Alternative Investment Funds: Tax Proposals Impact But Do Not Dampen Their Use: An Update

On November, 16, 2017, the House of Representatives passed the Tax Cuts and Jobs Act (the House Bill). On December 2, 2017, the Senate passed its own version of such legislation that is similar to the House Bill in many respects, but also contains significant differences (the Senate Bill). The House needs to determine if they can accept the Senate Bill as written or if not, the House must meet in conference with the Senate to reach a compromise bill acceptable to both the House and the Senate and then send it to the President for his expected signature that will make tax reform a reality.

Corporate, individual and international tax reform has been taking center-stage in the recently passed House and Senate Bills. Nonetheless, investment funds also would be affected by each bill, but in differing ways especially since each bill takes similar, but often different, paths to implementing the potentially most significant tax reform legislation of the 21st Century.

The grant of carried interests in a partnership has been a long-standing tax-favored way to reward sponsors, managers and other service providers involved in the creation and syndication of an investment partnership. The carried interest can be granted tax-free as long as it is only an interest in future partnership profits and not existing partnership capital; later capital gains on sale of partnership property flow through to the carried interest holder.

Both the House Bill and the Senate Bill would change the treatment of carried interests, but in a limited manner. Long-term capital gain treatment would only apply if a three-year (rather than a one-year) holding period were met. This change would not affect any carried interest holders unless there is turnover in investments in three years or less. Alternative investment fund (AIF) assets such as art and antiques, precious metals, fine wines, rare stamps and coins, and other collectibles are usually held for more than three years, but AIF assets can include more traditional assets such as hedge funds where the three-year holding period may not be met.

Leverage is often used and it has come under attack. Both bills generally limit the deduction for *business interest* to 30% of the taxpayer's adjusted taxable income (ATI) for the taxable year. However, the House Bill would allow excess interest expense to be carried forward only five years while the Senate Bill would allow carryforward indefinitely. Both bills may result in the permanent disallowance of excess interest that is carried forward but could not be utilized. Each bill has its own definition of ATI with the Senate taking a narrower approach that would limit more interest deductions than the House Bill, which is based on earnings before interest, taxes, and depreciation (EBITDA). However, the House Bill is more restrictive than the Senate Bill on allowing carryforwards of excess interest. Both bills do preserve the portfolio interest exemption, which has been a valuable tool for raising capital from non-U.S. investors without imposition of U.S. withholding tax on interest payments.

Under the House Bill, the tax rate on partnership business income that flows through to its partners would be lowered to as little as 25%, which is more than a third less than the proposed maximum regular tax rate for individuals of 39.6%. The 25% rate would apply to business income (such as real estate rental income) as long as the investor is a passive investor in the partnership as determined under the long-standing passive-activity loss rules. If the investor is active, then the 25% rate would only apply to 30% of the business income with the remainder taxed at regular tax rates. Qualified business income would not include active income from specified service trades or businesses. While capital gains would not be eligible for this special rate, the House Bill as well as the Senate Bill do not eliminate the preferential tax rate for long-term capital gains (LTCGs) recognized by individuals. Thus, LTCGs of individuals would still be taxed at a maximum rate of 20%.

In contrast to the House Bill, the Senate Bill would not change the tax rate applicable to partnership income, but would add certain deductions relating to partnership income to lower the tax burden on some, but not all, partners. After 2017, the Senate

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Bill would generally allow an individual taxpayer to deduct 23% of domestic qualified business income from a partnership. The deduction is limited to 50% of the taxpayer's allocable share of W-2 wages except for taxpayers whose taxable income is $500,000 or less ($250,000 or less if the taxpayer is not filing as a married filing jointly return). Qualified business income would not include income from specified service trades or businesses. If an individual were subject to the Senate's maximum individual tax rate of 38.5% (reduced from the current 39.6% rate), then the impact of this deduction is to lower the effective tax rate to 29.645%, which is a smaller tax break than that given by the House Bill. The Senate Bill deduction would not apply to trusts or estates.

