Tax Considerations for 2017

Schulte Roth & Zabel

26TH ANNUAL PRIVATE INVESTMENT FUNDS SEMINAR

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Partner
New York Office
+1 212.756.2508
noah.beck@srz.com

Practices

Tax

Mergers & Acquisitions

Private Equity

Noah D. Beck

Noah's practice focuses on tax aspects of domestic and cross-border mergers and acquisitions, joint ventures, spinoffs, restructurings and workouts, and private equity fund formation issues. He has advised on complex transactions, including the acquisition by Cerberus of the leading automotive supplier ABC Group Inc.; Home Meridian International's sale of its business to Hooker Furniture Corporation; the public acquisition of Safeway Inc. by Albertsons and a consortium led by Cerberus Capital Management LP; the sale of Orchard Brands Corporation to Bluestem Group Inc.; the acquisition by Cerberus of the automotive interiors business of Visteon Corporation; Tiptree Financial Inc.'s sale of subsidiary Philadelphia Financial Group Inc. to funds managed by the Tactical Opportunities Group of The Blackstone Group LP; and the sale by Cerberus, its affiliate The Traxis Group BV and Blue Bird Corporation of the outstanding capital stock of School Bus Holdings Inc., an indirect parent company of Blue Bird, to Hennessy Capital Acquisition Corp.

A member of the Tax Section of the New York State Bar Association, Noah is recognized as a leading lawyer by *The Legal 500 United States* and *New York Super Lawyers,* and he is also listed in *Private Funds Management*'s "30 Under 40: The 30 Most Influential Private Equity Lawyers Under the Age of 40." He is the co-author of "The Demise of CoCos and the Tax Consequences of Exchanging Convertible Debt" (Practising Law Institute, Corporate Tax Practice Series).

Noah earned an LL.M. and a J.D., *cum laude*, from the New York University School of Law, where he was a Robert McKay Scholar, and a B.A., *cum laude*, from Duke University.

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, including Senator Investment Group LP's sale of a minority stake to The Blackstone Group LP, Caxton Associates LP's sale of a minority interest to the Petershill II Fund affiliated with the Goldman Sachs Group Inc., and Credit Suisse's sale of Strategic Partners to Blackstone. Philippe advises on the tax aspects of securitizations, including his representation of affiliates of Fortress Investment Group LLC and affiliates of Highbridge Capital Management in the securitization of their leveraged facilities. He has also advised multiple alternative asset managers on the formation and structuring of funds, including Engineers Gate with the launch of a quant fund, Clearfield Capital with the launch of a hedge fund, Warlander Asset Management LP with the launch of a credit fund, and SG Capital Partners in the formation of a new fund; Gunnar Overstrom, formerly a partner at Maverick Capital Ltd., in the formation of Three Corner Global Investors LP; Junto Capital Management LP on the launch of Junto Capital Partners LP and Junto Offshore Fund Ltd.; Trian Fund Management LP on all aspects of launching new co-investment hedge funds; Sachem Head Capital Management LP with the launch of hedge funds and the establishment of long/short equity funds; and Capstone Investment Advisors LLC, JANA Partners, MKP Capital Management LLC and Scopia Fund Management LLC in their respective sales of a passive minority interest to Neuberger Berman Group-managed private equity fund Dyal Capital Partners. 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 United States*, *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 recently 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 2016 conference in New York. 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.

Partner
London Office
+44 (0) 20 7081 8009
nick.fagge@srz.com

Practices

Tax

Hedge Funds

Investment Management

Private Equity

Nick Fagge

Nick principally advises investment management clients on the structuring of U.K. management companies, covering all relevant partnership and tax issues. He also advises more widely on U.K. and international tax issues relating to the taxation of private investment funds, and their U.K. investors and managers.

Listed in *The Legal 500 United Kingdom* as a leader in his field, Nick is a Chartered Tax Adviser and an associate of the Chartered Institute of Taxation, the leading body in the United Kingdom for taxation professionals dealing with all aspects of taxation. He also is a member of the Tax Committee of the Alternative Investment Management Association. He has written and spoken about U.K., EU and international tax issues for various publications and engagements, particularly in regards to how changes in tax codes and regulations affect hedge funds and their U.K. managers.

Nick completed his legal training at the College of Law and graduated from Corpus Christi College at the University of Oxford.

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 formation and operation of onshore and offshore investment funds and their investment managers, as well as tax issues 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 United States* 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 recently presented "Hedge Funds" at PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances conference. 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.

