

# Investment Management and Hedge Funds: What's Happening Now

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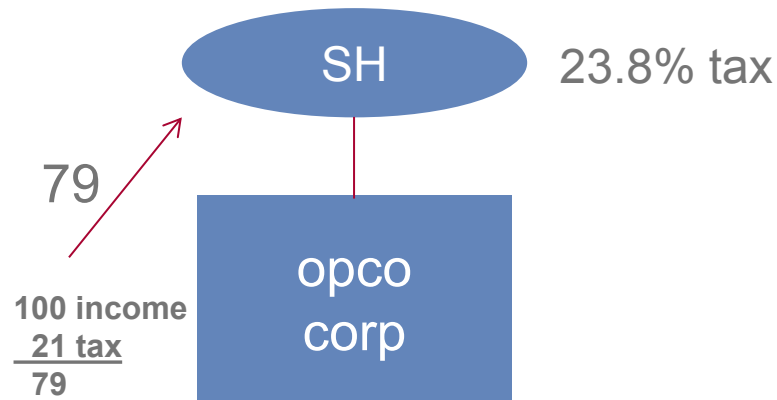
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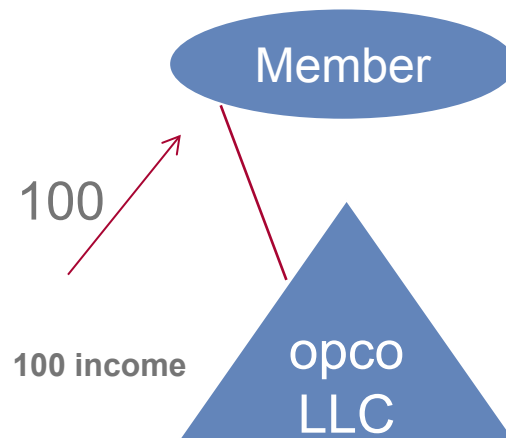
# Select Topics of Tax Reform for Businesses

- ▶ Rates & Choice of Entity
  - 20 % deduction
- ▶ Current Expensing of Tangible Property
- ▶ Limitation on Interest Deductibility
- ▶ Loss Limitation for Investors

# Rates & Choice of Entity



- ▶ Corporate rate 21%
- ▶ SH rate 23.8%
- ▶ Total rate 39.8%
- ▶ Don't forget SALT!

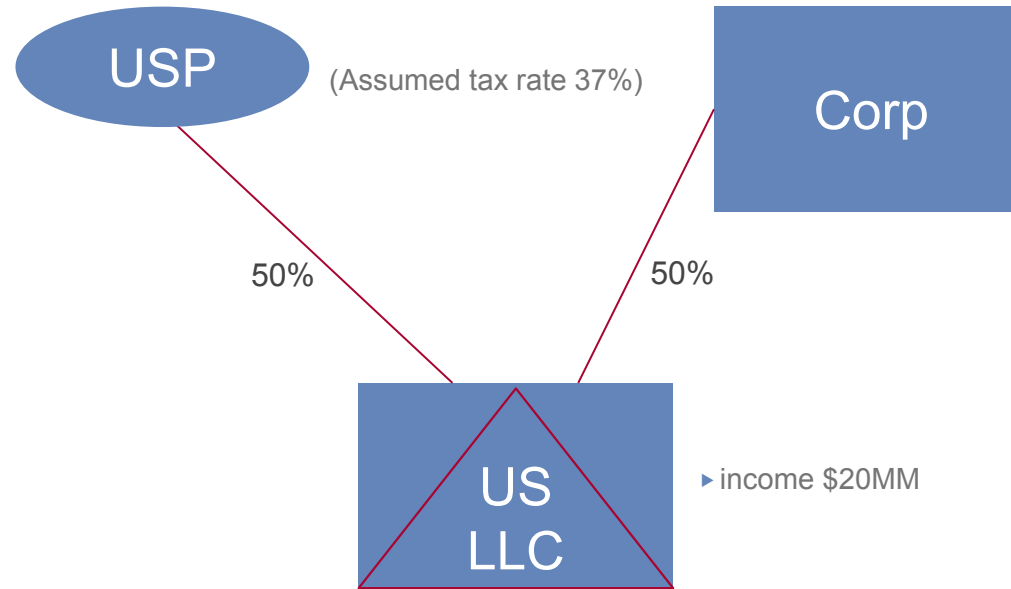


- ▶ Top individual rate 37%
- ▶ If 20% deduction is available, ETR 29.6%
- ▶ Don't forget SALT!

