TAX REFORM AND INVESTMENT MANAGEMENT: INITIAL OBSERVATIONS

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U.S. Public Policy, Tax, and Investment Management Alert

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On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "Act"). While the Act will impact many types of taxpayers, some of the more significant changes are relevant to private funds, investment advisers, mutual funds, and others in the investment management industry. We have highlighted various of those provisions below. In addition, other provisions of the Act will impact investors, such as revisions to the rules for Section[1] 529 plans (to allow $10,000 per year per beneficiary to be used for pre-college education) and to the rules for Individual Retirement Accounts, which may affect investor demand and behavior.

For calendar year taxpayers, most, but not all, of the provisions of the Act become effective for taxable years beginning on or after January 1, 2018. Many, but not all, of the provisions of the Act sunset after December 31, 2025.

This is the first in a series of alerts that K&L Gates will publish regarding the impact of the Act on the investment management industry. Please visit our Tax Reform Resources page for additional information and periodic updates about the Act. We invite you to contact any member of our tax team to discuss the methods that may be of most benefit in your situation as well as the stumbling blocks you should be aware of in the Act.

THREE-YEAR HOLDING PERIOD FOR CAPITAL GAINS TREATMENT FOR CARRIED INTERESTS.

Effective for taxable years beginning after this December 31, the Act imposes a three-year holding period requirement in order for capital gains realized with respect to a profits interest in an investment partnership (*e.g.*, carried interests) to be taxed as long-term capital gain. Under the law in effect for 2017 and prior taxable years, the holding period was one year. If the three-year holding requirement is not met, any gain on the sale of such an interest will be treated as short-term capital gain and taxed at ordinary income rates. The three-year holding period also applies to the carried interest holder's share of net capital gains realized with respect to investment assets held by the partnership. This provision, however, does not apply to (1) interests held, directly or indirectly, by a corporation or (2) capital interests that provide a right to share in partnership capital commensurate with the amount of capital contributed or with the amounts included in income as compensation under Section 83.

These new rules only apply to an "applicable partnership interest," which is generally a partnership interest received by a taxpayer in connection with the taxpayer's performance of substantial services in the trade or business of raising or returning capital and either investing in, or disposing of, securities, commodities, real estate held for investment, cash or cash equivalents, options or derivatives, and similar interests or developing such assets. Accordingly, this provision applies to carried interests and similar profits interests issued in connection with the asset management business. It appears that interests in partnerships issued before the effective date of the Act may be subject to these rules. It is anticipated that regulations or other guidance will be issued clarifying the scope of these new rules as a number of uncertainties remain (*e.g.*, the application of the rules in connection with tiered partnerships). Given the prevalence of the issuance of carried interests to managers of hedge funds, private equity funds, and similar asset managers, these new rules may implicate structural changes to traditional fund structures going forward.

CORPORATE INCOME TAX RATE – TOP RATE REDUCED FROM 35% TO 21%.

Effective for taxable years after December 31, 2017, the Act eliminates the current graduated corporate income tax rate structure and imposes a flat 21% tax rate. Under the law in effect for prior taxable years, the highest corporate income tax rate was 35%. Unlike many other provisions of the Act, there is no sunset date on this provision.

REDUCTION OF HIGHEST INDIVIDUAL INCOME TAX RATE.

Effective for taxable years beginning after December 31, 2017, and before January 1, 2026, there will be seven tax brackets applicable to individuals' taxable income: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. Under the law in effect for prior years, the tax rates have been10%, 15%, 25%, 28%, 33%, 35% and 39.6%. The reduction of the highest individual income tax rate from 39.6% to 37% will impact various disclosures of investment companies registered under the Investment Company Act of 1940, as amended (e.g., mutual funds and exchange-traded funds), where calculations of after-tax returns are based on the maximum individual income tax rates and certain other disclosures (e.g., backup withholding, which is based on the fourth lowest marginal rate for individual taxpayers, which has been reduced from 28% to 24%). Following the sunset of this provision after 2025, the pre-Act tax brackets and rates will apply.

MISCELLANEOUS ITEMIZED DEDUCTIONS FOR INDIVIDUALS, TRUSTS, AND ESTATES ARE ELIMINATED.

Effective for taxable years beginning after December 31, 2017, and before January 1, 2026, miscellaneous itemized deductions (*e.g.*, investment management fees) for individuals, trusts, and estates are eliminated. Under the law in effect for prior years, individuals have been permitted to deduct certain miscellaneous itemized deductions to the extent that such deductions exceed 2% of adjusted gross income.

PASS-THROUGH INCOME DEDUCTION OF 20%.

Effective for taxable years beginning after December 31, 2017, and before January 1, 2026, the Act provides a new deduction for certain pass-through income of noncorporate taxpayers. Specifically, the Act allows a partnership, S corporation, or sole proprietorship a deduction for "qualified business income" ("QBI"), which is the net amount of items of income, gain, deduction, and loss with respect to the trade or business of the taxpayer. In general, the deduction is 20% of the taxpayer's QBI. Notably, the Act provides that the 20% deduction may be taken against qualified real estate investment trust ("REIT") dividends and qualified publicly traded partnership income. The deduction is not applicable, however, to capital gain dividends or qualified dividend income. It is unclear how a registered fund's investment in these entities will be treated under the Act. Moreover, the deduction is only available to specified service trade or business income, including from the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities, to the extent that the income of the individual engaged in such business does not exceed certain levels ($315,000 for joint filers and $157,500 for single filers). While there will be no shortage of planning opportunities for taxpayers seeking to maximize the likelihood of benefitting from this deduction, in light of the Act's significant ambiguities and uncertain application to a variety of industries and situations, however, the precise contours of the deduction remain to be seen and likely will require interpretive guidance from the Internal Revenue Service (the "IRS"). Please refer to our client alert on this provision which can be found at the following link: U.S. Tax Reform: A Golden Ticket for Partnerships and S Corporations?

