Tax Considerations for 2019

Schulte Roth & Zabel

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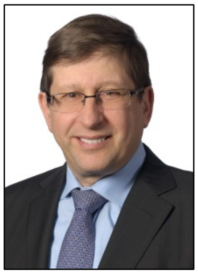

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Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of 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 The Blackstone Group LP. Philippe advises on the tax aspects of securitizations, including his recent 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 D1 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 and 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.

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 served on the staff of the *Journal of International Law and Politics*. He obtained his B.S., *summa cum laude*, from Adelphi University. *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 also speaks at prominent industry events, including PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances Conferences in New York, Chicago and San Francisco. He also recently presented on topics including FATCA, customized solutions for investors, and management company structuring and operations.

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

Nick is a Chartered Tax Adviser and associate of the Chartered Institute of Taxation, the leading body in the U.K. for taxation professionals dealing with all aspects of taxation. He is also a member of the Tax Committee of the Alternative Investment Management Association. Nick 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. He is listed in *The Legal 500 UK* as a leader in his field. Nick graduated from Corpus Christi College at the University of Oxford and completed his legal training at the College of Law in Guildford, England.

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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 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 has presented on the topic of "Hedge Funds" at PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances Conference for numerous years. 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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Christine focuses on the tax aspects of investment funds, private equity funds, joint ventures and registered investment companies. She provides advice with respect to structuring and formation of such entities as well as ongoing operations. 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 is a contributor to *Private Equity Funds: Formation and Operation* (Practising Law Institute) and co-authored "Year-End FATCA Action Items for Investment Funds That Are Sponsored Entities or Have Investors that Are Sponsored Entities," an *SRZ Alert*. She received her J.D. from Cornell Law School and her B.S. from Cornell University.

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Shlomo is co-head of the Tax Group and 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. Shlomo's most recent representations have addressed hedge fund and management company structures, funds in the energy space, tax considerations for private investment funds and FATCA.

Shlomo has been recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 US*, *New York Super Lawyers* and the *Tax Directors Handbook*. He is a member of the Tax Section of the New York State Bar Association and regularly speaks at industry conferences and events. 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 *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). Shlomo holds a J.D. from Hofstra University School of Law, where he was articles editor of the *Hofstra Law Review*.

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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.

Elie has spoken on issues and topics of interest to the private investment funds industry. Most recently, he discussed “Regulatory and Tax” at SRZ’s 6th Annual Private Equity Fund Conference and “Tax Considerations for 2018” at SRZ’s 27th Annual Private Investment Funds Seminar. A published author, Elie recently contributed to the “United States Fundraising” chapter 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 Alert*. Elie earned his LL.M. in taxation from New York University School of Law, where he received the *Harry J. Rudick Memorial Award* for distinction in the Graduate Tax Program, his J.D. from Osgoode Hall Law School and his B.A., with distinction, from York University.

Tax Considerations for 2019

I. Partnership Audits

A. 2018 was 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").

2. 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.

3. The partnership has 270 days to demonstrate to the IRS that its tax rate should be lower and the imputed underpayment should be reduced.

(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 that 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 (or, in certain situations, indirect U.S. owners of a foreign partner that is a "controlled foreign corporation" or a "passive foreign investment company") 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 3 and 4 on any adjustment that would have been subject to withholding in the reviewed year.

6. The Section 6226 election can 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.

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.

6. On Sept. 20, 2018, the IRS released Notice 2018-72, 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 2018-72, 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 2020, 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;

(iii) A payment that references a U.S.-source dividend made pursuant to a specified equity-linked instrument ("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).

(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: (a) the transactions were entered into two or more business days apart; or (b) 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.

(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, 2017-42 and 2018-72

1. Transactions Entered into During Calendar Years 2017-2020

(a) "Delta One" Transactions

(i) The term "delta one" was not defined in any of the notices. 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 2017-2020.

(d) "Qualified derivatives dealers" ("QDDs") will not be subject to tax on dividends and dividend equivalents received in 2017-2020 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 2020.

2. Transactions Entered into After 2020

(a) All other transactions entered into after 2020 (or significantly modified after 2020) 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 2021 for Section 871(m) Transactions entered into during 2021 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 IRS provided guidance in Notice 2014-21 that virtual currency (e.g., Bitcoin, Ether, Litecoin, Ripple, 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 or not 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. Cash-settled Bitcoin futures currently trade on the CBoE and CME, and it has been announced that Ether futures and physically settled Bitcoin futures are also expected to trade on these exchanges. As a result, these futures contracts can qualify as "regulated futures contracts" and are subject to the mark-to-market rules under Section 1256 of the Code.

3. Despite the fact that the CFTC has decided to treat virtual currencies as commodities for regulatory purposes, the IRS has not clarified whether or not some or all virtual currencies can be characterized as commodities for any or all U.S. federal tax purposes.

B. Considerations for Investment Funds Investing in Virtual Currencies

1. *Publicly Traded Partnership Status.* The uncertainty around the tax characterization of virtual currency (e.g., whether or not they are commodities for these purposes) can present challenges to investment funds that want to rely on "qualifying income" within the meaning of Section 7704(c) of the Code in order to avoid being taxed as a corporation under the publicly traded partnership ("PTP") rules. Until greater clarity on the treatment of virtual currency for PTP purposes is offered, investment funds should either rely on the "100 partner" safe harbor or limit investors' liquidity to avoid PTP status.