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

Practices

Tax

Hedge Funds

Investment Management

Real Estate Capital Markets & REITs

Regulated Funds

Shlomo C. Twerski

Shlomo is co-head of Schulte Roth & Zabel's Tax Group. 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 United States* 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. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and writes about topics such as FATCA provisions, FIRPTA and REIT rules, and compliance requirements for hedge funds.

Shlomo earned his J.D. from Hofstra University School of Law.

Tax Considerations for 2017

I. Earnings Stripping and Section 385

A. On Oct. 23, 2016, the IRS and the Treasury Department issued final and temporary regulations under Section 385 of the Internal Revenue Code (the "Code"), which made several significant changes to the regulations proposed in April 2016. In general, one set of rules recharacterizes certain debt instruments as equity to the extent issued in connection with certain transactions occurring within an affiliated group. The other set of rules requires issuers to satisfy documentation requirements with respect to certain debt instruments issued within an affiliated group, and failure to do so will, subject to certain exceptions, result in equity characterization.

Although the rules are generally effective for taxable years ending on or after Jan. 19, 2017, the documentation rules are not generally applicable to debt instruments issued before Jan. 1, 2018.

B. Foreign corporate issuers are exempted from the final regulations.

C. Debt of a partnership may still be treated as equity under the rules. Importantly, however, it is treated as equity of the corporate partner in the affiliated group and not the partnership itself.

This is significant in terms of avoiding the potential for publicly traded partnerships. This was a major concern, for example, in the CLO market for pass-through CLOs; however, the "debt for tax" opinions for secured notes issued by CLOs need to take into account these rules.

D. Highly relevant to the fund industry, although the Treasury is continuing to study the issue, the regulations do not apply to leveraged blockers, provided that the owner of the loan is not affiliated with the borrower under the rules. However, issues may still arise with regard to large LPs (e.g., funds of one) or structures with foreign blockers owning U.S. blockers.

E. In light of the congressional and presidential elections, the future relevance of these rules has been put somewhat in question by the possibility of general corporate tax reform, as well as the possibility that the new administration will not enforce these regulations.

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 "Final Regulations" and "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 indicates 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.

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 are 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 2015 Regulations, as modified by IRS Notice 2016-76, 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 2017, as applicable.

C. The 2015 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;

      (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 2015 Regulations.

   For example, the 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).

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

(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 these 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. Notice 2016-76

1. Transactions Entered Into During Calendar Year 2017

(a) "Delta One" Transactions

(i) The term "delta one" was not defined in the notice. However, the language of the notice 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 Notice. 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 2015 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.

(d) Non-U.S. long parties who are registering with the IRS to act as "qualified derivatives dealers" ("QDDs") can attest to that status on a W-8IMY if they apply for QDD status by March 31, 2017. Short parties can rely on such statement as a basis not to withhold on dividend equivalent payments made to such a counterparty until they are notified that the QDD designation is not valid.

2. Transactions Entered Into After 2017

(a) All other transactions entered into after 2017 (or significantly modified after 2017) that are considered Section 871(m) Transactions under the 2015 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 2018 for Section 871(m) transactions entered into during 2018 that are not "delta one" transactions, including whether taxpayers are properly applying the "substantial equivalence" test.

III. Planning for Payment of Deferred Fees in 2017

A. Section 409A Considerations

1. Pre-2009 fees that have been deferred by managers using the cash method of tax accounting (i.e., almost all such deferred fees) are still subject to Section 409A of the Code, even though Section 457A of the Code generally requires managers to include such amounts in the managers' taxable income no later than 2017.

2. Failure to comply with Section 409A of the Code can lead to an additional tax equal to 20 percent of the entire amount deferred, as well as additional interest on the amount deferred going back to the tax return due date for the initial year of deferral.

3. Any deferred fee agreements that are part of a "back-to-back" arrangement need to be operated such that both the payment by the fund to the manager and the related distribution or payment by the manager to its partners and employees comply with Section 409A of the Code.

4. Payment is not considered late under Section 409A of the Code if it is paid by the end of the calendar year in which the elected distribution date occurs.

B. Size of Deferral/Portfolio Management

1. If the deferred fees represent a significant portion of the fund's gross assets, the manager may want to consider exploring with the fund ways to gradually change how the deferred fees are indexed.

