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The Tax Cuts and Jobs Act (TCJA) effected sweeping reform across the Internal Revenue Code. This report, and future installments, will discuss this legislation and other important tax guidance, including how such authorities particularly impact the energy, technology and finance industries. These reports will provide insight on the application of the TCJA and other tax developments, its relevance in strategic decision making and practical implications for negotiating transactions and drafting the relevant documentation.

WEEK OF FEBRUARY 12

- Events
- Featured Articles
- Additional Reading
- Future Topics

EVENTS

WEBINAR - The Tax Cuts and Job Act: Its Impact on the Energy Industry

You can now view a recording of Bracewell's January 25th webinar *The Tax Cuts and Jobs Act - Its Impact on the Energy Industry* by clicking **here**.

Topics Covered:

- Business Taxes: The Impact of Reduced Corporate Rates, the Qualified Business Income Deduction, Immediate Expensing and the Interest Deduction Limitation
- Renewable Energy Credits: Outlook for Energy Credits and Changes in the Business Tax Regime Impacting the Value of Energy Credits
- Financing Transactions: Impact of the Interest Deduction Limitation and International

helpful.

Should you wish to have a dialogue on the topics covered in the recording, or if you have any questions, feel free to reach out to us by clicking **here**.

top

FEATURED ARTICLES

The New Three-Year Holding Period for Carried Interests
*By **Liz McGinley** and **Steven Lorch***

The Tax Cuts and Jobs Act (TCJA) modifies the holding period necessary for gains attributable to applicable partnership interests, commonly known as carried interests, to qualify as long-term capital gains, subject to federal income tax at a rate of 20%[1], from greater than one year to greater than three years. If the three-year holding period is not met, such gains are treated as short-term capital gains and, therefore, subject to tax at federal ordinary income tax rates at a maximum rate of 37%. The three-year holding period applies to gains from the sale or redemption of an applicable partnership interest, as well as gains attributable to such partnership's direct or indirect sale of assets to the extent allocated to the owner of the applicable partnership interest. An applicable partnership interest is an interest in a partnership transferred to a taxpayer in exchange for services performed in connection with the raising or returning of capital, and either investing in (or disposing of) or developing, specified assets. Specified assets include securities, commodities, real estate assets, cash and derivatives. An applicable partnership interest does not include a partnership interest held by a corporation, nor does it include a partnership interest, commonly referred to as capital interest, that constitutes a right to share in capital based on the amount of the taxpayer's contributed capital or the value of the interest taxable to the taxpayer upon receipt or vesting.

The three-year holding period applies to capital gains the taxpayer recognizes on or after January 1, 2018, regardless of when the taxpayer acquired the applicable partnership interest to which the gains are attributable. In other words, there is no grandfathering rule for applicable partnership interests issued to a taxpayer prior to 2018.

Several aspects of the new holding period rules are unclear. An example is whether the exclusion from the definition of applicable partnership interest for interests held by corporations is intended to exclude interests held by S-corporations as well. If so, fund managers could circumvent the holding period rule, but without sacrificing the benefits of pass-through taxation on their carried interests, simply by holding their interests indirectly through S-corporations. This opportunity may, however, be eliminated as yesterday Steve

Unfortunately, guidance resolving these issues, beyond addressing the loophole for carried interests held by S-corporations, is unlikely to be issued this year. Guidance relating to the holding period for carried interests is not mentioned in the 2017-2018 Priority Guidance Plan (click **here** for more). Moreover, the IRS has indicated, on an informal basis, that guidance on the scope of this rule is not a top priority, in part, because the rule will affect a small percentage of taxpayers relative to other new rules under the TCJA, particularly the deduction for qualified business income, the limitation on interest deductibility and the opportunity for 100% immediate expensing.

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[1] All income tax rates provided herein are exclusive of the Medicare tax on unearned income.

where REITs were leveraged in a manner to avoid the old earnings stripping rules (which had a 1.5:1 debt-to-equity limit), questions remain. First, REITs generally cannot actively engage in a trade or business; indeed, most of the REIT qualifications and requirements are designed for the REIT to function as a passive investor. Significantly, a lessor REIT is prohibited from performing activities under the terms of a lease other than those considered "usual and customary" in the market and otherwise must have the activities performed by an independent contractor. Moreover, a REIT may not own more than 35% of any such independent contractor and also is limited from owning interests in tenants. Query whether the new rule requires an active trade or business, a requirement that a REIT likely could not satisfy. This certainly is one interpretation, though REITs are not consistently excluded from provisions that require an active business; in some cases, they specifically are addressed. For example, REITs can participate in tax-free corporate spin-offs, which require an "active trade or business," but rules introduced in 2015 severely limited the ability of REITs to participate in a spin-off (see Code Section 355(h)).