2. *Wash Sales, Straddles, Short Sales and Mark-to-Market Elections.* The applicability of certain rules relating to wash sales, straddles, short sales and Section 475(f) mark-to-market elections is uncertain as applied to virtual currency. Some of these rules only apply to "stock and securities" or "commodities," while others apply to "actively traded personal property."

3. *Partnership Tax Allocations.* Many investment funds rely on "aggregation" for purposes of making "reverse Section 704(c) allocations" as permitted for "securities partnerships" under Treasury Regulations Section 1.704-3(e)(3). An investment fund is a securities partnership for these purposes if at least 90 percent of the investment fund's non-cash assets are considered "qualified financial assets" or personal property that is "actively traded" as determined for purposes of the straddle rules. Clarity from the IRS with respect to the applicability of the straddle rules to virtual currency should help determine if an investment fund that invests in virtual currency can use aggregation.

4. *Effectively Connected Income and the Trading Safe Harbors.* Non-U.S. 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. Absent guidance from the IRS, it is unclear whether either of these safe harbors could apply to virtual currency. For purposes of the "securities" trading safe harbor, the Treasury Regulations define "securities" as either corporate stock or evidence of indebtedness. For purposes of the "commodities" trading safe harbor, applicable guidance provides that the term commodities should be interpreted in its ordinary financial sense, thereby creating greater flexibility that virtual currency might be able to be considered a commodity for these purposes. However, the safe harbor only applies to trading that involves both (i) commodities that are "of a kind customarily dealt in on an organized commodity exchange" and (ii) transactions that are "of a kind customarily consummated at such place." While not free from doubt, it is helpful for purposes of the safe harbor analysis that Bitcoin futures (and eventually Ether futures) are actively traded on organized commodity exchanges in transactions customarily effected on those exchanges. However, the ability to extrapolate from Bitcoin futures to other transactions in virtual currencies that are not traded on the CME or CBoE remains unclear.

5. *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 IRS 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. Even if not considered effectively connected income, if determined to be U.S. source, non-U.S. investors may be subject to FDAP withholding on distributions received (or deemed received) from such virtual currencies. 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. Tax Reform

A. Carried Interest/Incentive Allocation

1. Federal 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.

(f) Under a technical reading of Section 1061 of the Code, not only is carried interest subject to the three-year holding period requirement, but any future earnings on carried interest may also need to meet the three-year requirement in order to qualify for the long-term capital gains tax rate.

2. State Proposals

   (a) Income from the Provision of Personal Services

      (i) Certain states, including New York and New Jersey, have proposals to treat income from the provision of "investment management services" as generating state-sourced income that is taxable in such states. This would pick up carried interest, taxing it the same way management fees are taxed.

      (ii) New Jersey's legislature approved A3088, which includes this concept, on July 1, 2018, and the New Jersey legislation was signed into law by Governor Murphy.

         a. Caveat: The provision is not operative unless New York, Connecticut and Massachusetts enact legislation with a provision having an identical effect.

         b. Governor Cuomo's proposed New York State budget for the 2019-2020 fiscal year, released on Jan. 15, 2019, includes changes that are substantially similar to New Jersey's statute, except that it also requires Pennsylvania to enact legislation with substantially the same effect, along with New Jersey, Connecticut and Massachusetts.

      (iii) State tax credits may not be available for residents of states that do not view carried interest as generating service-based income.

      (iv) For states with market-based sourcing, such as California, such a rule could have far-reaching consequences.

   (b) Soak-up Tax

      (i) Various states, including New York, New Jersey, Connecticut, Massachusetts, California and Illinois, have introduced proposals to subject carried interest income to an additional tax ranging from 17 percent to 24 percent, which, at a minimum, collects the difference between the federal long-term and short-term capital gains rates.

      (ii) The proposals largely ignore the actual tax character of the underlying income, meaning that a short term capital gain or ordinary income item would also generate this additional tax.

      (iii) New Jersey's legislature approved A3088, which includes the additional 17 percent tax, on July 1, 2018, and the New Jersey legislation was signed into law by Governor Murphy.

         a. As drafted, the provision may also pick up incentive fees and management fees, even though such items are already subject to full federal and state taxation.

         b. Caveat: The provision is not operative unless New York, Connecticut and Massachusetts enact legislation having an identical effect.

         c. Governor Cuomo's proposed New York State budget for the 2019-2020 fiscal year, released on Jan. 15, 2019, includes a similar "carried interest fairness fee," but it also requires Pennsylvania to enact legislation with substantially the same effect, along with New Jersey, Connecticut and Massachusetts. A similar proposal introduced into the New York State Senate on Jan. 9, 2019 does not require Pennsylvania to enact similar rules and uses a 19 percent rate rather than 17 percent.

      (iv) The California and Illinois proposals are not contingent on actions by other states.

3. 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). However, there is increased audit activity regarding the applicability of the Medicare tax on profit allocations to limited partners. 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.

(iv) For states with an unincorporated business tax, a fee might help with state and local tax deductions.

(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 for longer terms, 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 "effectively connected income" 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 United States real property interests. The IRS has appealed the decision of the Tax Court.

