Implications of Net Investment Income Tax to Asset Managers

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Introduction

On January 31, 2013, a comprehensive webcast addressing Net Investment Income (“NII”) Tax proposed regulations and effect they will have on the Asset Management industry has been presented by Kara Friedenberg, Alan Biegeleisen, Kevin Ciavarra, and Miriam Klein. We would like to thank all those who were able to join us at that time. If you did not have an opportunity to benefit from the presentation, please note, the webcast replay is available on PwC’s website: http://event.on24.com/r.htm?e=564461&s=1&k=BCF5CoB84oDB9838E54E220869BDEAA6

As a follow up to the webcast, we would like to highlight some of the issues raised by the proposed regulations and our recommendations for further IRS guidance, and some of the key NII tax planning and reporting issues and considerations. For a more detailed discussion of the proposed regulations and the planning considerations please refer to Part II of Kara Friedenberg’s Special Report on the NII Tax, “Proposed Net Investment Tax Regs Impact on Alternatives,” published on March 25, 2013, in Tax Notes Today, as well as Part I of the Special Report, “Impact of the 3.8 percent Net Investment Tax,” (Tax Notes Today, January 23, 2012).
Overview

The Patient Protection and Affordable Care Act of 2010 imposes on individuals, estates, and trusts a new Medicare tax equal to 3.8% on NII starting in the 2013 tax year. NII generally includes gross income from interest, dividends, annuities, royalties, rents, substitute interest and substitute dividends (generally referred to as “Category 1” type income); passive income to the taxpayer and income from the trading in financial instruments or commodities (“Category 2” type income); and net gain from the disposition of property (“Category 3” type income), reduced by properly allocable expenses that are allowed for federal income tax purposes.

The NII tax was originally drafted to tax “unearned income,” and the intent was to capture most income that is not already being taxed by either Medicare employer withholding or self-employment tax, which were both increased to 3.8 percent for high-income taxpayers. There are many issues with how the statute and the proposed regulations are drafted. Particularly relevant to the alternative investments industry is the distinction in treatment of income allocated from investor and trader funds.

Highlights from the regulations include the following:

- Gains and losses from trader funds are considered NII, but only net gains (not net losses) from investor funds are considered NII.

- Swap income (periodic payments and mark-to-market inclusions) earned by a trader fund is considered NII, but swap income earned by an investor fund is not. Gains from the sale of swaps would be NII for both investor and trader funds.

- Current inclusions of income from passive foreign investment companies (PFICs) and controlled foreign corporations (CFC) are taxed under the NII regime if the PFIC or CFC is held through a trader fund, however are not taxed until cash is received if held through an investor fund. Investment in a PFIC/CFC through an investor fund creates a timing difference requiring investors to keep (either directly or through a partnership) a separate set of records to track the basis and income inclusion for regular and NII tax purposes.

- There is a conformity election that allows investors to elect to follow the same timing as for regular tax purposes, but the election must be made by the individual taxpayer for all PFICs owned. Recommendations have been made to the IRS to either allow the conformity election to be made at the partnership level, or alternatively allow the taxpayer to make a separate election for each PFIC.

- There is a special rule for traders that allows any excess trading expense deductions used to offset self-employment income, to offset their trading income subject to NII tax. Although this rule was included as a taxpayer-friendly measure to ensure that a trader did not lose the benefit of the excess deductions, it provides an ordering rule that is less than optimal. The deductions must first be used to offset net income subject to self-employment tax, and only then can the remainder be used to offset NII. This is less than optimal because a taxpayer gets a deduction for regular tax purposes for half of the self-employment tax paid, but not for NII tax.

- Gain associated with the goodwill on the sale of a management company should not be subject to NII; gain associated with the goodwill on the sale of a general partnership entity earning an incentive allocation or carried interest would be subject to NII.
There are several issues with netting of gains and losses mechanics, as well as the distinction between gross and net gains in various sections, that will have a direct effect on the Asset Management industry. Recommendations have been provided to the IRS and hopefully many of these will get “fixed” in the final regulations.

Currently foreign tax credits (FTCs) cannot be used as a credit against NII. It has been recommended to the IRS that a taxpayer should be able to use any excess FTCs that are not already being used for regular tax purposes.

If a taxpayer has an ordinary loss (for example, a section 475 loss) in a year in excess of other ordinary income, she would not be able to carry that forward to a subsequent year to offset NII because it is part of an NOL. A more fair result would be to allow a taxpayer to carry over the ordinary loss portion of an NOL that is associated with NII (for example, a section 475 loss).
Planning considerations

New rules often offer new planning opportunities. As is always the case with tax planning, everything depends on the specific facts and circumstances, and care should be given to proper structuring.

**Incentive allocation vs. incentive fee**

The incentive allocation earned by a fund manager is generally subject to NII tax, however not the fee income. There are potential opportunities to structure an incentive allocation as an incentive fee and pay it to the management company that is not a partner in the fund if the fund generates sufficient ordinary income and is not losing the benefit of character from an allocation. Because the effect on investors would be detrimental if the fund were not respected as a trader (deductions could be limited as investment expenses), the structure of the incentive as a fee in a partnership with US investors would likely not be as attractive as it would be for offshore funds. In addition to the character of the income, the structure of the management company, SALT ramifications, self-employment tax, and potential carried interest legislation must be considered.

**Limited partnership and S-corp management companies**

Of particular importance in the NII planning is the structure of the management company as either a limited partnership or S corporation. Fee income received by an S corporation or a limited partnership relying on the LP exclusion (which provides that earnings from partnerships that are attributed to a limited partner are excluded from the definition of net earnings from self-employment) is not subject to either NII or self-employment tax. Therefore, if properly structured, an incentive fee may not be subject to either NII or self-employment tax (aside from any reasonable guaranteed payments made).

