or a related person, in any applicable trade or business.
- “Applicable trade or business” – Any activity conducted on a regular, continuous, and substantial basis which, **regardless of whether the activity is conducted in one or more entities**, consists, in whole or in part, of:
 - Raising or returning capital, and
 - Either (a) investing in (or disposing of) **specified assets** (or identifying specified assets for such investing or disposition), or (b) developing specified assets

Overview: Section 1061

- If applicable, capital gains from an asset with a holding period of 1-3 years re-characterized as short term capital gains
 - Only applies to holding periods determined pursuant to Code Section 1222(3) and (4)
 - No grandfathering for existing carried interest arrangements
- Special rules apply for transfers to certain “related persons”

Overview: Section 1061

- **“does not apply to”** an interest held by a person who is employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity
- **“does not include”** any interest held directly or indirectly by a corporation
- **“does not include”** any capital interest in a partnership which provides the taxpayer with the right to share in partnership capital commensurate with (i) the amount of capital contributed (determined at that time of receipt of such partnership interest, or (ii) the value of such interest subject to tax under §83 upon the receipt or vesting of such interest
 - Open questions: Hedge fund reinvestment; fee waivers; no fees/carry on GP capital?
- **Special Rule:** to the extent provided by the Secretary, the recharacterization rule shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors



Planning Opportunities

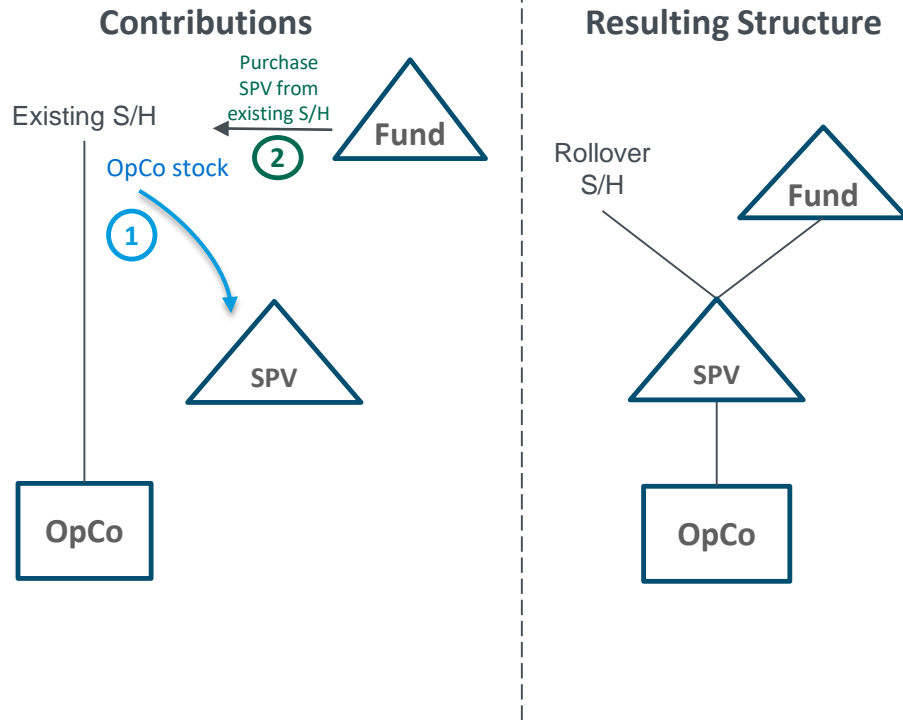
Planning Opportunity: Statute Not Applicable Based on Particular Facts

- Partnership interest held directly or indirectly by a corporation is not an “applicable partnership interest” with respect to such corporation
 - Opportunity: structure carry vehicle as a corporation
 - Notice 2018-19 eliminates S-corps planning opportunity
- Recharacterization rules only apply to holding periods pursuant to Section 1222(3) and (4)
 - Opportunity: If portfolio includes a pass through entity, structure disposition as asset sale, rather than sale of partnership interests
- Review fund investment activities to determine if “applicable partnership interest” and “applicable trade or business” tests are satisfied.

Adjust Economic Deal – Investment Level

- **Planning Opportunity**: utilize dividends in order to minimize exit proceeds that will be subject to re-characterization rule
- **Considerations**
 - FDAP withholding for non-US persons
 - Dividends recast as gain from sale?
 - Economic implications to other holders?