3. Section 864(c)(8) of the Code effectively reverses *Grecian Magnesite* by providing that gain or loss realized by a foreign partner from the sale or exchange of a partnership interest occurring on or after

[1] Rev. Rul. 91-32

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

Nov. 27, 2017 is treated as effectively connected with a U.S. trade or business (“ECI”) 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. Under Proposed Regulations issued on Dec. 27, 2018, Treasury provided that a gain realized by the transfer of partnership interests pursuant to a nonrecognition transaction will not generate ECI under this new rule. However, Treasury has stated that it is continuing to consider whether gain should be treated as recognized for certain nonrecognition transactions that reduce the scope of what may be subsequently taxed.

5. In addition, Code Section 1446(f) 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 Code Section 864(c)(8), 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.

6. 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 has been issued under Code Section 1446(f).

7. On April 2, 2018, the IRS issued Notice 2018-29, providing interim guidance upon which taxpayers may rely (pending the issuance of regulations or other guidance).

   (a) The Notice outlines methods to certify that Section 1446(f) withholding is not necessary.

      (i) No Section 1446(f) withholding is required if the transferor certifies to its non-foreign status. Transferors may use a modified FIRPTA certificate or a Form W-9 (so long as such Form W-9 contains the name and taxpayer identification number of the transferor and is signed and dated under penalties of perjury). A transferee may rely on a previously obtained Form W-9.

      (ii) No Section 1446(f) withholding is required if the transferor provides a certification that the transfer will not result in gain.

      (iii) No Section 1446(f) withholding is required if, within 30 days prior to a transfer, the transferor provides a certification that transferor’s allocable share of “effectively connected taxable income” in each of the three taxable years prior to such transfer was less than 25 percent of its entire distributive share of partnership income in each such year. It should be noted that this exception does not apply when the transferor is disposing of the interest to the partnership (e.g., through a withdrawal).

      (iv) No Section 1446(f) withholding is required if the partnership provides a certification that a hypothetical sale of all of its assets at fair market value would generate less than 25 percent effectively connected gain (including, for these purposes, FIRPTA gain).

   (b) The Notice suspends withholding under Section 1446(f) for nonrecognition transactions if the transferor provides a notification of a nonrecognition transaction to the transferee, signed under penalties of perjury, containing the transferor’s name, TIN, address and a brief description of the transfer and an explanation of why gain or loss is not recognized in such transaction.

   (c) The Notice also suspends withholding in situations in which the partnership would be required to withhold under Section 1446(f) due to a transferee’s failure to withhold as required.

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 (unreduced by business interest expense and excluding business interest income). For these purposes, business interest expense and business interest income do not include "investment interest" or "investment income," respectively, within the meaning of Section 163(d) of the Code. For tax years beginning before January 2022, adjusted taxable income is generally equivalent to EBITDA. For tax years beginning on or after January 2022, adjusted taxable income is generally equivalent to EBIT.

(b) Generally, Section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization or other limitation, but applies before the operation of the at-risk loss limitations, passive activity loss limitations and the limitation on excess business losses.[3]

(c) 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.

(d) 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. Such activities, including the performance of services as an employee, are excluded from the meaning of trade or business for purposes of Section 163(j). Adjusted taxable income is computed without regard to income not properly allocable to a trade or business.

(e) Recently proposed regulations provide an expansive definition of "interest" and an anti-avoidance rule for amounts associated with the time value of money. This includes guaranteed payments for use of capital, a portion of the payments on swaps with significant nonperiodic payments, substitute interest payments on securities-lending transactions, income from hedging transactions in which the underlying security is an interest-bearing instrument, commitment fees, debt issuance costs and factoring income.

(f) Application to Partnerships.

  (i) 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.

  (ii) Partner-level adjustments (e.g., Section 743 adjustments, remedial allocations, etc.) are not taken into account when determining the partnership's adjusted taxable income. Rather, they are taken into account at the partner level.

  (iii) As described above, 163(j) only applies to business interest expense and not to other types of interest expense such as investment interest expense. Notwithstanding the foregoing, the preamble to the proposed regulations indicates that for partnerships that are engaged in a trade or business, a partner that does not materially participate may be subject to the interest limitations under both Section 163(j) and Section 163(d).

  (iv) Business interest expense of a partnership disallowed as a deduction by the operation of Section 163(j) is allocated to the partners ("disallowed business interest"). Such amounts are carried forward and treated as paid in subsequent years, subject to certain limitations.

[3] Prop. Reg. § 1.163(j)-3(b)(3)

(v) Under recently proposed regulations, a partner may deduct its share of such disallowed business interest in a subsequent year to the extent of (a) its allocated excess business interest income from such partnership and (b) its allocated excess taxable income from such partnership (with the deduction of the amounts otherwise allowable under this clause (ii) capped at 30 percent of the sum of the partner's share of the excess taxable income from the partnership and adjusted taxable income from other sources). However, the Blue Book states that a partner can deduct its share of such disallowed business interest in a subsequent year only to the extent of its allocated excess business interest income and 30 percent of its share of the excess taxable income from the partnership).

(vi) If non-business interest expense of a partnership is allocated to a corporate partner, 163(j) limitations would apply at the corporate partner level because all interest expense and income of a corporation is treated as business interest expense and income.

(vii) Computation of a corporation's E&P does not take into account the application of 163(j). As a result, the limitations under 163(j) may not adversely impact investors in offshore feeder funds under certain circumstances.

(viii) Recently proposed regulations explicitly reserve on the application of 163(j) to tiered partnerships, partnership mergers and divisions and self-charged interest.