LIMITATION OF DEDUCTION FOR BUSINESS INTEREST.

The deduction for business interest for any taxable year beginning after December 31, 2017, will be limited to the sum of (1) business interest income for such year, (2) 30% of "adjusted taxable income" for such year (which cannot be less than zero), plus (3) floor plan financing interest for such year.

"Adjusted taxable income" means a taxpayer's taxable income, computed without regard to (1) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss ("NOL") deduction under Section 172; (4) the amount of any deduction under Section 199A; and (5) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. In addition, the IRS may provide for other adjustments in computing adjusted taxable income. Business interest that is not deductible because of this limitation may generally be carried forward indefinitely except with respect to partnerships, which are subject to certain additional special rules.

NET OPERATING LOSS ("NOL") LIMITATIONS.

The NOL deduction is now limited to 80% of taxable income, calculated without regard to the NOL deduction. In addition, the two-year carryback of NOLs has been repealed, and taxpayers are no longer permitted to carryback

NOLs, with a limited exception for farming businesses. However, taxpayers are no longer restricted to a 20-year carry over period, and may now carry over NOLs indefinitely. These rules are effective for losses and NOLs arising in taxable years beginning after December 31, 2017.

REDUCTION IN DIVIDENDS RECEIVED DEDUCTION.

As discussed above, the highest corporate income tax rate has been reduced from 35% to 21%. Prior to the Act, corporations were generally entitled to a 70% deduction for dividends received from other corporations or an 80% deduction for dividends received from a corporation in which the corporate parent owned 20% or more of the stock. Under what is thought to be a corresponding revision to partially offset the corporate income tax rate reduction, the dividends-received deductions have been reduced from 80% and 70% to 65% and 50%, respectively. In the case of dividends received from a corporation that is a member of the same consolidated group, a recipient corporation is still permitted a 100% deduction. The reduction in the deduction is effective for taxable years beginning after December 31, 2017.

TIMING OF INCLUSION OF INCOME FOR ACCRUAL BASIS TAXPAYERS.

For accrual basis taxpayers, unless an exception applies, an amount is included in income when all events have occurred that fix the right to receive that income and the amount of that income can be determined with reasonable accuracy. This is known as the "all events test." Generally, under the Act, the all events test will not be met with respect to an item of income any later than when that item is taken into account as revenue in (1) an applicable financial statement of the taxpayer or (2) under rules specified by the IRS, another financial statement. In addition to other types of income, this rule will also apply to income from original issue discount ("OID") and market discount on loans and mortgage-backed securities. This rule does not apply to a taxpayer that does not have a financial statement as described above for a taxable year, and it does not apply to income from mortgage servicing contracts (including, presumably, income from excess servicing). These changes are effective for taxable years beginning after December 31, 2018, for income from a debt instrument having OID, and for taxable years beginning after December 31, 2017, for other types of income.

GAIN FROM SALE OF PARTNERSHIP INTEREST.

The IRS has previously taken the position that gain or loss realized by non-U.S. persons from the disposition of an interest in a partnership that conducts a trade or business through a permanent establishment or fixed place of business in the United States should be treated as gain or loss effectively connected with a U.S. trade or business or attributable to a permanent establishment. However, in the 2017 Tax Court case *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, the Tax Court rejected this position. The Act, in turn, effectively codifies the reversal of *Grecian Magnesite Mining*. If a non-U.S. person disposes of an interest in a partnership engaged in a trade or business in the United States through a permanent establishment or fixed place of business, gain or loss on the disposition of such partnership interest is treated as effectively connected with the conduct of the trade or business if certain rules and conditions are met. Such income is generally subject to withholding requirements similar to withholding under the FIRPTA regime. This provision applies to sales, exchanges, and dispositions of a partnership interest on or after November 27, 2017. The withholding requirements apply to sales, exchanges, and dispositions of a partnership interest after December 31, 2017.

INTERNATIONAL TAX PROVISIONS.

In addition to the above changes, the Act contains numerous international tax provisions. A new provision adds a deduction for the foreign-source portion of dividends received by a domestic corporation from a 10%-owned foreign corporation. A new "participation exemption" provision adds rules for treating deferred foreign income as "Subpart F income." Changes are made to the existing Subpart F rules and the definition of a "United States shareholder" for purposes of those rules. Provisions are added to prevent base erosion, to modify the rules for foreign tax credits, and to modify the insurance business exception to the passive foreign investment company rules. These rules, especially in the context of various investments of different investment vehicles, are complex.

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As noted above, in light of the Act's significant ambiguities and uncertain application to a variety of industries and situations, the precise impact of the Act remains to be seen and likely will require interpretive guidance from the IRS. Congress may also consider corrections legislation to address issues that arise as implementation moves forward.

As more details emerge, we will continue to publish updates on the matters addressed in this alert and other aspects of the Act, all of which are addressed in the publications listed on our Tax Reform Resources page.

We invite you to contact any member of our tax team to discuss the methods that may be of most benefit in your situation as well as the stumbling blocks you should be aware of in the Act.

Notes

1. All "Section" references are to the Internal Revenue Code of 1986, as amended.

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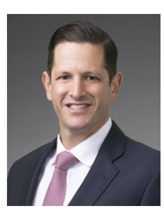

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