Planning Opportunity: Tack Holding Period of Prior Owners



Planning Opportunity

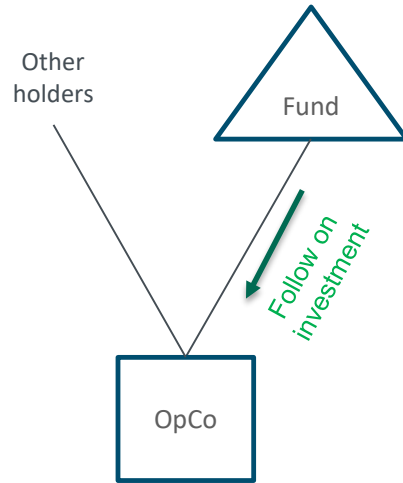
Contribution of target OpCo stock to a SPV (partnership for US tax purposes) followed by purchase of SPV interest by Fund

Considerations

- Additional cost and complexity of SPV
- Economics and governance of SPV
- Non tax considerations
- Partnership anti-abuse?
- Divided holding period for future investments in OpCo

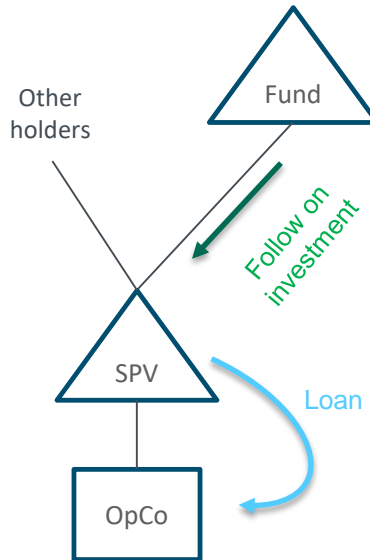
Planning Opportunity: Avoid New Holding Period for Follow-Ons

Follow On Investment



New holding period for follow-on investment

Alternative: SPV/Loan



No new holding period for SPV's equity in OpCo

Planning Opportunity

Fund follow-on rounds through debt rather than equity

Considerations

- Additional cost/complexity of SPV
- Economics and governance of SPV
- Non tax considerations
- Partnership anti-abuse?
- FDAP withholding?

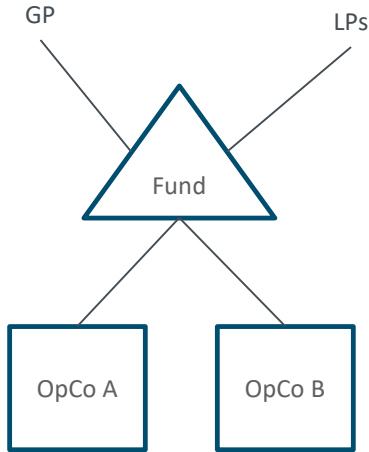
Alternative

- Fund follow-on rounds through preferred equity with limited upside

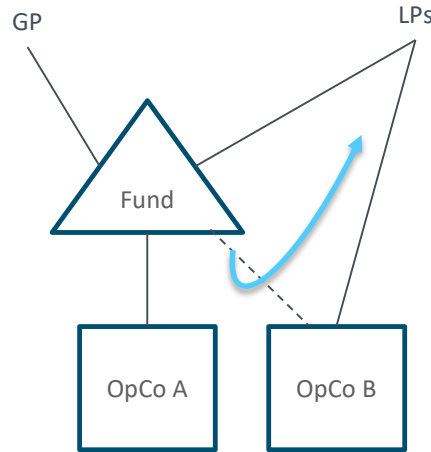
Adjust Economic Deal – Fund Level Stock Distributions to GP

- **Planning Opportunity**: distribute OpCo stock in kind
 - Sponsor holds stock until gains eligible for LTCG
 - Sponsor receives shares with longer hold period, and shares with shorter holding period distributed to other partners
- **Considerations**
 - Non tax considerations
 - LPA authority

Adjust Economic Deal – Fund Level – Stock Distributions to LPs

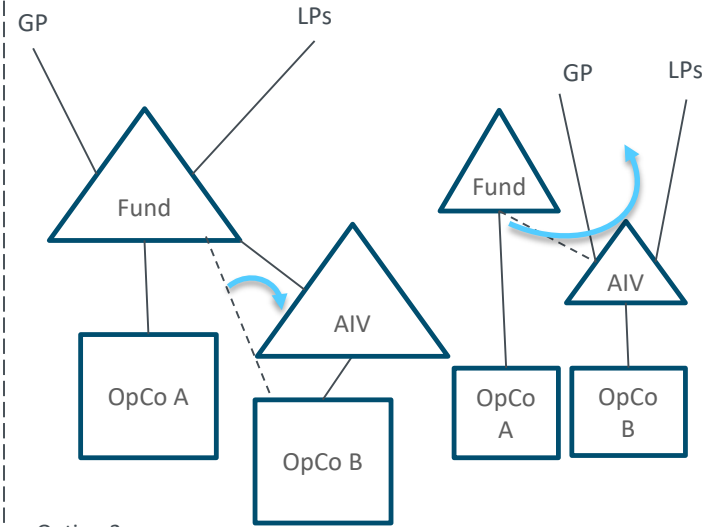


- Assume sale of OpCo B, with <3 year holding period and carry allocated but no carry distributable.
- Disregard GP capital.