(g) Taxpayers may rely on recently proposed regulations before they are finalized, so long as the taxpayer consistently applies all the rules of such proposed regulations.

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

(a) Under Section 461(l) of the Code, which applies 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.

D. Deduction for Qualified Business Income of Pass-Through Entities

1. A deduction ("QBI Deduction") for taxpayers other than "C" corporations for certain qualified business income ("QBI") and certain other income is equal to the lesser of: (a) 20 percent of the taxpayer's QBI, plus 20 percent of the taxpayer's qualified REIT dividends and qualified PTP income and (b) 20 percent of the taxpayer's taxable income minus net capital gains. In no event may a taxpayer's QBI Deduction exceed 20 percent of the excess of the taxpayer's taxable income over such taxpayer's net capital gain for the relevant taxable year, thus ensuring that the QBI Deduction will not be applied to offset capital gain.

   (a) The QBI Deduction for taxpayers whose taxable income exceeds $157,500 ($315,000 in the case of a joint filer) (the "Threshold Amount") is subject to a wage/basis limitation equal to the greater of the taxpayer's allocable share of (x) 50 percent of the W-2 wages paid with respect to the qualified trade or business ("W-2 Wages") and (y) the sum of (i) 25 percent of W-2 Wages plus (ii) 2.5 percent of the "unadjusted basis immediately after acquisition" of all qualified property held by the trade or business ("UBIA").

   (b) The QBI Deduction is also available to offset income from qualified REIT dividends and qualified PTP income, without regard to the limitations described in (i) above.

2. Income earned with respect to a business that constitutes a "specified service trade or business" ("SSTB") is excluded from qualifying for the QBI Deduction (except for taxpayers that fall below the Threshold Amount).

   (a) On Jan. 18, 2018, final regulations were released to clarify certain of the provisions related to the QBI Deduction. Such regulations clarified that the determination of whether a business constitutes a SSTB is made at the entity level. Pass-through entities are required to report this determination to their owners. SSTBs include trades or businesses involving the performance of services in the investment management field.

   (b) 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. For most investment funds, the wage/basis limitation described will be $0.

3. Anti-Abuse Rules

   (a) The regulations provide that a SSTB includes any business that shares 50 percent common ownership (direct or indirect) with a SSTB. This provision prevents many structures that aim to segregate out certain activities in order to take advantage of the benefits of the QBI Deduction.

   (b) Amounts received for the performance of services as an employee are not eligible for the QBI Deduction. To prevent employees from changing employment status to take advantage of the new deduction, the regulations provide a rebuttable presumption that if an employee changes employment status but continues to provide substantially the same services to the former employer, the individual is presumed to be providing such services as an employee for three years following such change in status, and thus cannot offset any compensation income by the QBI Deduction.

   (c) The regulations exclude from treatment as a "qualified REIT dividend" eligible for the QBI Deduction any dividend received with respect to stock that has been held for 45 days or less, taking into account applicable rules under Section 246 that suspend holding periods for stock with respect to which the holder has a diminished risk of loss due to a hedge or straddle, during the 91-day period beginning on the date which is 45 days prior to the date on which the stock becomes ex-dividend. While the final regulations establish a holding period of 46 days, the Technical Corrections draft circulated on Jan. 2, 2019 indicates that this holding period is 60 days.

E. UBTI: Notice 2018-67

1. Section 512(a)(6) of the Code provides that UBTI must be calculated separately with respect to each separate trade or business with losses usable only against the same related trade or business and not against UBTI generally.

2. On Aug. 21, 2018, the IRS released Notice 2018-67 which noted that a tax-exempt organization may rely on a reasonable, good faith interpretation of Sections 511 through 514 of the Code, considering all of the facts and circumstances when determining whether an exempt organization has more than one unrelated trade or business.

   (a) A reasonable, good faith interpretation includes using the North American Industry Classification System six-digit codes.

   (b) Notice 2018-67 also provided interim and transition rules for partnership investments. Under such rules, an exempt organization may aggregate UBTI from its interest in a single partnership with multiple trades or businesses as long as the directly-held interest in the partnership meets the requirements of either the de minimis test or the control test (each, a "qualifying partnership interest"). An exempt organization may aggregate all qualifying partnership interests as a single trade or business for purposes of section 512(a)(6).

      (i) De Minimis Test: An exempt organization may aggregate UBTI from a single partnership so long as the entity holds no more than 2 percent of the profits interest and no more than 2 percent of the capital interest in the partnership. For purposes of this test, an exempt organization must combine the interests held by disqualified persons with respect to the exempt organization, a supporting organization or a controlled entity.

      (ii) Control Test: An exempt organization may aggregate UBTI from a single partnership so long as the organization holds no more than 20 percent of the capital interest and does not have control or influence over the partnership. For purposes of this test, an exempt organization must combine the interests held by disqualified persons with respect to the exempt organization, a supporting organization or a controlled entity. "Control or influence" will exist if an exempt organization may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership. An exempt organization also has control or influence over a partnership if any of the exempt organization's officers, directors, trustees or employees have rights to participate in the management of the partnership or conduct the partnership's business at any time, or if the exempt organization has the power to appoint or remove any of the partnership's officers, directors, trustees, or employees.

      (iii) Under an additional transition rule, an exempt organization may choose, for a partnership interest acquired prior to Aug. 21, 2018, to treat such partnership interest as a single trade or business.

