Akin Gump
STRAUSS HAUER & FELD LLP

Tax Alert

November 7, 2017

Key Points:

- Significant corporate and potential individual tax rate reductions and a 25% individual tax rate on certain "qualified business income" would be introduced (although many fund investors and sponsors would not be eligible for the 25% rate). The deduction for state and local taxes (SALT) available under current law would be reduced significantly for individuals.
- The grant of a carried interest without liquidation value would continue to be tax-free, but holders would need to take into account a three-year holding period to obtain the preferential tax rate of long-term capital gains treatment.
- Leveraged U.S. "blocker" structures would need to be revisited and potentially optimized taking into account the post-reform tax regime.
- State pension plan investors that take the view that they are "super" tax-exempt investors would be subject to unrelated business taxable income (UBTI) rules, which may result in significant restructuring of existing fund structures and managed accounts for such investors who desire to block such UBTI.

Carried Interest and Other Tax Reform Highlights for Investment Funds and Asset Managers

On November 2, 2017, the House of Representatives released the first draft of the Tax Cuts and Jobs Act (the Bill), which could result in the most significant overhaul of the U.S. federal tax system since 1986. Subsequently, two substantive amendments were introduced by the Chairman of the House Ways and Means Committee. While the Bill is expected to change substantially and the Senate version remains to be unveiled, the Bill provides certain indications as to how tax reform may affect investment funds and asset managers. Significant aspects can be summarized as follows:

Tax Rate and Business Tax Reform

- The Bill would consolidate the tax brackets for all individual taxpayers and reduce the maximum corporate tax rate to 20%. The rate reductions would also be available for U.S. tax-exempt investors subject to tax under the UBTI rules. The alternative minimum tax (AMT) would be repealed for all taxpayers. The 3.8% tax on net investment income (aka the Medicare tax) would continue to apply.

- A maximum 25% individual tax rate would be introduced for certain qualified business income, which is intended to capture trade or business income from "passive" activities and a portion of income derived from "active" activities (i.e., a capital percentage). Income arising from investment or trading activities (such as long- and short-term capital gains, dividends, non-business interest and derivative income) would generally be excluded. However, certain income derived from direct lending activities and portfolio investments in pass-through entities may be eligible. Thus, U.S. individual investors and carry recipients would be eligible for the reduced rate only in specific circumstances. Further, management fee and other service income realized by fund managers would be specifically excluded from the scope.
- Fund managers would no longer benefit from the "limited partner" exception of the self-employment tax. Instead, they would be subject to such tax on the basis of their "labor percentage," which would be defined by reference to the new rules applicable to qualified business income for purposes of calculating the 25% rate.
- The Bill would disallow the SALT deduction for non-corporate taxpayers, with a limited exception for property taxes. On the other hand, the overall limitation on miscellaneous itemized deductions (which may include management fees) for individual investors would be repealed, although the 2% floor applicable to such itemized deductions would remain.
- The estate tax would be repealed effectively in 2023, following a phase-out period.

Carried Interest Reform

- Under the Bill, the concept of an "applicable partnership interest" (API) would be introduced in the Code, which is generally intended to capture the profits interest (aka "carried interest") held by the sponsors of private equity, hedge, venture capital and other investment funds that are structured as flow-through entities. An API would cover any interest held in connection with the performance of substantial services in a trade or business that involves both capital raising or returning and investing or trading in securities, commodities, real estate and/or certain other assets (i.e., very generally, an asset or portfolio management business).
- The grant of an API would not be subject to Section 83 (and generally be tax-free as under current law), but holders would be eligible for the preferential tax rate of long-term capital gains only with respect to gains realized on a disposition of a capital asset held for more than three years, although it is unclear whether such minimum holding period requirement also applies for items of income that may be characterized as long-term capital gains other than by reference to the fund's holding period in the relevant asset (e.g., qualified dividend income). However, such treatment would not result in nonqualifying income for publicly traded partnerships (PTPs) or UBTI for U.S. tax-exempt investors. The Bill is not entirely clear, however, on how it would treat gains realized upon a disposition of the API itself (other than upon transfer to a related person).
- The reform would likely leave unaffected many carry recipients in funds that focus on asset classes with a longer holding period (e.g., private equity and venture capital). Asset managers that have an investment horizon of less than three years should however consider how the Bill would apply in their

particular circumstances. Since grandfathering would not apply, fund sponsors should also consider the implication for profits interests currently held that would likely be treated as APIs under the Bill before it enters into effect.