# The 20% Deduction (2018 through 12/31/25)

- ▶ Available to individuals, trusts & estates
- ▶ Individuals deduct up to 20% of qualified business income (“QBI”)
  - from S corps, LLCs, sole proprietorships
- ▶ Specified services excluded
  - health, law, accounting, actuarial services, performing arts, consulting, athletics, investment banking services, employee, principal asset is repetitive or shall govern more employees
- ▶ Also applies to qualified REIT dividends and qualified PTP income

# Taxation of Pass Through Income – The Basics



- ▶ US LLC is actively involved in a qualified business (other than a specified business), \$10MM is allocated to USP on her K-1
- ▶ Assuming US LLC has sufficient W-2 wages or assets, USP may be able to claim 20% deduction of taxable income
  - if USP can claim deduction of 20% of \$10MM, USP has reduced the assumed tax rate of 37%, to an effective tax rate of 29.6%

# Pass Through Details

- ▶ The deductible amount for a qualified trade or business (QTB) is limited to the lesser of
  - 20% of Qualified Business Income, or
  - the greater of
    - (i) 50% of W-2 wages for QTB or
    - (ii) sum of 25% of W-2 wages for QTB and 2.5% of unadjusted basis of all qualified property immediately after acquisition
- ▶ Result is that the 20% deduction may be reduced if there aren't sufficient W-2 wages or assets supporting the business
- ▶ Only applies 2018-2025

# Pass Through Details

- ▶ Qualified trade or business – only if effectively connected with conduct of trade or business in US (or Puerto Rico under certain rules)
  - QBI doesn't include:
    - investment income
    - reasonable compensation/guaranteed payments
    - income from a specified service business

# Pass Through Details

- ▶ Specified service business
  - include performance of services in law, health, accounting, actuarial science, consulting, athletics, financial services, etc. and any trade or businesses where the principal asset of such trade or business is the reputation or skill of one or more of its employees.
  - Also includes certain investment management services
- ▶ There is a limited exception for specified service businesses, but only up to a threshold of (\$157,500 + 50,000 for a single filer of \$315,000 + 100,000 for married filing jointly)
  - This threshold amount also applies to QTB. If the QBI is under the threshold amount, the wage limitations don't apply
  - Solo practitioner lawyers may use this



# Thinking of the Impact on Deal Structures

- ▶ Is a C Corp with 21% federal rate preferred?
  - Great for cash flow (watch AET)
  - Still have double tax on distributed earnings (37% federal rate)
  - Will earnings be reinvested in the business or distributed out?
  - On sale, could sale qualify for small business rate of 0% for individuals?
  - Can an asset sale be done more efficiently?

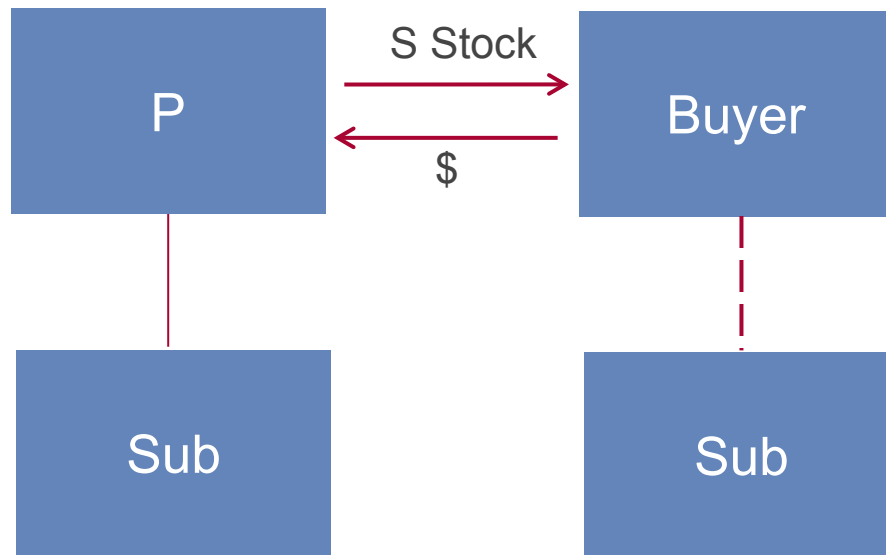
# Thinking of the Impact on Deal Structures

