# Tax Update

## Effects of House Tax Reform Bill on Securitizations and Funds

**November 9, 2017**

On November 2, 2017, Republicans in the House of Representatives released their long-anticipated tax reform bill (the "Bill"). The Bill, which is entitled the "Tax Cuts and Jobs Act," includes significant changes to the current U.S. federal income tax regime, several of which we summarized in a previous update.[1] This update summarizes provisions in the Bill that could, if enacted in their current form, significantly affect securitization vehicles and investment funds.

### 1. Taxation of Voluntary "Keepwell" Contributions

Collateralized loan obligations ("CLOs") and other securitization vehicles often permit an equity holder to contribute additional funds to the securitization vehicle to avoid the failure of a coverage test. These contributions typically do not change the contributor's entitlements under the securitization vehicles' payment waterfall but, instead, increase the contributor's basis in its equity and, thereby, reduce the amount of gain (or increase the amount of loss) recognized by the contributor on a disposition of its equity.

U.S. equity holders in securitization vehicles typically are taxable annually on their *pro rata* share of the securitization vehicle's net income and gain (whether or not distributed). Under the Bill, a contribution by an equity holder to a securitization vehicle would increase the securitization vehicle's gross income unless (i) the contributor receives additional equity in exchange for the contribution or (ii) the contribution is made on a *pro rata* basis by all equity holders. As a result, U.S. equity holders could be subject to "phantom" taxable income upon a contribution.

### 2. Limitation on "Super" Tax-Exempt Status

To avoid tax on unrelated business taxable income ("UBTI"), many tax-exempt investors prefer to invest in hedge funds and private equity funds through a "blocker" vehicle that is treated as a corporation for U.S. federal income tax purposes. However, some state pension plans take the position that they are not subject to tax on UBTI and, thus, prefer instead to invest directly into the

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[1] *See* Cadwalader Clients & Friends Memo, "Eleven Business Provisions to Watch in the House Tax Reform Bill."

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fund or through a domestic "feeder" vehicle that is treated as a partnership for U.S. federal income tax purposes.

Under the Bill, all entities that are exempt from tax under section 501(a) of the Internal Revenue Code, including state pension plans, would be subject to tax on UBTI. This could significantly affect the way that hedge funds, private equity funds, and similar funds are structured for U.S. federal income tax purposes.

### 3. Lower Tax Rate for Certain Flow-Through Business Income

Under current law, a U.S. equity holder in a fund that is treated as a partnership for U.S. federal income tax purposes generally is taxed on the equity holder's allocable share of the partnership's net business income at the equity holder's regular marginal tax rate.

Under the Bill, if a partnership is treated as engaged in a trade or business for U.S. federal income tax purposes, then:

- A passive equity holder in the partnership would be taxed on his or her entire allocable share of the partnership's net business income at a maximum tax rate of 25% instead of the current 39.6% maximum individual tax rate; and
- An active equity holder in the partnership (*e.g.*, management personnel) could either (x) elect to categorize 30% of his or her allocable share of net business income as eligible for the 25% rate, or (y) establish a different ratio based on the facts and circumstances of the partnership's business.[2] (The election described in clause (x) is not available for wage-type income or income from a law, accounting, consulting, financial services, or other services business.)

Many real estate funds, "statistical arbitrage" funds, and loan origination vehicles (including some middle-market loan CLOs) are treated as engaged in a trade or business for U.S. federal income tax purposes. Thus, U.S. equity holders in these funds could benefit from this provision.

### 4. Self-Employment Tax on Fund Management Personnel

Under current law, investment management personnel are subject to a 15.30% self-employment tax on their first $118,500 of fee income each year, plus 2.9% of all fee income thereafter. However, a limited partner's distributive share of income from a limited partnership is not subject to the self-employment tax. Accordingly, many investment management vehicles currently are organized as limited partnerships that allocate substantially all (*e.g.*, 99%) of their fee income to their limited partners and the remainder of their fee income to the general partner (which, in turn, is owned by the limited partners). The management personnel take the position that their allocation from the

[2] The same rule would apply to equity holders in "S" corporations.

investment management vehicle is not subject to the self-employment tax because they are receiving the allocation as limited partners, and that only the allocation to the investment management vehicle's general partner is subject to the self-employment tax.

The Bill would eliminate the "limited partner exception" from self-employment tax discussed above. Accordingly, under the Bill, investment management personnel generally would be subject to self-employment tax on all of the investment management vehicle's fee income.[3]

### 5. Limitations on Partnership Business Interest Expense Deductions

Under current law, business interest expenses of a fund that is treated as a partnership for U.S. federal income tax purposes generally "flow through" to the fund's U.S. equity holders, and can be used to offset income earned from other sources.

Under the Bill, if a fund is treated as engaged in a trade or business for U.S. federal income tax purposes (other than real property or certain public utilities businesses), then the fund's annual business interest expense deductions would be limited to 30% of the fund's adjusted taxable income (calculated without regard to business interest income and business interest expenses). This limitation would be determined at the fund level, so that any disallowed business interest expense deductions would not "flow through" to the fund's U.S. equity holders but, instead, could be carried forward by the fund for up to five years.

Many "statistical arbitrage" funds and loan origination vehicles (including some middle-market loan CLOs) are treated as engaged in a trade or business for U.S. federal income tax purposes. Under the Bill, if these vehicles incur outsized interest expense in later years, this interest expense generally would not be available to offset net income from other sources, and could be disallowed entirely (*e.g.*, upon the vehicle's liquidation).

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[3] In certain situations, the Bill's repeal of the "limited partner exception" from self-employment tax also could subject passive U.S. equity holders to the self-employment tax on their entire allocable share of a partnership's net business income. As mentioned above, many real estate funds, "statistical arbitrage" funds, and loan origination vehicles are treated as partnerships that are engaged in a trade or business for U.S. federal income tax purposes. Under the Bill, the self-employment tax applies to a limited partner's allocable share of the partnership's net trade or business income, less a portion of the partner's "active" business income. Passive limited partners do not earn any "active" business income, so their entire allocable share of the partnership's net trade or business income arguably would be subject to the self-employment tax.

Please contact any member of Cadwalader's Tax Department with any questions.


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