2. If a fund is in liquidation, the manager generally cannot receive accelerated payment of its deferred fees until the termination of the manager's services to the fund (e.g., if the liquidation were complete). The manager may desire to elect, with the fund's consent, to have the portion of its

deferred fees that would otherwise have been paid to it had the manager been a shareholder of the fund indexed to treasury bills as and when shareholders are paid.

C. Payment In Kind

1. As deferred fees must generally be paid out when due, a payment in kind may be a desirable approach for a fund where the manager either does not wish to liquidate substantial assets or is not able to monetize particular positions (e.g., side pockets) to pay the deferred fees out in cash.

2. If payment is made in the form of shares of the fund from which the deferral election was made, the manager should consider whether a "qualified electing fund" election is available and, if so, desirable.

3. If the fund is part of a mini-master or master-feeder structure, payment may be made in the form of a master fund interest. Managers who are in this situation may want to consider whether it would be feasible to make an election under Section 754 of the Code at the master fund level, which would avoid the manager's picking up additional tax in that situation.

4. Managers need to note that they will still be subject to full U.S. federal, state and local income tax on the value of the in-kind assets paid to them and should consider their cash needs in relation thereto.

D. Investor Relations

1. Managers should be prepared to answer investor inquiries regarding what they plan to do with the after-tax portion of the deferred fees they are paid.

2. For managers who had treated their deferred compensation as a way of aligning their interests in the fund with those of their investors, payment in kind of at least a portion of the deferred fees may be desirable.

IV. United Kingdom: Changes to the Taxation of Carried Interest

On April 6, 2016, the United Kingdom's new rules on "income-based carried interest" (IBCI) became effective. The IBCI rules are the final piece of a comprehensive new regime for the taxation of sums arising to investment managers from their provision of investment management services in the United Kingdom. This regime is made up of the "disguised management fees" (DMF) rules — of which the IBCI rules are a subset — and the rules on "performance-related returns," i.e., carried interest that is not IBCI.

In relation to carried interest in the usual form of partnership allocations, the most radical departure under the new regime is that there is no look-through to the particular items of income or gain which make up the carried interest, with the investment manager taxed according to the character of those underlying items. Rather, an allocation of carried interest received by an investment manager is treated as a separate sum arising to the investment manager (whether this is comprised of underlying income, realized gains or unrealized gains), which is taxed under the new regime according to where the manager has performed the investment management services that give rise to his carried interest.

In summary, where carried interest is not IBCI, the investment manager is chargeable to U.K. capital gains tax (CGT) at a special carried interest CGT rate of 28 percent. Where, however, the carried interest is IBCI, the investment manager is chargeable to tax on his carried interest as if he had received a disguised management fee for purposes of the DMF rules. Disguised management fees are taxed as the profits of a notional trade carried on by the investment manager, and so are subject to 45-percent income tax and 2-

percent national insurance contributions. The determination of whether a carried interest is or is not IBCI is therefore of crucial importance.

A. Income-Based Carried Interest

1. The income-based carried interest rules require an investment manager to calculate, on each occasion, when a sum of carried interest arises to him, the average value-weighted holding period of all the assets ever held by the fund from which the carried interest is derived, as at the date upon which the carried interest arises. If that period is 40 months or more, none of the carried interest is IBCI and the sum arising is taxed entirely under the CGT carried interest regime, at 28 percent. If the period is less than 36 months, all of the carried interest is IBCI and is taxed as a disguised management fee at an effective rate of 47 percent. There is a taper where the period is between 36 months and 40 months, with an increasing proportion of the carried interest being taxed under the CGT carried interest regime (28 percent) for each additional month of average value-weighted holding period between 36 months and 40 months.

2. There are some complex provisions in the IBCI rules dealing with how managers should calculate the average value-weighted holding period for which a fund has held its assets, in particular, in the areas of derivatives, hedging and foreign exchange gains and losses, direct lending and position-building. There is also provision for carried interest arising in the first four years of a fund's life to be treated as "conditionally exempt," so that such sums arising can be treated as not IBCI if the 40 months or more average value-weighted holding period test is met at the expiry of that initial four-year period, even if the test is not met as at the date on which the carried interest arises.