- ▶ Is a flow through preferred?
  - If QBI, at best, maximum federal tax rate for individual is 29.6% through 2025
  - Allows for single level of tax on distributed earnings
  - On exit, does it matter if you sell assets or LLC units?
  - Whether operating distributions are anticipated or if proceeds will be reinvested in the business
  - How long the exit will be (*i.e.*, factoring into the structure equation the sunset on the deduction (and the lower rates))

# Current Expensing

# Current Expensing of Tangible Property

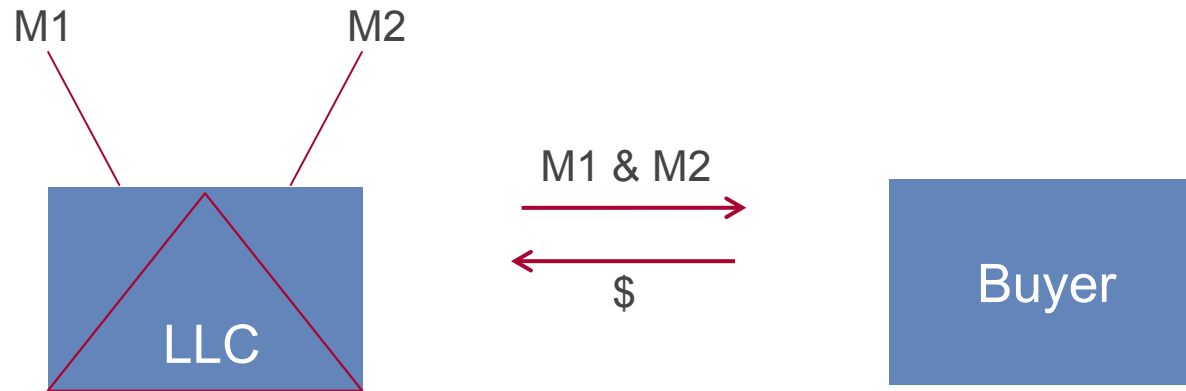
- ▶ Generally, tangible property with recovery period of 20 years or less and certain computer software. Doesn't apply to goodwill.



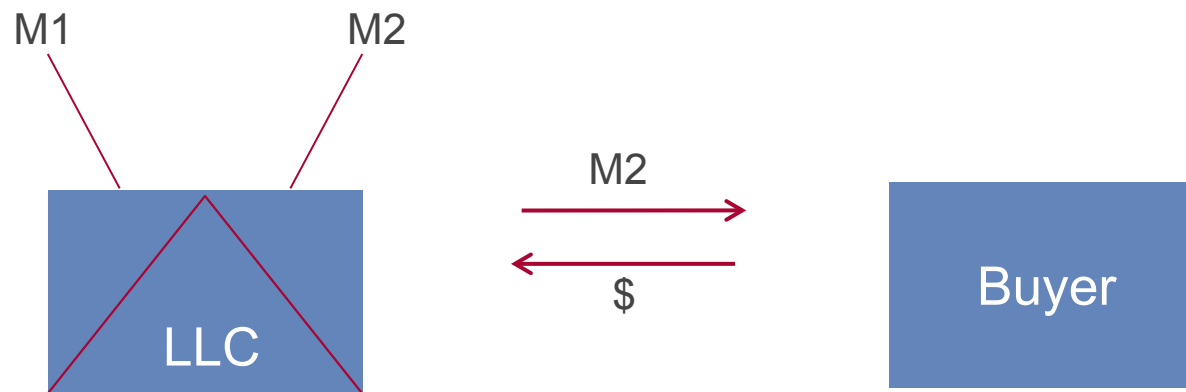
- ▶ Buyer pays \$100MM for Sub
- ▶ Makes §338(h)(10) elect

