

# U.S. Tax Reform – Key Highlights for Private Investment Funds in Tax Cuts and Jobs Act Bill

**December 18, 2017**

On Friday, December 15, 2017, the Congressional conference committee released a revised version of the Tax Cuts and Jobs Act (the "Tax Bill"). [1] The Senate and the House are expected to vote on the Tax Bill this week. The Tax Bill, if passed, will represent a major change in U.S. tax law with significant and complex implications for private investment fund sponsors, their investment professionals and fund investors, as well as for structuring fund investments and secondary sales of partnership interests.

We are continuing to analyze all of these aspects of the Tax Bill and will be conducting further outreach to our clients and friends. In this client alert, we briefly identify certain key provisions. The impact of the Tax Bill will not be the same for all private investment funds. In particular, there may be special issues for hedge funds, real estate funds and other types of funds that are not addressed in this client alert. Please contact the Proskauer Tax Group to discuss these issues further.

Importantly, certain provisions that had been included in prior versions of the proposed tax legislation were not included in the Tax Bill. In particular, the Tax Bill does *not* include (i) a provision that state and local entities, such as public pension plans, that are tax-exempt under section 501 and 115 as government entities are subject to tax on unrelated business taxable income, (ii) a provision repealing the "limited partner" exception to self-employment taxes in Section 1402 of the Internal Revenue Code or (iii) a provision requiring the cost basis of certain securities sold to be determined on a first-in first-out basis where the taxpayer had acquired different lots of the securities on different dates or at different prices.

## **Certain Key Provisions in the Tax Bill**

### **1. Tax Rates and the AMT**

#### *Individuals*

There are seven tax brackets with a top rate of 37%. These tax rates are effective for taxable years 2018 through 2025, and then revert back to a top rate of 39.6%. [2]

The "alternative minimum tax" (AMT) is retained for individuals. The exemption amount and phase-out thresholds are temporarily increased for taxable years 2018 through 2025, and then revert back to the current amounts. [3]

The current 20% maximum rate on net capital gain and qualified dividend income is retained.

### *Corporations*

The corporate rate is permanently cut to 21% for tax years beginning in 2018. [4]

The AMT is repealed for corporations. [5]

## **2. Carried Interest - 3 Year Holding Period**

A significant change is made with respect to the taxation of carried interest and other partnership interests held in connection with the performance of services, such as profits interests related to deemed contribution mechanisms. In particular, gain with respect to these partnership interests is recharacterized as short-term capital gain to the extent the capital asset giving rise to the gain has been held for 3 years or less. [6] This is a material departure from current law which provides that gain from the sale of a capital asset held for more than one year is generally eligible for long-term capital gain treatment. Short-term capital gain is taxed at the higher ordinary income tax rates (but generally can be offset by net long-term capital losses). The 3-year holding period requirement does not apply to any capital interest in a partnership which provides a right to share in partnership capital commensurate with the amount of capital contributed (determined at the time of receipt of such partnership interest). The provision does not impact the tax treatment of any qualified dividend income. This new provision applies to taxable years beginning after December 31, 2017.

## **3. 20% Deduction on Qualified Business Income**

Subject to various limitations and special rules, this complex provision of the Tax Bill generally permits a taxpayer other than a corporation to deduct from its taxable income 20% of its qualified business income. [7] "Qualified business income" ("QBI") generally does not include the types of income realized by many private investment funds such as capital gains, dividends, interest income (other than interest income which is properly allocable to a trade or business) and certain other passive income. QBI also does not include reasonable compensation for services or any guaranteed payments paid to a partner for services. A "qualified trade or business" (which can give rise to QBI) does not include, among other excluded businesses, the performance of services that consist of investing and investment management, except for certain taxpayers with taxable income below a certain threshold. This provision is effective for taxable years beginning after December 31, 2017.

#### **4. Gain on Sale of Interest in Partnership Engaged in a U.S. Trade or Business Treated as ECI; New Withholding Requirement for Buyers**

The Tax Bill reverses the recent Tax Court decision *Grecian Magnesite Mining v. Commissioner* [8], and thereby effectively codifies Revenue Ruling 91-32, by treating gain or loss from the sale of a partnership interest as income that is "effectively connected" with a U.S. trade or business ("ECI") to the extent attributable to a trade or business of the partnership in the United States. [9] Specifically, the Tax Bill treats the sale of a partnership interest as a sale of all of the partnership's assets for their fair market value as of the date of sale, and determines the amount of ECI to the selling partner based on the amount of ECI that would be allocated to that partner by the partnership in the hypothetical sale transaction. This provision of the Tax Bill would apply to sales on or after November 27, 2017.

Of particular significance to secondary sales of partnership interests, the Tax Bill also requires the buyer of an interest in a partnership, where any portion of the gain would be treated as ECI to the seller under the new provision described above, to withhold 10% of the amount realized by the seller on the sale of the interest. This withholding requirement does not apply if the seller furnishes to the buyer an affidavit stating under penalties of perjury the seller's U.S. taxpayer identification number and that the seller is not a foreign person. If the buyer fails to withhold the required amount, the partnership is required to withhold that amount from distributions to the buyer. This provision of the Tax Bill would apply to sales after December 31, 2017.