Issues also could come up where a REIT shareholder is a holding company for a majority interest in a REIT. This is raised in the context of a private "domestically controlled" REIT (DCREIT), the interests of which are not considered interests in a "United States real property holding corporation," which otherwise would subject foreign shareholders to tax and withholding under the Foreign Investment in Real Property Tax Act (FIRPTA). While FIRPTA is outside the scope of this article, in the case of such a DCREIT, a domestic corporation is formed to hold a majority interest. Many of these domestic corporations were leveraged up to the 1.5:1 debt-to-equity limit formerly allowed under the old earnings stripping rules in order to mitigate entity-level tax. The "new" Code Section 163(j) rules would permit these corporations to leverage with foreign shareholder debt subject to the Interest Limitation (and other applicable limitations). However, if a REIT has a "real property trade or business" and elects out, query whether such a corporate shareholder also would be exempt, as it is akin to a holding company to which the trade or business arguably could be attributed? Even if a true holding company is eligible for the exception because its operating subsidiary is so eligible, this arguably would be directed at a parent corporation of an affiliated group (which requires 80% ownership by vote and value) that has no other assets besides stock of subsidiaries, rather than a shareholder that happens to have just the interest in a DCREIT (which is just over 50%).

The shift in focus away from related parties under "new" Code Section 163(j) is balanced by new so-called "hybrid" rules that specifically limit deductions – including for interest paid to certain related parties (click **here** for more). The new hybrid transaction rules deny taxpayers, including REITs, a deduction for interest or royalty payments to a foreign related party in transactions where such payments would not be taxed in either the United States or the other jurisdiction. These new rules eliminate the benefit of any remaining structures, including those used by REIT investors that survived being eliminated by treaties and foreign tax law (particularly transactions that are treated as loans in the United States but not in the foreign recipient's jurisdiction). Moreover, in cases where the REIT's potential status as a hybrid entity is relevant, one can see the tension between treating it as a corporation for these purposes, consistent with their treatment for most other purposes of the Code, and treating it as transparent, given that a REIT is not subject to entity-level taxation if it complies with distribution and other requirements. This may be an open question unless or until clarified by regulations.

Finally, corporations receiving flow-through treatment, such as REITs and S-corporations, are exempt from the new Base Erosion and Anti-Abuse Tax (click **here** for more) contained in the TCJA.

Bipartisan Budget Breakthrough Gives Orphans New Life

top

- Computational, definitional and other guidance with respect to the limitation on the deductibility of interest under Code Section 163(j) (click **here** for more);
- Guidance related to the new opportunity for immediate expensing of qualified property under Code Section 168(k) (click **here** for more); and
- Guidance regarding various international provisions of the TCJA.

Treasury and the IRS have already issued guidance with respect to the implementation of certain international provisions of the TCJA. Notice 2018-7 provided guidance with respect to the one-time tax on accumulated offshore earnings under Code Sections 951 and 965; Notice 2018-8 provided a suspension of the withholding requirement that otherwise would have been imposed under Code Section 1446(f) on the disposition of certain publicly traded partnership interests; and, most recently, Revenue Procedure 2018-17 modifies the circumstances under which certain foreign corporations can change their annual accounting periods in order to prevent abuse under Code Section 965.

Treasury has indicated, on an informal basis, that it plans to use the traditional regulatory process – pursuant to which Treasury issues proposed regulations, followed by a review and comment period during which the public may provide written feedback on the proposed regulations, followed by the issuance of final regulations – as a means of providing guidance under the TCJA. Although Treasury and the IRS intend to issue additional limited-scope notices that address narrow issues, notices generally will be issued more sparingly than in the past, including as compared with the guidance period following the 1986 Tax Reform Act.

Treasury expects that guidance under the TCJA will be developed over the next 18 to 24 months.

top

ADDITIONAL READING

How the Carried Interest Break Survived the Tax Bill

Carried Interest 'Reform' is a Sham

The Trump Tax Cuts Hurt This Manufacturer. It Kept On Lobbying.

top

FUTURE TOPICS

The Bracewell Tax Report will be distributed on a regular basis. Upcoming topics will include:

- Multi-part series focused on the partnership audit rules issued in 2015 and subsequent related guidance

interest deduction limitation and outlook for the extension of the 80% PTC/ITC carve-out from BEAT beyond 2025

If there are topics of interest that you would like us to cover, please click **here**.

top

Additional Information
Tax Practice
Upcoming Events
Firm Rankings
News & Publications

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