- ▶ Step up basis in all tangible assets, deduct in buyer tax return
- ▶ If NOL is created, carried forward indefinitely, but limited to 80% of taxable income

# Current Expensing of Tangible Property



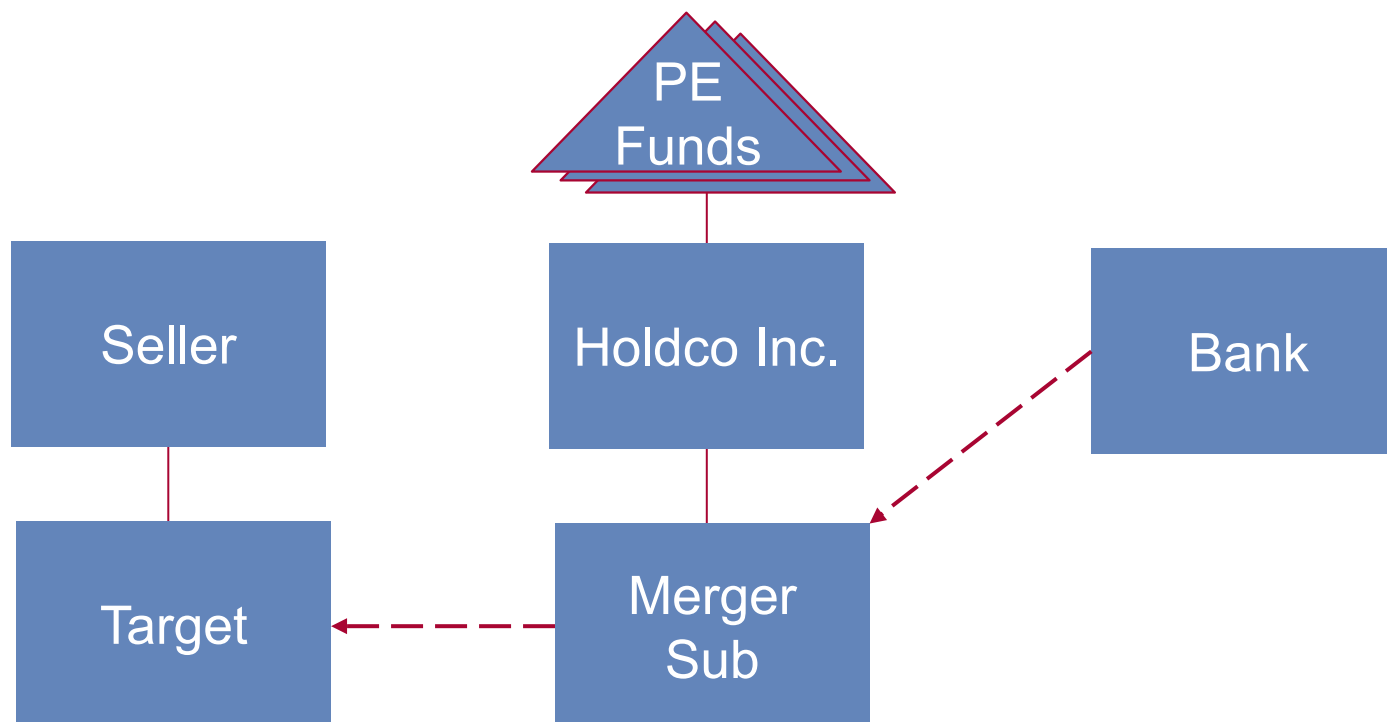
- ▶ Rev Rul 99-6 → asset purchase by Buyer, full expensing



- ▶ Buyer makes §754 election. Can Buyer expense the cost attributable to the tangible assets?

