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Client Alert
Commentary

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How US Tax Reform Proposals Will Affect Private Investment Funds and Asset Managers

Aspects of the current proposals could significantly alter the US taxation of investment funds, sponsors, and investors.

Key Points:

- Major changes to US tax laws on business tax rates, interest deductibility, and international taxation would have ramifications for funds, sponsors, and investors
- Carried interest preserved but subject to three-year holding period for long-term capital gains

Both the House and the Senate have recently released detailed tax reform proposals. This *Client Alert* addresses certain aspects of the proposals likely to affect private investment funds and their sponsors. Latham & Watkins will soon publish additional materials analyzing the proposals more broadly and other specific provisions in them, including provisions applicable to domestic and international companies that will particularly affect the taxation of a fund's portfolio companies.

Legislative Process and Potential Timing

The House Ways and Means Committee approved an amended bill on November 9 (the House Bill), which House Republicans expect to vote on shortly. In the meantime, the Senate Finance Committee has released and updated its own proposal (the Senate Bill) in the form of a detailed summary. The Senate Finance Committee has not yet released the legislative text of their proposal. Moreover, Senators, including some Republicans, have submitted numerous amendments to the Senate Bill, although in many cases they have not publicly disclosed the substance of those amendments. Industry groups and lobbyists will focus on the differences between the two bills. House and Senate lawmakers will have to reconcile those differences before both houses of Congress can vote on a final version. In order to pass under Senate rules for bills enacted through budget reconciliation (which generally allows a bill to pass the Senate with only 51 votes), Republicans also must demonstrate that the tax reform bill should not increase the deficit beyond the 10-year budget window or increase the deficit during that window beyond the US$1.5 trillion limit established in the 2018 fiscal year budget resolution. While Republican lawmakers hope that the president will be able to sign a tax reform bill before the end of the year, passing the bill in that timeframe may prove challenging given the breadth of the proposed changes and the significant differences between the House and Senate bills.

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Carried Interest

- Generally, the House Bill imposes a three-year holding period requirement for long-term capital gains treatment on carried interest. Gains that do not satisfy the three-year holding period requirement are treated as short-term capital gains taxed at ordinary income rates.
    - The provision does not apply to interests (i) held by a corporation or (ii) that provide for a return commensurate with capital contributions made by the interest holder, or with amounts included in the holder's income as compensation under Internal Revenue Code Section 83.
    - The House Bill clarifies that it does not apply to profits interests held by a partner who is an employee of an entity that is not engaged in an investment-related business, if the partner provides services only to that other entity — which appears to exclude profits interests granted to portfolio company managers.
- The Senate Bill does not modify the current law treatment of carried interest. Senators (including one Republican) have proposed several amendments relating to carried interest, but the specific changes suggested in those amendments are not yet publicly available.

Observation: The House Bill does not contain the broad changes to carried interest taxation included in prior legislative proposals, such as recharacterizing all income from carried interest as ordinary income. Like most prior proposals addressing carried interest, the House Bill leaves unchanged the position under current law that a profits interest grant in exchange for services is not a taxable event to the recipient if certain conditions are satisfied.

The three-year holding period requirement only recharacterizes long-term capital gains, and therefore appears to leave intact preferential rates on qualified dividend income with respect to carried interest.

The language of the House Bill is unclear in several respects. For example, a provision requires a taxpayer transferring carried interest to a "related" person to include in income (as short-term capital gain) any long-term capital gains attributable to assets held for fewer than three years. While unclear, this provision arguably could impose a tax in relatively routine scenarios that generally are not taxable under current law, such as certain estate planning transfers and subsequent grants of carried interest to new investment professionals.

Limitation on Interest Deductions

30% cap on business interest

- Both bills would cap interest deductions for business interest at 30% of operating income (generally determined by starting with taxable income and adding back various items such as interest expense, NOLs and, in the case of the House Bill, depreciation and amortization).
    - Unlike the House Bill, the Senate Bill applies the 30% limit after reducing operating income for depreciation and amortization deductions, which could significantly reduce the allowable interest deduction for companies with substantial depreciable assets.
    - The Senate Bill permits disallowed interest to be carried forward to future years indefinitely. The House Bill permits only a five-year carryforward.

- Both bills exempt smaller businesses — with annual gross receipts of less than US$25 million under the House Bill or US$15 million under the Senate Bill — from the 30% limitation. The House Bill also generally exempts real estate businesses.

- Both bills also apply to pass-through businesses by applying the 30% limit at the partnership level.