V. Cayman Islands Economic Substance Requirements

A. The Cayman Islands has introduced legislation, effective Jan. 1, 2019, requiring certain entities resident in the Cayman Islands to demonstrate that they have appropriate economic substance in the jurisdiction.

B. Other commonly used fund and investment management jurisdictions, such as Jersey, Guernsey, the British Virgin Islands and Bermuda, either have or are expected to put in place similar legislation.

C. The introduction of these measures is intended to fulfil commitments made by these jurisdictions as members of the OECD in the context of the OECD's Base Erosion and Profit Shifting ("BEPS") initiative, and is also a response to their inclusion on the "grey list" of non-cooperative jurisdictions for tax purposes produced by the EU's Code of Conduct Group on Business Taxation.

D. Although the Cayman Islands has passed the relevant legislation effective Jan. 1, 2019, it is anticipated that the Cayman Islands will also issue regulations and guidance. It is hoped that the guidance, in particular, will clarify many matters related to the new legislation which are presently uncertain, especially in the context of outsourced activities, such as where a Cayman Islands manager delegates investment management and ancillary services to a sub-adviser in another jurisdiction (such as the U.K.).

E. The new Cayman Islands legislation is applicable to "Relevant Entities." Relevant Entities will include most Cayman limited companies, LLCs and LLPs, but not limited partnerships (although entities that are general partners of limited partnerships may be Relevant Entities).

F. Importantly, an "investment fund" is not a Relevant Entity (and so is not within the scope of the new legislation).

G. An "investment fund" is an entity whose principal business is the issuing of investment interests to raise funds or pool investor funds with the aim of enabling a holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management or disposal of investments and includes any entity through which an investment fund directly or indirectly invests or operates. Most funds and their trading or subsidiary holding entities should therefore be outside the scope of the new rules.

H. Each Relevant Entity must make a report each year to the tax authority as to whether or not it is carrying on one or more "Relevant Activities." If it is, then it must meet an economic substance test in respect of such Relevant Activities and provide to the tax authority a detailed report describing the basis upon which it is meeting that economic substance test.

I. The "Relevant Activities" are:

   1. Fund management business
   2. Banking business
   3. Financing and leasing business
   4. Distribution and service center business
   5. Headquarters business
   6. Intellectual property business
   7. Shipping business
   8. Holding company business

   However, "investment fund business," meaning the business of operating as an investment fund, is excluded and is not a "Relevant Activity."

J. A Relevant Entity that carries on one or more Relevant Activities must satisfy the economic substance test. This requires the Relevant Entity to:

   1. Conduct Cayman Islands "core income generating activities" ("CIGA");
   2. Be "directed and managed" in an appropriate manner in the Cayman Islands;
   3. Having regard to the level of relevant income derived from a Relevant Activity:
      (a) Have an adequate amount of operating expenditure incurred in the Cayman Islands;
      (b) Have adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands; and
      (c) Have an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

K. CIGA are defined as those activities that are of central importance to the Relevant Entity in terms of generating activity and that are being carried out in the Cayman Islands. There are then further examples given of particular types of activity that may constitute CIGA for a Relevant Activity. For fund management, these examples include:

   1. Taking decisions on holding and selling investments;
   2. Calculating risks and reserves;
   3. Taking decisions on currency or interest fluctuations and hedging positions; and
   4. Preparing reports or returns to investors and the Cayman Islands Monetary Authority.

L. A Relevant Entity may still satisfy the CIGA requirements where its CIGA activities are conducted by another person on its behalf, provided that the Relevant Entity is able to monitor and control the carrying out of those activities.

M. In terms of the requirement that a Relevant Entity carrying on a Relevant Activity must be "directed and managed" in an appropriate manner in the Cayman Islands in order to meet the economic substance test, the legislation contains detailed provisions which require that:

   1. The Relevant Entity's board of directors, as a whole, has the appropriate knowledge and expertise to discharge its duties;
   2. That board meetings are held in the Cayman Islands with adequate frequency with a quorum of directors present in the Cayman Islands; and
   3. That minutes of the board meetings record the strategic decisions taken and that such minutes and appropriate records are retained in the Cayman Islands.

N. Various penalties may be imposed on a Relevant Entity carrying on a Relevant Activity that fails to meet the economic substance test. In the first period of non-compliance, the Cayman Islands tax authorities may impose a $10,000 penalty and if the failure continues into subsequent periods, the penalty can be $100,000. There is also the possibility of criminal sanctions where any person (which might be a Relevant Entity or a director, manager, secretary of other officer of a Relevant Entity) knowingly or willfully supplies false or misleading information under these provisions or fails to provide information specifically requested by the tax authorities under these provisions.

O. Although the new law is effective as of Jan. 1, 2019, regulations and guidance are still awaited and there is much that remains unclear. Given that affected Cayman Islands entities have had little or no time to prepare, it is possible that regulations might defer the date upon which Relevant Entities carrying on a Relevant Activity are required to meet the economic substance test. Furthermore, the due date and form of the annual notification that a Relevant Entity must make to the tax authority that is potentially within the scope of the legislation has not yet been prescribed.

P. It is hoped that the promised guidance will clarify a number of the outstanding issues, such as the degree of economic substance required of a Relevant Entity that outsources activity, such as a Cayman Islands fund manager that delegates to an investment manager or sub-adviser in another jurisdiction (such as the U.K.). The Cayman Islands tax authority is required by the legislation to consult with the private sector prior to issuing its guidance and the industry will want to press its concerns as part of that consultation.