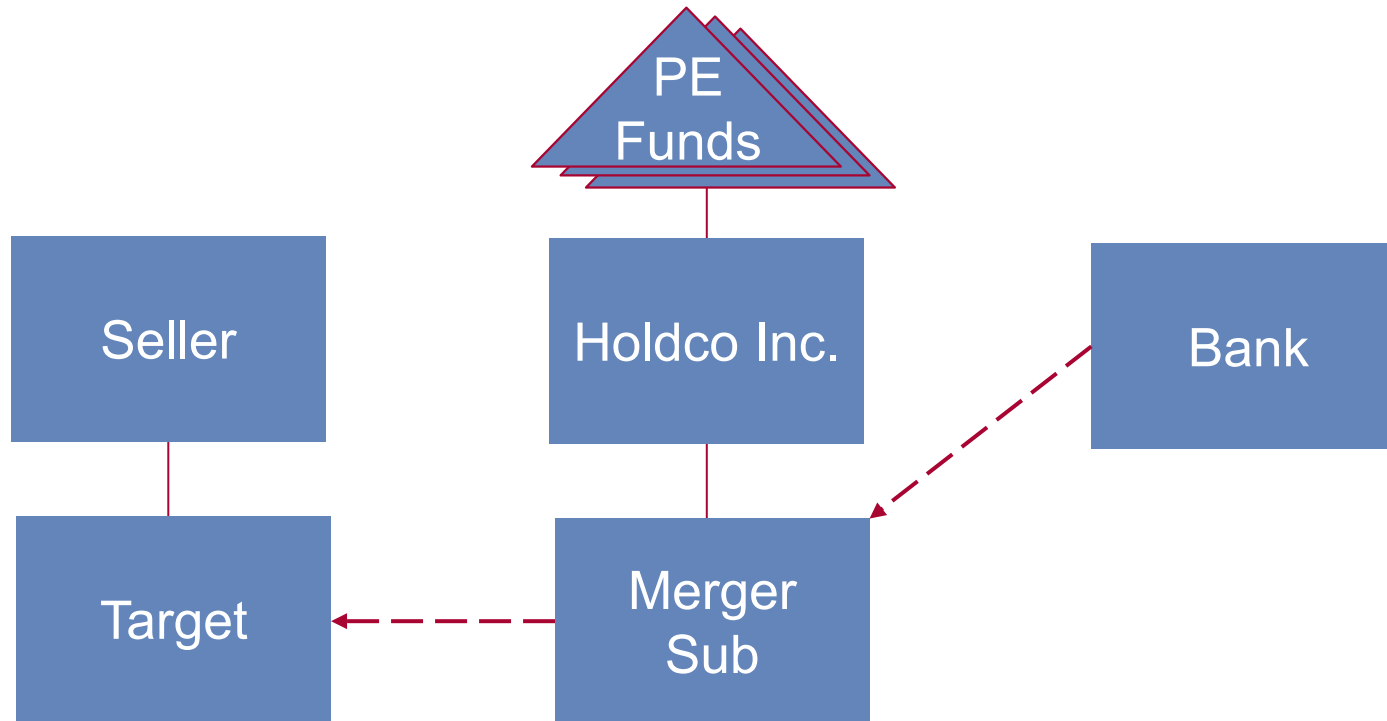
# Financing Deals

# Base Case: LBOs Under Current Law



- ▶ Bank lends to Merger Sub, which then merges with and into Target, with Target surviving
- ▶ After the transaction, Target is obligor on debt and pays interest out of operating income
- ▶ Interest payments from Target to Bank will be generally deductible, subject to various limitations (e.g., AHYDO, earnings stripping, debt/equity analysis)