Option 1

- Distribute OpCo B stock to LPs, and LPs sell.
- GP allocated gain from distribution in kind, but not taxable → subsequent distributions to GP taxable because of distribution in excess of basis.
- Practical limitations for LPs to effect a sale.
- LPA limitations on ability to distribute illiquid securities?



Option 2

- Address practical issues arising from LPs selling securities by using an AIV.
- Fund contributes OpCo B stock to AIV and distributes AIV interests to Partners; AIV sells OpCo B stock.
- Various tax risks.

Adjust Economic Deal – Fund Level Waiver of Carry Allocations, Option A

- **Planning Opportunity:** “hard wired” waiver
 - No carried interest earned from assets with a holding period that is not more than 3 years
 - “Catch up” allocation from assets with a holding period that is more than 3 years
- **Considerations**
 - Business risks
 - Potential GP-LP conflict issues
 - Risks of changes in law

Adjust Economic Deal – Fund Level Waiver of Carry Allocations, Option B

- **Planning Opportunity**: Discretionary gain allocation waiver
 - Same as “hard wired” approach, but waive allocation of gain on a deal-by-deal basis
- **Considerations**
 - Make-whole only out of future net appreciation in value?
 - Timing for waiver?
 - Make-whole allocations arising in same year?
 - Tax items to include in make-whole allocation?

Key Take Away

- Evaluate alternative structures at time of investment
- Alternative structures for dispositions are possible, but not without complexity
- Consider ability for “fund level” planning

Management Company – Choice of Entity

- Limited Partnership (or LLC)
- C–corp
- S–corp

Management Company – Choice of Entity

- Limited Partnership (or LLC)
 - No U.S. federal entity-level tax
 - Fee flows through as ordinary income (37%)
 - LP (not LLC) may be able to mitigate 3.8% self-employment tax

Management Company – Choice of Entity

- Limited Partnership (or LLC)
 - Flexibility to structure bespoke economics
 - Easy to restructure tax-free
 - Attractive to third-party investors

Management Company – Choice of Entity

- Limited Partnership (or LLC)
 - No ability to defer income taxation
 - Owners cannot also be employees (K-1s)
 - Owners subject to state tax return filings

Management Company – Choice of Entity

- C-corp
 - Federal entity-level tax of 21%
 - Dividends taxed at 23.8%
 - Effective tax rate of 39.8% (assuming all profits paid out as dividends)

Management Company – Choice of Entity

- C-corp
 - Effective tax rate essentially same as LP/LLC (except C-corp cannot mitigate 3.8% self-employment/net investment income tax)
 - If retain profits, only 21% corp tax (assuming not a personal holding company (PHC))
 - Potential exposure to accumulated earnings tax (AET)
 - Future administration / Congress may seek to raise corp tax rate

Management Company – Choice of Entity

- C-corp
 - Another approach is to run C-corp at near break even and pay out all profits as compensation
 - Owners can be W-2 employees and protected from state tax filings; can't mitigate employment taxes
 - Reasonable comp exposure

Management Company – Choice of Entity

- C-corp
 - May result in higher state income tax than LP/LLC, but overall state and federal tax may be lower (C-corp can deduct state taxes)
 - May be subject to different state apportionment rules than LP/LLC
 - Difficult to restructure; corp-level tax to liquidate if company has value
 - Not as attractive to third-party investors
 - More difficult to have complex economic arrangements

Management Company – Choice of Entity

- S-corp
 - No U.S. federal entity-level tax on fee income
 - Fee passes through to owners as ordinary income (37%)
 - No deferral

Management Company – Choice of Entity

- S-corp
 - Can mitigate self-employment tax on income in excess of reasonable comp
 - May be subject to state income tax at entity level, resulting in higher state tax than LP/LLC
 - May limit state tax filings for owners

Management Company – Choice of Entity

- S-corp
 - Difficult to have complex economics (only 1 class of shares)
 - Liquidation can trigger corp-level tax if company has value
 - Limited to certain types of permissible shareholders
 - Generally an inferior option for management companies versus LP/LLC or C-corp

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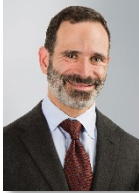
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