Q. Since the Cayman Islands is introducing these new rules with the intention of ensuring its removal from the EU's "gray list" of uncooperative tax jurisdictions, the EU is expected to review the legislation in early 2019 prior to its announcement of an updated "gray list." Depending upon the outcome of that review, it is possible that further changes will be made to the legislation.

VI. BEPS Implementation in the EU

A. Introduction

1. The EU has been an active participant in the BEPS initiative from the outset and has generally sought to enshrine BEPs-related measures into EU-wide law as a means of ensuring a smooth and cohesive implementation of these measures in all EU member states. In particular, the EU is introducing the Anti-Tax Avoidance Directive ("ATAD") and the DAC6 Directive amendments on mandatory disclosures of certain tax planning arrangement, and is actively supporting the adoption and ratification by EU member states of the Multi-Lateral Instrument and its measures aimed to prevent double tax treaty abuse.

B. The Multi-Lateral Instrument

1. Many countries, including all EU member states, have now adopted and ratified the OECD's Multi-Lateral Instrument ("MLI") to modify the application of their bilateral double tax treaties.

2. One of the key aims of the MLI is to implement the recommendations of Action 6 of BEPS on treaty abuse, which introduced minimum standards to prevent the granting of treaty benefits. Action 6 proposed that tax treaties should include either a principal purpose test ("PPT") alone or, if the jurisdictions in question choose it, both a PPT and a simplified limitation on benefits ("LOB") test.

3. The MLI presents the PPT as the default option and indeed it is the option that has been selected by most countries that have adopted the MLI.

4. The PPT denies a treaty benefit to an entity located in a treaty jurisdiction – most commonly, a reduced or zero rate of withholding tax on interest or dividend income paid by an entity in the other treaty jurisdiction – where it is reasonable to conclude, having regard to all the facts and circumstances, that obtaining the treaty benefit was one of the principal purposes of any arrangement that resulted directly or indirectly in that benefit.

5. There has been much discussion as to how the PPT should be interpreted and applied to funds and their investment-holding subsidiaries, particularly in the context of alternative investment funds (so-called non-CIVs). In January 2016, the OECD published a consultation document on non-CIV funds that includes three fact patterns where the OECD would regard the PPT as having been met. It is anticipated that this will be used as a guide to interpretation and application of the PPT by tax authorities and courts in many relevant jurisdictions.

6. The most useful of the three non-CIV examples describes a subsidiary established as a regional investment platform to invest across a wider economic area, such as the EU, and which earns dividends on its investments. This example concludes that the subsidiary is entitled to treaty benefits where it is set up for non-tax reasons and carries out material investment functions and other activities in the jurisdiction where it is established. Specified relevant functions include:

   (a) An experienced local management team which reviews investment recommendations;

   (b) Approval and monitoring of investments;

   (c) Treasury functions;

   (d) Maintenance of books and records and ensuring compliance with local regulatory requirements in investee jurisdictions;

   (e) A board of directors composed of a majority of locally resident directors with expertise in investment management; and

   (f) Payment of taxes and filing of tax returns in the jurisdiction.

7. It remains unclear how many of these functions need to be carried on, or to what extent, in order for the PPT to be satisfied. OECD Guidance is expected to continue to involve, as is the practice of investee jurisdictions in interpreting and applying the PPT that is now incorporated into their double tax treaties.

C. Anti-Tax Avoidance Directive ("ATAD")

1. The ATAD establishes a minimum standard that EU member states must meet in their domestic legislation in five key BEPS-related areas. ATAD requires EU member states to introduce:
   (a) Limitations on interest deductibility;
   (b) A general anti-abuse rule ("GAAR");
   (c) Controlled foreign company ("CFC") rules;
   (d) Hybrid mismatch rules; and
   (e) Exit taxation.
2. These measures generally need to be applied into domestic law with effect from Jan. 1, 2019, although there is a one-year delay permitted in relation to exit taxes and the rules on hybrid mismatches are not required until Jan. 1, 2020 (Jan. 1, 2022 in relation to reverse hybrid mismatches).

D. DAC6 — Mandatory Disclosure Rules

1. The DAC6 Directive amends a previous EU Directive with respect to the mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements. DAC6 in substance requires "intermediaries" such as tax advisers, accountants and lawyers that design and/or promote tax planning arrangements to report certain specified arrangements that are considered potentially abusive. If there is no such intermediary in relation to a specified arrangement, then the obligation shifts to the taxpayer. Following reporting, reported information is then automatically exchanged between EU member states.
2. The specified reportable arrangements are those that concern more than one EU member state, or an EU member state and a third country, and that have one or more "hallmarks." Although the hallmarks are intended to limit the reportable arrangements to potential tax-avoidance arrangements, a specific "main tax benefit" threshold test is not part of the regime.
3. The specific hallmarks include where an arrangement involves:
   (a) Confidentiality conditions
   (b) Standardized documentation
   (c) Success fees
   (d) Use or transfer of losses
   (e) Converting income into capital
   (f) Gifts or low/exempt income
   (g) Circular transactions
   (h) Transactions between related parties that include tax-exempt payers
   (i) Exempt or preferentially treated receipts
   (j) Taxpayers in non-cooperative jurisdictions
4. EU member states must implement DAC6 into their domestic law by no later than Dec. 31, 2019, so that the law applies from July 1, 2020 onwards. At present there is very little information available about how and when each EU member state will adopt these measures in their own domestic legislation. However, this raises a difficult issue since the Directive, once introduced and effective from July 1, 2020, will require disclosure in respect of any reportable arrangement where the first step in that reportable arrangement is implemented on or after June 25, 2018. DAC6 therefore has a retrospective effect, and intermediaries and taxpayers should be monitoring relevant transactions that they may have been

involved with since June 25, 2018 in case they may be required to make a report in respect of those transactions in August 2020.