# Base Case Under the New Rule



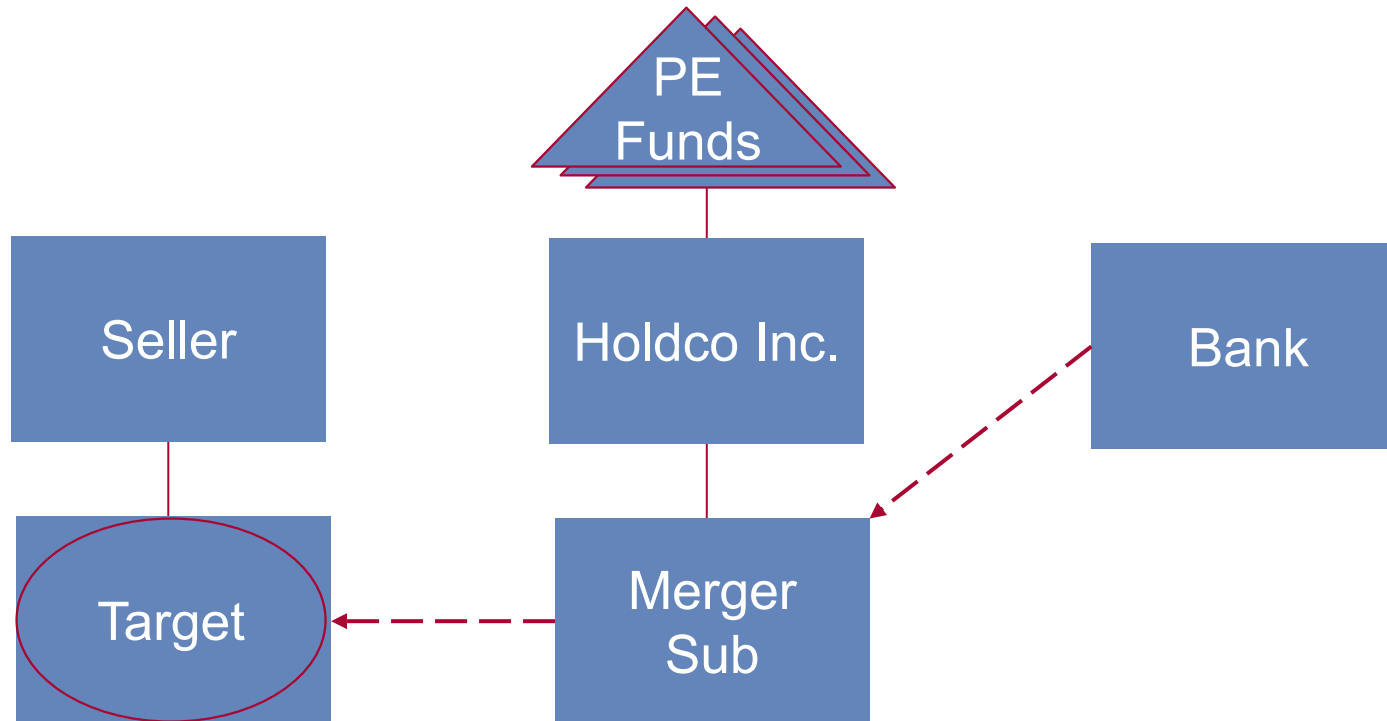
- ▶ Deductibility of interest payments may be significantly reduced
- ▶ Generally, 30% of EBITDA starting in 2018, EBIT after 2022