  - For partnerships with net interest expense below the 30% limitation in a given year, the bills permit partners to take into account their share of the partnership's excess limitation to determine the partner's own interest limitation from other sources. The bills do not permit the reverse scenario, however; partners with excess interest limitation capacity cannot "share" that capacity with partnerships in which they hold an interest.

Observation: The limitation is broadly comparable to limitations enacted by other countries in response to the OECD's base erosion and profit shifting, or BEPS, initiative.

Unlike the current US earnings stripping rules, the new 30% interest limitation would apply without regard to the overall debt-equity ratio of the borrower or whether the lender is a related party or the lender's interest income is subject to US tax. The proposed limitations could significantly affect portfolio company leverage.

Because many private equity funds do not engage in a trade or business, these limitations, which apply to "business interest," should generally not apply to fund-level borrowing by those funds. Non-business interest expense on fund-level borrowing would remain subject to the limitations on the deductibility of investment interest for individual investors.

Whether the provision would apply to a blocker corporation that owns an interest in a pass-through portfolio company is unclear. If the limitations did apply, blocker corporations would be constrained in their ability to lower their effective tax rate through shareholder loans, currently a common structuring feature of many funds. Even so, non-US investors might still prefer to capitalize US blocker corporations with shareholder loans, since non-US investors may receive interest and principal payments free of US withholding tax — unlike dividends on blocker corporation shares.

Under the House Bill, real estate funds, including REITs, would in many cases be exempt from the 30% interest limitation.

Interest limitation on domestic entities of international groups

- Both bills limit the interest deductions of US corporations that are part of multinational groups.

  - The House Bill applies to domestic corporations that are members of "international financial reporting groups" (generally groups that file consolidated financial statements and have average annual gross receipts exceeding US$100 million). The premise of the provision is that a corporation's share of the group's worldwide interest expense should align with the corporation's share of worldwide EBITDA. The provision limits a US corporation's interest deductions to 110% of the international group's worldwide interest expense, multiplied by the ratio of the US corporation's EBITDA to the group's worldwide EBITDA. Similar limitations would apply to foreign corporations and partnerships engaged in a US business.

  - The Senate Bill applies to "worldwide affiliated groups" (generally an affiliated group of foreign and domestic corporations linked by 50% ownership). The Senate Bill proportionately reduces a US corporation's interest deductions to the extent its overall debt exceeds 110% of

the debt that the corporation would have had if the aggregate debt-equity ratio of all US corporations in the group equaled the debt-equity ratio of the worldwide affiliated group.

Observation: These provisions will affect portfolio companies with international operations. Although not entirely clear, the provisions likely will not apply to different portfolio companies held by a fund. Generally, funds are not required to "consolidate" their portfolio companies on their financial statements — a requirement for the application of the House provision. While the Senate Bill applies to affiliated groups of corporations, it defers to future regulations for rules applying the provisions to partnerships. If the proposal applied to a fund portfolio as a whole, the interest deductions of the fund's US investments may be affected by reference to the leverage of other portfolio companies the fund holds.

Reductions in Corporate and Pass-Through Tax Rates

- Both bills reduce the top corporate tax rate to 20% (from 35% today), although the Senate Bill would postpone this reduction to 2019.

- The House Bill would apply a 25% tax rate to business income of partnerships.

  - For passive investors, the 25% rate would apply to all business income of the partnership.

  - For active investors who materially participate in the partnership's business, the percentage of business income subject to the 25% rate will depend on the partnership's "capital percentage" (which is generally 30%, subject to elective higher rates for certain capital intensive businesses, and 100% for certain service businesses).

  - The Senate Bill would lower the tax rate on certain pass-through businesses by allowing owners to deduct 17.4% of the business income of the entity. The proposal would generally limit the deduction to 50% of the owner's allocable share of the W-2 wages paid by the entity, other than for owners with taxable incomes below certain thresholds.

Observation: Generally, lower corporate tax rates would make US blocker corporations less tax-inefficient structuring alternatives for tax-exempt and non-US investors than under current law. Although the limitations on interest deductions discussed above may limit investors' ability to reduce the effective tax rate of a US blocker corporation through shareholder debt, the overall effective tax rate of a US blocker corporation would likely be lower under the bills in many cases.

Individual fund investors in portfolio companies treated as partnerships would generally benefit from the preferential rates on pass-through business income under both bills. It appears that in many cases, carry plan participants would also benefit from the lower pass-through rates on business income from pass-through portfolio companies. Owners of fund management companies, however, generally would not receive preferential rates on the management company net income under either bill.