VII. Qualified Opportunity Zones

A. Congress enacted, at the end of 2017, significant tax incentives for investments in Qualified Opportunity Zones ("QOZs"). The QOZ legislation was intended to spur investment in lower-income communities by allowing for the reinvestment of capital gain into a QOZ on a tax-favored basis, thus encouraging economic growth in such communities.

1. On Oct. 19, 2018, the Treasury Department issued Proposed Regulations under sections 1400Z-1 and 1400Z-2, a draft IRS Form with instructions, and Revenue Ruling 2018-29 (together, the "QOZ rules") to provide clarification on the legislation and to settle some open questions.

2. Additional guidance is expected in early 2019.

B. A QOZ is a low-income area that has been certified by the Secretary of the Treasury. As of this time, all QOZs have been certified. The QOZ designations expire on Dec. 31, 2028; however, for taxpayers with properly deferred gains generated prior to Dec. 31, 2026, the QOZ tax benefits remain available through Dec. 31, 2047.

C. Investment in a QOZ provides a taxpayer with three major benefits:

1. Deferral of tax on eligible capital gain until the earlier of the date the investor disposes of their interest in the QOZ investment or Dec. 31, 2026.

(a) If the investment is held through Dec. 31, 2026, there will be a tax on the deferred gain without corresponding cash available to pay the liability.

(b) Upon realization, the deferred gain will have the same tax attributes in the year of inclusion that it would have had if it had not been deferred under the QOZ rules.

2. A step-up in the basis of the QOZ investment in the amount of 10 percent of the amount of gain deferred if the interest is held for five years, and an additional 5 percent if held for seven years. Thus only 85 percent of the initial deferred amount will be subject to tax. Given that on Dec. 31, 2026 the deferred gain is realized, in order to obtain the step-up in basis, the five- and seven-year holding periods need to be met before such date.

3. The exclusion from taxation of any additional gain over the initial deferred amount upon the disposition of the investment interest if the interest is held for 10 years. Note that the interest in the QOF (as defined below) must be sold for the investor to realize this tax benefit.

D. An investor makes an investment in a QOZ by investing qualifying capital gain into a qualified opportunity fund ("QOF").

1. A QOF may be organized as a corporation or partnership for federal income tax purposes.

2. Only equity interests in a QOF are eligible, although a QOF equity interest may be pledged as collateral to obtain debt financing.

3. Deemed contributions due to allocations of partnership liabilities under Section 752 do not constitute investments in a QOF.

4. A QOF must hold 90 percent of its assets in "QOZ Property" as defined below (the "90-Percent Assets Test"). This is measured at the end of the first six months of the fund's taxable year and again at the end of each taxable year of the QOF.

(a) For purposes of the 90-Percent Assets Test, the value of the QOF's assets should generally be the book value reflected on the QOF's applicable financial statements. If the QOF has no such statements, the cost of the assets is used.

(b) Because the QOF interest must ultimately be disposed of after the 10-year holding period in order for the investor to enjoy tax-free gain on the investment, investors should consider setting up single-asset funds to facilitate disposition.

(c) If a QOF fails to satisfy the 90-Percent Assets Test for any month, the QOF will be subject to a penalty equal to the dollar amount by which it fails, multiplied by the then-effective IRS underpayment rate. The penalty calculation uses the yearly underpayment rate divided by 12.

5. A fund self-certifies as a QOF by filing a Form 8996 with its federal income tax return.

E. Any person that may recognize capital gain is eligible to invest in a QOF, including individuals, entities treated as partnerships, entities treated as corporations (including S corporations, regulated investment companies ("RICs") and real estate investment trusts ("REITs")), trusts and estates.

1. To qualify, capital gains must arise from a transaction with a person unrelated to the taxpayer.

2. Amounts other than qualifying capital gain may be invested, but the rules state that the investment will be bifurcated and such other amounts will not be subject to favorable tax treatment.

3. Capital gain recognized from Section 1256 contracts (e.g., regulated futures contracts, foreign currency contracts, non-equity options) is only eligible for the QOZ tax benefits to the extent of net gain from all of the investor's Section 1256 contracts.

4. Capital gain recognized from a position that is or ever has been part of an offsetting-positions transaction during the investor's holding period of the position is not eligible for the QOZ tax benefits under the QOZ rules.

(a) The QOZ rules suggest, however, that the net gain limitation applied to Section 1256 contracts, rather than a complete disallowance of the QOZ tax benefits, will apply to offsetting-positions transactions in which both positions are Section 1256 contracts.

(b) Straddles (as defined in Section 1092) are included in the definition, but the rule applies to the positions in a straddle whether or not the underlying property is actively traded.

(c) This rule may pose administrative burdens for pass-through entities that regularly hedge investments using offsetting-positions transactions.

F. Capital gain must be invested within 180 days of the date on which the investor would otherwise recognize the gain for federal income tax purposes.