# The New Net Interest Limitation

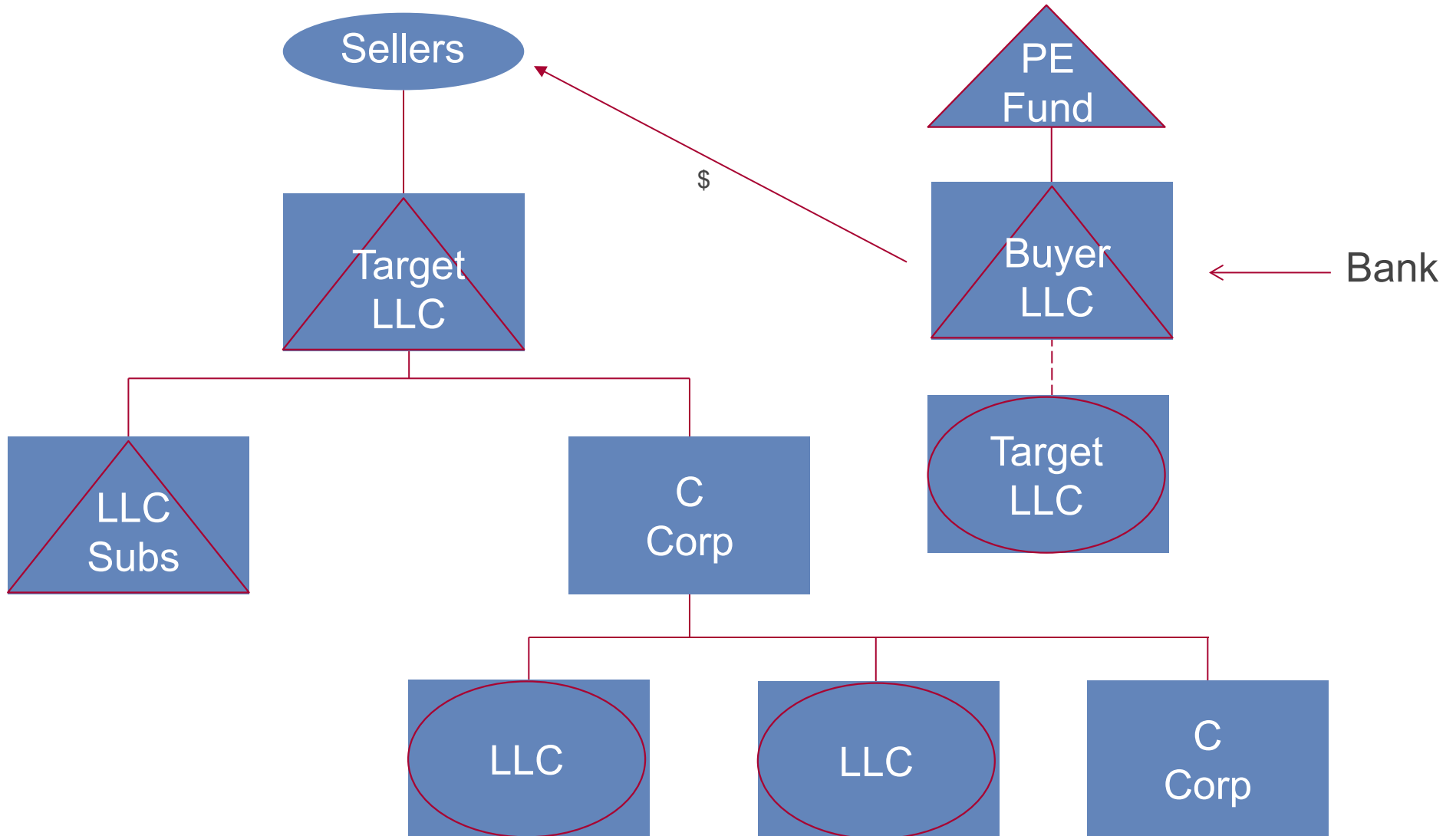
- ▶ Replaces current “earnings stripping” rule
  - But does not address what happens to a corporations' existing disallowed interest expense for which a deduction was not claimed under current earnings stripping rules
- ▶ Applies to all business regardless of form, with exceptions for taxpayers with average annual gross receipts of less than \$25M for the prior three-year period.
  - ▶ No exception for financial services businesses
- ▶ Limits the deduction for “net business interest expense” to 30% of “adjusted taxable income” plus business interest income and floor plan financing interest
- ▶ Adjusted taxable income is taxable income computed without regard to:
  - any item of interest, gain, deduction or loss that is not properly allocable to a trade or business
  - any business interest or business interest income
  - the amount of any net operating loss deduction
  - the new 20% deduction for certain pass-through income
  - in the case of tax years beginning prior to Jan. 1, 2022, any deduction allowable for depreciation, amortization or depletion
- ▶ Disallowed interest may be carried forward indefinitely.
- ▶ Adjusted taxable income may not be less than zero for this purpose; *i.e.*, current year losses do not increase the limitation

