McDermott Will & Emery

CUTTING THROUGH THE COVID-19 CHAOS: STRATEGIES FOR FAMILY OFFICE COMPENSATION STRUCTURES & INVESTMENT PARTNERSHIPS

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Wednesday, April 22, 2020

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QUESTION SUBMISSIONS

During this webinar you can submit questions through the Zoom Q&A function

- Questions will be visible to the presenters immediately after you submit your question
- The presenters will answer as many questions as possible live

GENERAL OVERVIEW

- CARES Act and Family Offices
- COVID-19's Impact on Profits Interest and Family Office Compensation Structures

CARES ACT – NOL HIGHLIGHTS

- The Tax Cuts and Jobs Act of 2017
  1. No NOL carryback
  2. NOLs carried forward indefinitely, but limited to 80% of taxable income
- CARES Act
  1. NOLs incurred in 2018, 2019 and 2020 can be carried back 5 years preceding the tax year of loss (to earliest year in which taxable income, then to next, etc.);
  2. Taxpayers can waive and carryforward
  3. Removes 80% taxable income limitation in 2018, 2019 and 2020; reinstated in tax years beginning after 2020
  4. Election to exclude 2017 from carryback years to avoid offsetting low-taxed Section 965 income
- NOTE: NOL carryback applies to individuals, subject to continuing application of basis, at-risk and passive loss limits

CARES ACT – NOL HIGHLIGHTS

- Additional Guidance
  - **Rev. Proc. 2020-24**: Rules to follow in taking into account NOLs
  - **Notice 2020-26**: Grants six-month extension of time to claim NOL that arose in tax year that began in 2018 and ended on or before June 30, 2019 through the "quick refund" procedure as opposed to amended tax returns for the carryback year
  - **Rev. Proc. 2020-23**: Generally allows partnerships subject to 2015 partnership new audit rules (BBA Partnership) to file an amended return instead of an Administrative Adjustment Request. A BBA Partnership that files an amended return pursuant to this revenue procedure is still subject to the centralized partnership audit procedures enacted by the BBA
  - **FAQs on Faxing Refund Forms**

CARES ACT – EXCESS BUSINESS LOSS HIGHLIGHTS

- The Tax Cuts and Jobs Act of 2017
  i. Imposed limit on "excess business losses" of noncorporate taxpayers
  ii. Excess business loss defined as excess of (A) taxpayers' aggregate deductions for tax year attributable to taxpayer's trades or businesses over (B) the sum of (y) taxpayer's aggregate gross income or gain for tax year attributable to taxpayer's trades or businesses plus (z) $250,000 ($500,000 married filing jointly)
  iii. Disallowed amount is carried forward as a NOL
- CARES Act
  i. Eliminates "excess business loss" limitation for 2018, 2019 and 2020
  ii. Capital losses not taken into account in determining excess business losses
  iii. Capital gains included in aggregate business income to the extent of the lesser of
     A. Net capital gain attributable to a trade or business or
     B. The capital gain net income
  iv. Provides that the excess business loss limit does not apply to NOLs used in the carryforward year

CARES ACT – BUSINESS INTEREST LIMITATION HIGHLIGHTS

- The Tax Cuts and Jobs Act of 2017
  i. Business interest deduction in tax year limited to sum of (a) taxpayer's business interest income for the year + (b) 30% of taxpayer's ATI + (c) taxpayer's floor plan financing interest expense for year
  ii. Special coordination rules between partners and partnerships
- CARES Act
  i. Increases the limitation from 50% of ATI from 30%; for partnerships this increase applies to tax years beginning in 2020 only; taxpayers can elect to keep 30% ATI limitation for 2019 and 2020 tax years
  ii. Partner's allocable share of partnership's "excess business interest expense" or EBIE for 2019 tax year is treated as follows
     A. 50% of partner's 2019 allocable share of EBIE treated as deductible business interest expense beginning in 2020
     B. Remaining 50% subject to same 163(j) coordination rules between partners and partnership
  iii. Taxpayers can elect to apply their 2019 ATI, rather than their 2020 ATI, in applying Section 163(j)