1. In the case of a sale or exchange, this period begins on the date of the transaction.

2. In the case of a capital gain dividend received by a RIC or REIT shareholder, this period begins on the date the dividend is paid.

3. If a RIC or REIT shareholder is required under the Code to include an undistributed amount as capital gain, the shareholder's period begins on the last day of the RIC or REIT's taxable year.

4. If a partnership derives capital gain from a sale or exchange, the partnership may elect to defer the gain within 180 days of the transaction. If the partnership so elects, the gain will not be allocated to the partnership's partners. Instead, the gain will be allocated to the partners when the partnership recognizes it.

5. The partnership may instead allocate the gain to its partners, who then may choose to elect to defer the gain. In this instance, the partners' 180-day period begins on the last day of the partnership's taxable year.

6. Alternatively, partners may also invest their share of a partnership's gain within 180 days of the date the partnership realizes the gain, provided the partnership does not make the election.

(a) Gain that is allocated to a partner by a partnership is only eligible for deferral if the gain arose from a transaction with a person unrelated to both the partner and the partnership.

(b) The QOZ rules provide parallel treatment for other pass-through entities and their owners, including LLCs, S corporations, trusts and estates.

(c) Partnerships with partners who are interested in investing in QOFs may be asked for faster processing of Schedules K-1 and side letters or other agreements that the partnership will not elect to defer gain in a QOZ investment without the consent of the partners.

G. The assets that qualify for the 90-Percent Asset Test are QOZ stock, QOZ partnership interests and QOZ business property (together, “QOZ property”).

1. QOZ stock means any stock in a domestic corporation if:

   (a) Such stock is acquired by the QOF after Dec. 31, 2017 at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash;

   (b) At the time the stock was issued, the corporation qualified as a QOZ business (as defined below) or was formed for such purpose; and

   (c) During substantially all of the QOF’s holding period for such stock, such corporation qualified as a QOZ business.

2. QOZ partnership interest means any capital or profits interest in a domestic partnership if:

   (a) Such interest was acquired by the QOF after Dec. 31, 2017 from the partnership solely in exchange for cash;

   (b) At the time the interest was acquired, the partnership qualified as a QOZ business or was formed for such purpose; and

   (c) During substantially all of the QOF’s holding period for such interest, such partnership qualified as a QOZ business.

3. QOZ business property means tangible property used in a trade or business of the QOF if:

   (a) Such property was acquired by the QOF by purchase from an unrelated person after Dec. 31, 2017;

   (b) The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property (as defined below); and

   (c) During all of the fund’s holding period for such property, substantially all of the use of such property was in a QOZ.

H. A QOZ business, as described above, means a business in which:

1. Substantially all of the tangible assets held by the business are QOZ business property. The proposed regulations state that the term “substantially all,” as used in this provision, means “70 percent or greater.”

2. At least 50 percent of the total gross income of the business is derived from the active conduct of a trade or business;

3. A substantial portion of any intangible property owned by the business must be used in the active conduct of a trade or business;

4. Less than 5 percent of the average of the aggregated unadjusted bases of the property in the business is attributable to “nonqualified financial property” (which includes debt, stock, partnership interests, derivatives, etc.); and

5. The underlying business is not a: private or commercial golf course; country club; massage parlor; hot tub facility; suntan facility; racetrack or other gambling facility; or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

I. Original Use or Substantial Improvement of QOZ business property

1. "Original use" is undefined in the QOZ rules. Given the permanence of land, the original use of land can never commence with a QOF in a QOZ and thus the QOZ rules do not require land to meet the original-use requirement.

2. Under the QOZ rules, property is considered to be substantially improved by a QOF if, during the 30-month period following the date on which the property is acquired, the QOF makes additions to the basis of the property equal to the acquisition cost of such property. In short, the QOF must double its basis in the property after purchasing it. If a QOF purchases a plot of land with an existing building on the land, the determination of whether a QOF has substantially improved land is made only with respect to the adjusted basis of the building (without regard to the basis allocable to the land) and separate improvements to the land are not required.

J. Realizing that developing businesses will have difficulty meeting some of the requirements under the QOZ rules, the rules provide a safe harbor for amounts deemed to be reasonable working capital.

1. The safe harbor applies to cash and other financial property held by a QOZ business if the QOZ business:

(a) Keeps written records that designate the use of the working capital for the acquisition, construction or improvement of QOZ business property;

(b) Provides a reasonable schedule for the use of the working capital in the QOZ business within 31 months of acquisition; and

(c) Actually uses the working capital in a manner that is substantially consistent with the written plan.

2. Several benefits apply to working capital that fits within the safe harbor:

(a) Working capital that meets the safe harbor can be set aside for use in acquiring, constructing and/or substantially improving tangible property that is expected to qualify as QOZ business property, and such property can thereby be considered QOZ business property, even if the working capital has not been fully invested, as long as the use of the capital is in accordance with the schedule required by the safe harbor;

(b) Income derived from safe-harbored working capital will be counted toward the requirement that 50 percent of the total gross income of the business be derived from the active conduct of a trade or business;

(c) Any intangible property of a business will be deemed used in the active conduct of a trade or business during the period of time that the business satisfies the three requirements in clause 1 above; and

(d) Property that is deemed to be safe-harbored working capital will be excepted from the requirement that less than 5 percent of the business property be attributable to nonqualified financial property.

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