Blocker Tax Efficiency

- Inbound tax planning for non-U.S. investors via U.S. "blocker" corporations would likely change significantly in light of the reduced 20% corporate tax rate that is imposed on a net income basis (especially taking into account the disparity with the 30% gross-based rate of U.S. withholding with respect to U.S. source passive income directly realized by foreign investors, regardless of whether such investors are individuals or corporate taxpayers). Similar planning opportunities may be available for U.S. tax-exempt investors otherwise subject to individual rates of taxation.
- U.S. blockers would also be able to immediately and fully expense the cost of certain qualified property placed in service between September 27, 2017, and January 1, 2023. However, the use of net operating losses (NOLs) carryovers and carrybacks would be limited to 90% of a blocker's taxable income.
- The "earnings stripping" rules that limit the deduction of interest expense arising from shareholder loans under current law would be repealed (Section 163(j)). Instead, the deduction of any business net interest expense would be limited to 30% of a U.S. blocker's "adjusted taxable income," irrespective of the debt-to-equity ratio of such blocker. A limited carryforward would be available. Grandfathering would not be available, suggesting that a review of any pre-existing blocker leverage would be required. However, the new limitation would not apply to blockers with less than $25 million of average gross receipts, or blockers utilized in the context of direct lending opportunities or engaged in the active conduct of a real estate business.

International Tax Reform

The taxation of multinational corporations and certain other non-U.S. investors would change dramatically and would lean towards a territorial system of U.S. taxation:

- A 100% participation exemption would apply for dividends from foreign subsidiaries received by U.S. corporations that qualify as U.S. shareholders under existing controlled foreign corporation (CFC) rules. A minimum holding period would apply. During a phase-in period, a reduced tax would be imposed on such U.S. shareholders (but not limited to domestic corporations) in respect of earnings currently deferred in foreign subsidiaries on a deemed-repatriation basis.
- The indirect foreign tax credit (Section 902) and the deemed repatriation of earnings upon reinvestment in the United States (Section 956) would be repealed.
- The CFC and passive foreign investment company (PFIC) regimes would generally be preserved, although the availability of the active insurance company exception under the PFIC rules would be restricted.

Increased Efficiency of Management Fees and Incentive Fees

The Bill may increase the likelihood that certain asset managers would be compensated via management and incentive fees:

- The deduction of fee payments by individual taxpayers would no longer be limited under the overall limitation for miscellaneous itemized deductions or under the AMT rules. However, the 2% floor for such deductions would remain (Section 67).
- Certain existing deferral rules (including Sections 409A and 457A) would be repealed and replaced with a new Section 409B. Deferred incentive compensation would be taxable at the time of vesting rather than at the time of payment. For this purpose, only service based conditions would be used. The definition of deferred fees is very broad and would likely encompass performance fee arrangements that may not otherwise be thought of as deferred compensation (e.g., realization-based fees and other multi-year performance fee arrangements).

Real Estate Funds

- The Bill would introduce a UBTI override rule for tax exemptions otherwise available under other Sections of the Code (including the exemption for state and local pension plans). This provision may present a significant change for certain governmental investors in real estate and other industries who heavily rely on the use of leverage.
- The new limitation on the deduction of business interest to 30% of adjusted taxable income would not apply to interest expense accrued in the conduct of a real estate business.
- Certain dividends paid by real estate investment trusts (REITs) would be subject to a new 25% preferential tax rate for individual taxpayers.

Provisions Remaining Unaffected – For Now

The Bill would leave many provisions that were previously targeted for potential change unaffected. These include:

- the preferential individual tax rates applicable to net capital gains and qualified dividend income
- the timing and character aspects of notional principal contract and other derivative income
- the 3.8% net investment income tax (aka the Medicare tax)
- the partnership audit regime introduced under the Bipartisan Budget Act of 2015 (BBA).

Reform Process

Under the ambitious timeline set by the Republican leadership, the mark-up of the Ways and Means Committee is expected to be completed in the course of this week. The Bill could move to the House for a vote as early as mid-November. Congress intends to enact the Bill by Thanksgiving using the “reconciliation” procedure which requires a simple majority vote so long as the Bill remains within the parameters set forth in the recently agreed upon Federal Budget.

Akin Gump
STRAUSS HAUER & FELD LLP

Contact Information

If you have any questions regarding this alert, please contact the Akin Gump lawyer with whom you usually work or

Patrick B. Fenn
pfenn@akingump.com
+1 212.872.1040
New York

Stuart E. Leblang
sleblang@akingump.com
+1 212.872.1017
New York

Lewis J. Kweit
lkweit@akingump.com
+1 212.872.1041
New York

Ron G. Nardini
rgnardini@akingump.com
+1 212.872.1079
New York

Joshua R. Williams
jrwilliams@akingump.com
+1 212.872.8014
New York

Olivier De Moor
odemoor@akingump.com
+1 212.872.1032
New York

Alexander Specht
aspecht@akingump.com
+1 212.872.7490
New York

Monte A. Jackel
mjackel@akingump.com
+1 202.887.4178
Washington, D.C.

Brett D. Fieldston
bfieldston@akingump.com
+1 212.872.8057
New York