The House Bill would eliminate one partnership nuisance factor. If within a 12-month period, there are sales or exchanges of interests in a partnership that equal or exceed 50% of the total interest in partnership profits and capital then the partnership is deemed terminated for tax purposes. This hyper-technical rule can serve to reset the clock for depreciating the partnership's assets, which can lower the annual depreciation deduction and increase a partner's tax bill, but otherwise it just adds the need for more tax filings and cost. The House Bill would eliminate this tax-termination rule and this trap for the unwary. The Senate Bill, however, did not choose to address terminations.

AIFs sometimes seek to take advantage of tax credits. The low-income housing tax credit is untouched by both bills and remains as a valuable tool to assist construction of affordable housing. However, historic preservation and community development were dealt a blow by the House Bill's elimination of the rehabilitation tax credit and the new markets tax credit. By contrast, the Senate Bill would retain the new markets credit and the rehabilitation credit but only for historic properties and at a lower 10% rate. Also, the tax-exempt status of private activity bonds would be eliminated under the Senate Bill, which would eliminate the use of these bonds to finance low-income housing and other investments.

AIFs may invest in personal property used in a trade or business. Both bills would allow for an immediate and full deduction for the cost of certain qualified tangible personal property. Only the Senate Bill would allow for a reduced 25-year recovery period for commercial and residential rental real estate. However, both bills limit the use of net operating losses (NOLs). Carryovers would be limited to 90% of taxable income while carrybacks would generally be eliminated. The Senate Bill proposes a new limitation for losses on active businesses, similar to current law rules for passive-activity losses.

State pension funds are another active investor in the AIF market. Private pension funds have had to cope with the unrelated business income tax (UBIT), which has sometimes led them to invest in offshore blocker funds that are the regular sanctuary for foreign investors. By investing in these offshore feeders, UBIT that may arise from the use of leverage or otherwise can often be avoided. By contrast, state pension funds are often part of local government and did not have to worry about UBIT. They could invest alongside U.S. taxable investors in a domestic feeder fund or directly into the fund. The House Bill seeks to change that by making state pension plans subject to the UBIT rules. Of great concern is that there is no grandfather rule for pre-existing investments; rather, the House Bill treatment would spring into effect next year. The impact could lower the investment yield to state pension plans already strapped with growing demands from retirees unless they can restructure their investments to match that done by private pension plans. The Senate Bill did not incorporate this change.

The Senate Bill would also adversely affect foreign investment in funds. As a reaction to a recent favorable Tax Court case, the Senate Bill would provide that gain from the sale of a partnership interest would be subject to U.S. tax if, and to the extent that, the partnership would have had fully taxable income (i.e., so-called effectively connected income) if it sold its assets at a gain. The House Bill does not contain this provision.

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Management fees may also be impacted by these proposals. The Senate Bill would repeal miscellaneous itemized deductions (such as management fees). By contrast, the House Bill retains such deductions. Also, an individual's deduction of management fees would no longer be limited under the overall limitation for miscellaneous itemized deductions. The House Bill will eliminate the alternative minimum tax (AMT) but the Senate Bill retains the AMT.

An increased standard deduction coupled with the removal of many time-honored deductions (such as for state and local income taxes) would mean itemization of deductions would not be necessary for millions of Americans. Fortunately, proposals originally in the bills to substantially curtail use of tax deferral rules relating to compensation were omitted from the final bills.

The Takeaway

The bottom line assessment is that many AIFs are generally breathing a sigh of relief by the terms of these bills. However, the differences between the House Bill and the Senate Bill need to still be resolved and, thus, further change is still possible. Of even greater importance is how investors will react to these new rules when adopted. Stay tuned as we keep you apprised of the ever-changing efforts in the Beltway to enact significant tax reform and the reaction once the market starts to digest the reality of what this all means. For more information on these bills and how it may impact other areas of taxation, please see our recent Tax Release.

For further information, please contact your Andersen Tax advisor.

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