Non-US Partners' Treatment of Gain on Sale of Partnership Interests

- Under the Senate Bill, gain recognized by a non-US investor on the sale of a partnership interest (including an LLC taxed as a partnership) would be subject to US tax as "effectively connected income" (ECI) in proportion to the US business assets held by the partnership. This effectively codifies the IRS' long-standing position, which was called into question this summer when the Tax Court held against the IRS on this issue in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner* (149 T.C. No. 3 (July 13, 2017)).

Observation: Recently, some private equity funds with non-US or tax-exempt investors have structured investments in US pass-through businesses using non-US blocker corporations, rather than US blocker corporations, in order to take advantage of the exemption from US income tax on exit gain under the holding in *Grecian Magnesite.* That structure can significantly reduce the overall US tax burden to non-US investors in pass-through businesses. The Senate Bill generally would eliminate the advantages of that structure by taxing all or a substantial portion of the exit gain as ECI, consistent with IRS' historic position. Under the proposal, funds would more likely structure investments in US pass-through businesses through a US blocker corporation, as was more common prior to *Grecian Magnesite*. For further discussion of the *Grecian Magnesite* decision, see Latham's prior *Client Alert* US Tax Court Exempts Gain on Sale of a Partnership Interest.

Changes in the Scope of the Controlled Foreign Corporation (CFC) Rules

- Both bills broaden the definition of a CFC by changing the constructive ownership rules determining whether a foreign corporation meets the US ownership threshold to qualify as a CFC (generally 50% ownership by "US shareholders"). This proposal would treat US entities as constructively owning CFC stock owned by their foreign owners. Under current law, only CFC stock held by an entity's US owners is attributed through "downward" attribution to the US entity.

- The Senate Bill also broadens the definition of US shareholders who are required to include certain earnings and profits from CFCs on a current basis. Under the Senate Bill, US shareholders would include any US person that directly or indirectly owns 10% or more of the value *or* voting power of a foreign corporation's stock (under current law, only voting power is considered).

Observation: These proposals will increase the possibility that foreign corporations owned by a fund would be treated as CFCs, and that US investors would be treated as US shareholders subject to the CFC anti-deferral rules. For example, the changes to the constructive ownership rules arguably could be applied to treat any foreign portfolio company owned by a non-US fund as a CFC, if the fund (or a parallel fund with the same investor base) also owns a US portfolio company. CFC status may result in "phantom" income to investors that are US shareholders and additional tax reporting obligations.

Other International and Anti-Base Erosion Measures

- Both bills would make significant changes to US international tax rules, including:

    - Exempting US corporations from tax on dividends from foreign subsidiaries attributable to active business operations

    - Imposing a "one-time" repatriation tax on accumulated earnings of US corporations' foreign subsidiaries

    - Various measures intended to limit "base erosion" in the US

- Latham's forthcoming *Client Alert* will address these provisions, which likely will significantly affect fund portfolio companies with international operations, in more detail.

Tax-Exempt Investors and UBTI

- The House Bill would subject state pension plans and other state and local governmental entities to tax on their unrelated business taxable income (UBTI). Under current law, many state governmental

and pension investors take the position that they do not pay tax on UBTI, and typically, such investors do not invest in funds through "blocker" corporations as a result.

Observation: Many state governmental and pension investors take the position that they are not subject to tax on UBTI under the U.S. Constitution and would likely challenge the proposal, if enacted. If the proposal becomes law, more state pension fund investors would prefer investing through blocker corporations, particularly in funds that make non-US investments or leveraged funds where debt-financed income is the primary source of UBTI. Since the proposal contains no grandfathering clause, state pension fund investors may seek to restructure their existing direct fund investments through blocker corporations. US tax rules governing "outbound" transactions could make that restructuring difficult to achieve tax efficiently, in the case of existing investments, if investors desire a non-US blocker corporation.

- The Senate Bill would require tax-exempt investors to determine their UBTI separately for each unrelated trade or business. This would prevent losses from one UBTI activity of a tax-exempt investor from offsetting income from a different UBTI activity.

Observation: Many sophisticated tax-exempt investors do not participate in UBTI investments through "blocker corporations," because the overall tax burden resulting from the blocker corporation can exceed the investor's direct tax liability from UBTI. The proposal could make it more attractive for tax-exempt investors to hold multiple investments through a blocker (especially in light of proposed reductions in corporate tax rates) because a blocker corporation — unlike a tax-exempt investor under the proposal — would be able to net UBTI income and losses from separate investments.

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