**State and local tax (“SALT”) considerations**

One of the most significant SALT considerations is obviously the 4 percent NYC UBT that most NYC-based management companies pay on their fee income. An incentive allocation, however, is generally not subject to the NYC UBT due to the trading for your own account exception. The structuring to a fee in NYC would essentially be trading a 3.8 percent tax for a 4 percent tax. Importantly, however, the NYC UBT is deductible for regular tax purposes. When applying the specific facts and circumstances, consideration should be given to the amount of income apportioned or allocated outside of New York City.

**Carried interest considerations**

If carried interest legislation passes as currently drafted, any carried interest income treated as ordinary income under that legislation would be subject to self-employment tax (the “carried interest” legislation).

The carried interest legislation does not, however, say that fee income received for the purposes of providing investment advisory or management services is subject to self-employment tax. In other versions of the legislation, there was a separate section that specifically applied to fee income received by a partnership engaged in a professional services business (including investment advice or management) that essentially subjected that income to self-employment tax, even when it was earned by an S corporation or limited partnership. If the professional services legislation is enacted and thus eliminates the limited partner exclusion and the S corporation rules, structuring an incentive allocation as a fee is not as effective. However, if only the carried interest legislation passes in its current form, structuring an allocation as
a fee when a management company does not subject its fee income to self-
employment tax is still beneficial.

**NII tax vs. self-employment tax**

Some management companies (generally those organized as other than limited
partnerships or S corporations) subject their management company income to self-
employment tax. Again, the benefit of restructuring an allocation as a fee may not be
as apparent in this situation in which an investor is trading a 3.8 percent NII tax for a
3.8 percent self-employment tax. However, two significant differences should be
considered. First, 1.45 percent of the self-employment tax is deductible for regular
tax purposes, whereas none of the NII tax is deductible. Further, only 92.35 percent
of self-employment income is subject to tax. A basic analysis with certain
assumptions comparing $100 of gross income subject to NII tax versus self-
employment tax will demonstrate there is a 0.56 percent tax savings. As a result,
absent carried interest legislation, it may still be beneficial for management
companies that do subject their distributive share of fee income to self-employment
tax to structure it as an allocation instead of a fee.

**Allocation of management company expenses**

Assuming a fund is maintaining an allocation and not a fee, there has been
considerable discussion around the potential for a fund manager to allocate a portion
of its management company expenses to its incentive allocation, thereby reducing its
NII base. In general, the allocation of expenses between management company
income and the carried interest income should be consistent for NII and regular tax
purposes. As a result, this structure may be more palatable for a manager in a trader
fund than an investor fund. Furthermore, it is difficult to argue that the expenses are
properly allocable to the incentive allocation of trader funds but not to the incentive
allocation of investor funds. As a result, careful consideration should be given before
implementing this plan.

**Charging a management fee on GP invested capital**

Another planning consideration that has been discussed is charging a fund manager’s
invested capital a management fee. Essentially, a manager will reduce the amount
subject to NII and pick up that same income in the management company. At first
blush, this appears to be beneficial (particularly when the management fee income is
not subject to self-employment tax or NYC UBT). However, the economic impact
should be closely examined because every dollar of income that is paid to the
management company is a dollar of income that is not staying in the fund to benefit
from the fund’s rate of return. Generally, that rate of return is higher than any tax
savings associated with the 3.8 percent tax paid.

**PFIC planning**

From the investor’s perspective, a planning opportunity would be to invest in
offshore funds. Absent an election otherwise, the NII tax is deferred for investment in
PFICs until the cash is distributed. Consequently, an investor can get a deferral on
3.8 percent of the PFIC’s earnings that is not available if she is invested in a
partnership and taxed at the time of income allocation.

In addition to the deferral under the NII tax, there are benefits of PFIC investing
under regular federal income and SALT tax as well.

Careful consideration should be given to investing through a PFIC and to making or
not making a QEF election. However, given some of the existing benefits, as well as
the deferral of the NII tax, it will be interesting to see if a trend develops toward US
investors investing in the offshore fund instead of the onshore fund.
Reporting considerations

As can be seen, the reporting ramifications of this new tax will be difficult. The IRS has informally stated that over 30 different publications will need to change. Aside from the new NII form that will be required of individual taxpayers, there will be changes to the Form 1065, the Form 1065 Instructions, Form 1120-S, the Form 1120-S Instructions, the Schedule K-1, and so on. It is not anticipated the IRS will require funds to provide the exact amount of NII derived from each fund, as it is a calculation performed at the individual level. However, there will be an expectation that the fund will provide all of the necessary detail to the investors that they will need to do their individual calculations. The disclosures associated with the dual basis tracking of PFICs and CFCs are a perfect example. Funds and investors should expect a number of new Line 20 informational items to be populated on the Schedule K-1s.

Funds should also consider any impact that the NII will have on provisions of their legal documents. For example, offering memorandums may now include disclosures as to whether they anticipate the income to be subject to such tax. More importantly, partnership agreements that call for tax distributions should consider whether they are now required to make a distribution for NII tax, or whether they want to modify their agreements to allow for one.
Conclusion

The Asset Management industry is gearing up for what may turn out to be one of the most complex chapters of the Internal Revenue Code. Investors and funds should continue to closely monitor the regulatory activity around the proposed regulations, draft forms, and guidance, which is anticipated to be issued by the IRS in 2013. It is anticipated that further guidance will address some of the undue complexity and alleviate the administrative burden for taxpayers and their service providers. In the interim, the NII should be taken into consideration when analyzing estimated income tax payments and taxpayers should focus on potential planning.
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