## **5. UBTI Computed Separately for Each Trade or Business Activity**

Under current law, income and loss from all of an exempt organization's unrelated trade or business activities is calculated on an aggregate basis. The Tax Bill instead requires the computation of UBTI separately for each unrelated trade or business of the organization. [10] This change would prevent a tax-exempt organization from using expenses or losses related to one trade or business to offset UBTI generated from another trade or business. This change may impact the decision of some tax-exempt investors regarding whether to invest in certain investments through a "blocker" corporation. It may also add significant complexity to UBTI reporting by investments with multiple sources of UBTI (especially funds of funds). The provision is effective for taxable years beginning after December 31, 2017, although a special transition rule permits operating losses arising in a taxable year beginning before January 1, 2018 to be carried forward.

## **6. Excise on Net Investment Income of Certain Colleges and Universities**

The Tax Bill imposes a 1.4% excise tax on net investment income of private colleges and universities (i) that have at least 500 tuition paying students during the preceding taxable year (more than 50% of which are located in the United States) and (ii) the aggregate fair market value of the assets of which at the end of the preceding taxable year (other than assets used in directly carrying out the organization's exempt purpose) is at least \$500,000 per student. [11] This provision applies to taxable years beginning after December 31, 2017.

## **7. Changes to Interest Deductibility**

The Tax Bill changes Section 163(j) of the Code to limit generally the deduction for business interest expense for any taxable year to the sum of (i) the business interest income of the taxpayer for the taxable year and (ii) 30% of the "adjusted taxable income" of the taxpayer for the taxable year. [12] "Business interest" expense means any interest paid or accrued on indebtedness properly allocable to a trade or business regardless of whether it is related party or unrelated party indebtedness. Any business interest expense that is not allowed as a deduction for any taxable year under this provision can be carried forward indefinitely. Taxpayers are exempt from this deduction limitation if their average annual gross receipts for the three taxable year period ending with the prior taxable year do not exceed \$25 million.

Accordingly, this change has implications not only for portfolio companies, but also leveraged "blocker" corporations that might be used by investment funds.

This provision applies to taxable years beginning after December 31, 2017. However, for taxable years beginning after December 31, 2017 and before January 1, 2022, "adjusted taxable income" is computed without regard to any deduction allowable for depreciation, amortization or depletion thereby potentially increasing the base to which the 30% is applied and potentially increasing the permitted interest deduction for those years.

#### **8. Limitation on Excess Businesses Losses for Taxpayers other than Corporations**

For taxable years 2018 through 2025, an excess business loss of a non-corporate taxpayer is disallowed and is permitted to be carried over as a net operating loss. [13] The "excess business loss" of a taxpayer for a taxable year is (i) the aggregate deductions of the taxpayer for the taxable year that are attributable to trades or businesses over (ii) the aggregate gross income or gain of the taxpayer for the taxable year attributable to such trades or businesses plus \$250,000 (or twice this amount in the case of a joint return). This provision applies after the application of the passive loss rules.

#### **9. Expansion of Controlled Foreign Corporation Rules**

The Tax Bill will likely increase the number of non-U.S. portfolio companies that are treated as "controlled foreign corporations" ("CFCs") as it fundamentally expands the reach of the CFC rules.

Under current law, a non-U.S. corporation is a CFC if U.S. persons who own, directly or by attribution, 10% or more of the total combined *voting power* of all classes of stock entitled to vote of the non-U.S. corporation - "United States shareholders" - own directly or by attribution, more than 50% of the non-U.S. corporation (by vote or value).

The Tax Bill expands the definition of "United States shareholder" so that any U.S. person that owns 10% or more of the *total value* of shares of all classes of stock of the non-U.S. corporation also is considered a United States shareholder. [14] This expansion generally would apply to taxable years beginning after December 31, 2017.

The Tax Bill also provides for expanded downward attribution from a non-U.S. person of its stock in a non-U.S. corporation to a related U.S. person for purposes of determining whether the U.S. person is a United States shareholder and whether the non-U.S. corporation is a CFC. [15] This change generally would be effective for the last taxable year of non-U.S. corporations beginning before January 1, 2018.

## **Next Steps**

If you would like to discuss the provisions discussed above, or the Tax Bill more generally, please contact a member of the Proskauer Tax Group. In addition, as mentioned above, we will be doing more detailed outreach soon.

[1] H.R. 1. The Tax Cuts and Jobs Act can be found [here](#). All Section references are to the Tax Bill.

[2] Sec. 11001. Modification of Rates.

[3] Sec. 12003. Increased Exemption for Individuals.

[4] Sec. 13001. 21-Percent Corporate Tax Rate.

[5] Sec. 12001. Repeal of Tax for Corporations.

[6] Sec. 13309. Recharacterization of Certain Gains in the Case of Partnership Profits Interests Held in Connection with Performance of Investment Services.

[7] Sec. 11011. Deduction for Qualified Business Income.

[8] 149 T.C. No. 3 (July 13, 2017).

[9] Sec. 13501. Treatment of Gain or Loss of Foreign Persons from Sale or Exchange of Interests in Partnerships Engaged in Trade or Business Within the United States.

[10] Sec. 13702. Unrelated Business Taxable Income Separately Computed for Each Trade or Business Activity.

[11] Sec. 13701. Excise Tax Based on Investment Income of Private Colleges and Universities.

[12] Sec. 13301. Limitation on Deduction for Interest.

[13] Sec. 11012. Limitation on Losses for Taxpayers Other than Corporations.

[14] Sec. 14214. Modification of Definition of United States Shareholder.

[15] Section 14213. Modification of Stock Attribution Rules for Determining Status as a Controlled Foreign Corporation.

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