B. Territorial Scope

1. The fact that investment managers are now chargeable to U.K. tax on carried interest according to where they perform the investment management services that give rise to the carried interest has led to a substantial increase in taxation for some U.K. investment managers. In particular, those U.K. investment managers who are not domiciled for tax purposes in the United Kingdom were previously able to claim the remittance basis of taxation — and defer any U.K. tax charge — to the extent that their carried interest was made up of non-U.K. source income or non-U.K. source capital gains. Under the new regime, any carried interest is subject to U.K. tax if the investment management services that give rise to it are performed in the United Kingdom, with no account being taken of the domicile status of the investment manager or income and gains of which the carried interest is made up. This change in the territorial basis of the tax charge, combined with the application of the IBCI rules where a fund does not meet the 40 months or more average holding period test, will mean that some non-U.K. domiciled investment managers who were previously not liable to tax on their carried interest will now be liable to tax at 47 percent.

2. When the DMF and IBCI rules were first published, there were some initial concerns that the fact that IBCI is charged to U.K. tax on the basis of whether investment management services are performed in the United Kingdom might cause U.S. or other non-U.K. resident investment managers receiving carried interest to become liable to U.K. tax even if they spend only short amounts of time in the United Kingdom. However, HMRC guidance has confirmed that because the new rules tax IBCI as the profits of a notional trade carried on by the investment manager, applicable double tax treaties will mean that most such managers will only be liable to U.K. tax if they could be regarded as carrying on that notional trade in the United Kingdom through a U.K. permanent establishment. Since it is unlikely that individuals spending short amounts of time in the United Kingdom would have a U.K. permanent establishment (a permanent establishment of their own, not of the business for which they work), it seems that this should not be an issue in practice.

C. Tax Credits

The new rules have the effect of shifting the point at which investment managers become liable to U.K. tax on carried interest to the time at which an amount of carried interest arises to the investment manager, rather than the time of realization of portfolio assets. Where carried interest is calculated by reference to unrealised gains, this means that the U.K. tax charge could precede the realization of the asset by a substantial period. Where an investment manager is subject to tax in more than one jurisdiction (for example, a U.S. citizen living and working in the United Kingdom), this raises some difficult issues as to how the manager can claim and match tax credits on carried interest if the bases of taxation are different. If, for example, the U.K. taxes by reference to the point at which the carried interest sum arises to the investment manager, but the United States continues to tax by reference to the investment manager's allocation of gain arising on realisation of the underlying portfolio asset, it is not clear that the U.K. tax paid on the carried interest will automatically be creditable against U.S. tax determined on a different basis. Further guidance is awaited from HMRC on the IBCI rules and it is to be hoped that at least some consideration will be given to these difficult international issues.

V. Amendments to Cayman Islands Common Reporting Standard ("CRS")

A. Amendments to the Cayman Islands CRS Regulations were released in mid-December 2016 as part of the Cayman Islands' implementation of CRS.

The amendments address CRS compliance and enforcement in the Cayman Islands.

B. Key Provisions of the Amendments

1. Financial Institutions ("FIs") need to maintain written policies and procedures on CRS compliance.

2. Notification/Registration Requirement for Reporting and Non-reporting Financial Institutions

All Cayman Islands Financial Institutions — both reporting and nonreporting — must file an "information notice," as well as a change notice when changes occur.

The notice must include:

(a) Institution name and number from the Cayman Islands Tax Information Authority (the "TIA");

(b) Whether the FI is reporting or nonreporting; and

(c) The specific type of reporting or non-reporting FI, as applicable (e.g., "investment entity").

3. Annual Reporting: Cayman Islands FIs with no reportable accounts for the year must file a nil return.

4. What is considered an offense?

(a) Investors

(i) An offense is committed if a person makes a false self-certification and gives it to a Cayman Islands FI.

(ii) It does not matter that:

(1) The self-certification was made outside of the Cayman Islands;

(2) The person did not know or have reason to know the self-certification was false; or

(3) Someone else gave the FI the self-certification.

(b) Cayman Islands FIs

An offense is committed if a Cayman Islands FI discovers but does not report inaccurate information to the TIA "as soon as practicable."

(c) A reasonable excuse defense is available, but reliance on a service provider is not a reasonable excuse.

(d) Liability of Individuals in Charge of Cayman Islands FIs

(i) The individuals in charge of a Cayman Islands FI that commits an offense are also guilty of that offense.

(ii) Proof that the individual exercised reasonable due diligence is a defense.

5. Penalties for Offenses

(a) The "primary penalty" for an offense is $50,000 for entities or $20,000 for individuals.

(b) A further penalty of $100 per day may be imposed if the contravention has not been remedied and the party is capable of remedying it.

6. Statute of Limitations: The statute of limitations for imposing penalties is typically one year after the TIA learns of the contravention or six years after the contravention occurs.

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New York | Washington DC | London

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