CARES ACT – BUSINESS INTEREST LIMITATION HIGHLIGHTS

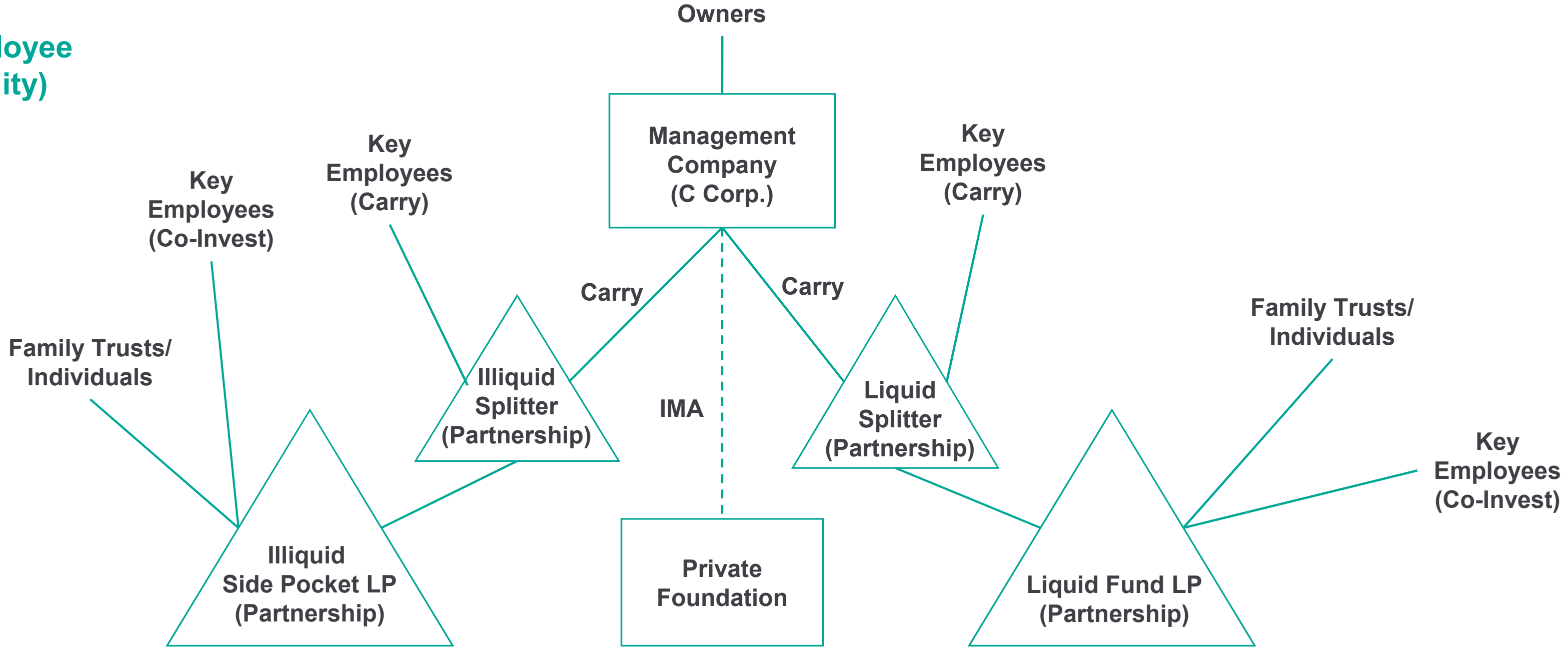
- Additional Guidance
  - <u>**Rev. Proc. 2020-22**</u>: Provides time and manner to elect (1) out of the 50% ATI for tax years beginning in 2019 and 2020 (only 2020 for partnerships), (2) to use the taxpayer's 2019 ATI for 2020 tax year, and (3) out of deducting 50% of EBIE for taxable years beginning in 2020 without limitation

CARES ACT – PAYROLL

- Social Security Tax Deferral – Interplay with loan forgiveness programs
- Employee Retention Tax Credits

COVID-19'S IMPACT ON PROFITS INTEREST AND FAMILY OFFICE COMPENSATION STRUCTURES

Sample Structure (With Key Employee Incentive Equity)



COVID-19'S IMPACT ON PROFITS INTEREST AND FAMILY OFFICE COMPENSATION STRUCTURES

- Potential Impact on Existing Family Office Compensation Structures
  - Resetting of High-Water Marks
  - Lower AUM Base (for AUM-Based Profits Interest)
  - Potential Reductions in Family Office Operating Budgets
  - Valuation Challenges with Respect to Illiquid Assets
  - Reduced K-1 Management Fees if Fees Based on AUM
  - Dealing with Market Volatility on Profits Interest Models
  - Liquidity Impacts (e.g., Hedge Fund Gates)
  - Limited Partners with Capital Loss Carryforwards
  - Revisiting Side Pocket Structures

COVID-19'S IMPACT ON PROFITS INTEREST AND FAMILY OFFICE COMPENSATION STRUCTURES

- Potential Impact New Structures
  - Potential Opportunity for Low AUM Starting Point
  - Same Considerations as Identified Above for Existing Structures
- Key Employee Incentive Equity Planning
  - Resetting High-Water Marks
  - Catch-Up Allocations
  - Change in Direct Investment Opportunities and COVID-19's Impact on Private Equity More Broadly
  - Overall Budget Considerations

THANK YOU

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