# Asset Deal As a Potential Alternative



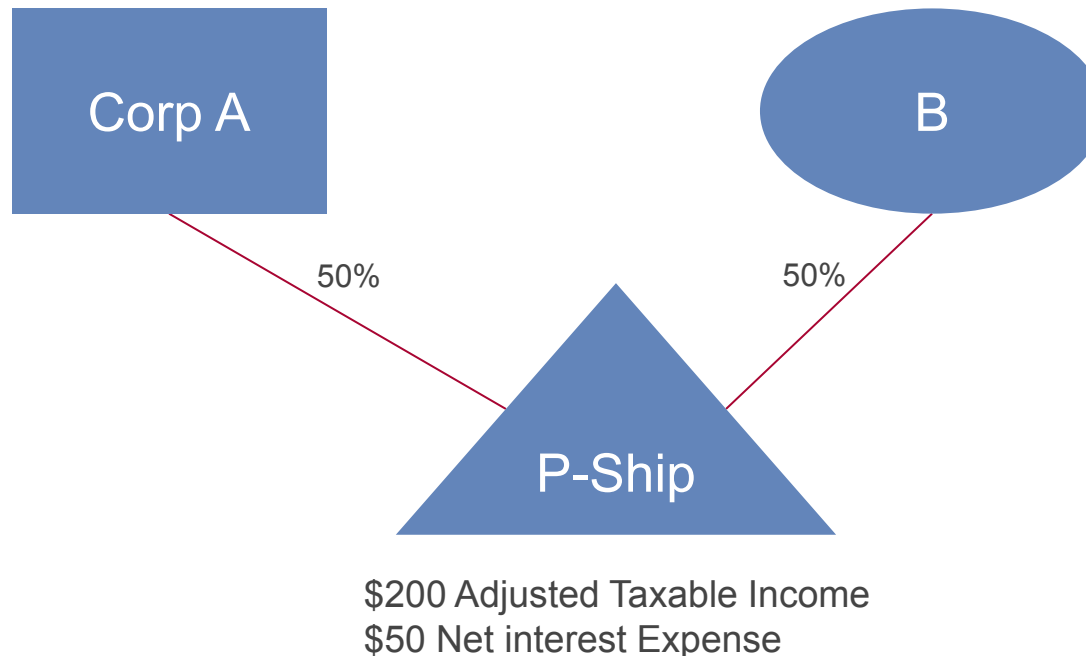
- ▶ As an alternative to a stock acquisition, the LBO is structured as a (deemed or actual) asset purchase
- ▶ Buyer may deduct 100% of purchase price for “qualified property” in year of acquisition
- ▶ Goodwill would still be depreciated over 15 years
- ▶ Where asset sale is not available, will the limitation result in “pure equity” financing?

# Calculating the EBITDA Base



- ▶ Does EBITDA Base include that of C Corp?

# Partnership Example



- ▶ Corp A and Individual B compute their limitations separately without regard to interest or income of P-ship
- ▶ In this example, no limitation as \$50 of net interest expense is less than 30% of ATI
- ▶ \$5 excess limitation is added to each of Corp A and B's computation of their respective limitation

# Application to Partnerships and S corps

- ▶ Limitation is computed for partnerships and S corps at the *entity* level
- ▶ Double counting rule prevents a partners/shareholder from double counting the entity's adjusted taxable income when determining the partner's/shareholder's business interest limitation.
- ▶ Excess business interest is not carried over by the partnership. Instead, excess business interest is allocated to each partner and is treated as business interest paid by the partner in the next year in which the partner is allocated excess taxable income.
- ▶ Excess limitation is permitted to increase the limitation of each partner

# Excess Business Loss New Limitation on Use of Losses

- ▶ Effective for years beginning after 12/31/17 and before 1/1/26
- ▶ Aggregate Losses attributable to trades or businesses of non-corporate taxpayers are limited to \$250k (\$500k if married filed jointly)
- ▶ Amount shall be adjusted for inflation after 2018

# Excess Business Loss New Limitation on Use of Losses

- ▶ Any amounts disallowed by these rules is treated as a net operating loss and carried over to the following taxable year, under rules applicable to net operating losses
- ▶ If Passive Activity Loss and Excess Business Loss rules apply, Passive Activity Loss rules apply first
- ▶ Rules apply at Partner/"S" shareholder level

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