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Tax Reform: Effects on Funds and Securitizations

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On November 16, 2017, the House of Representatives passed its tax reform bill, titled the "Tax Cuts and Jobs Act." On December 2, 2017, the Senate passed its own version of the tax reform bill, which differs in several ways from the House bill. This article summarizes provisions in the current tax reform proposals that could, if enacted in their current form, significantly affect securitization vehicles and investment funds.

1. LOWER TAX RATE FOR CERTAIN FLOW-THROUGH BUSINESS INCOME

Under current law, a U.S. investor in a fund that is treated as a partnership for U.S. federal income tax purposes generally is taxed on the investor's allocable share of the fund's net business income at the investor's regular marginal tax rate. The House proposal would reduce the rate of tax imposed on certain types of business income derived by an individual investor from a fund that is treated as a partnership for U.S. federal income tax purposes. (The proposal also applies to "S" corporations and sole proprietorships. Because most funds are treated as partnerships for U.S. federal income tax purposes, this article focuses on partnerships.)

As discussed below, although the Senate proposal also includes a provision that would reduce the effective tax rate applicable to partners in certain partnerships, this reduction generally would not be available to fund investors.

A. House Proposal

Under §1004 of the House proposal, if a partnership is treated as engaged in a trade or business for U.S. federal income tax purposes, then:

- A passive individual investor in the partnership would be taxed on his or her entire allocable share of the partnership's net ordinary income that is derived from the trade or business at a maximum tax rate of 25% instead of the current 39.6% maximum individual tax rate; and
- An active investor in the partnership could either (x) elect to categorize 30% of his or her allocable share of net ordinary income that is derived from the trade or business as eligible for the 25% rate, or (y) establish a different ratio based on the facts and circumstances of the partnership's business. The election described in clause (x) is not available for wage-type income or income from a law, accounting, consulting, financial services, or other services business.

Most collateralized loan obligations (CLOs), asset-backed securitization vehicles, and similar vehicles — even if treated as partnerships — are not treated as engaged in a trade or business for U.S. federal income tax purposes. U.S. investors in these vehicles therefore would not benefit from the House proposal.

However, many real estate funds are treated as partnerships that are engaged in a trade or business for U.S. federal income tax purposes, and derive substantial ordinary income from their trade or business. Individual investors in these funds could be entitled to preferential tax rate on this income under the House proposal.

Many loan origination funds (including some middle-market CLOs) also are treated as partnerships that are engaged in a trade or business for U.S. federal income tax purposes. However, as noted above, the House proposal's reduced tax rate for flow-through business income generally does not apply

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with respect to financial services income. Financial services income has been understood in other contexts to include income from the active conduct of a banking, financing, or similar activity. It may be difficult for a loan origination fund to establish that it is engaged in a trade or business of lending, but is not engaged in the active conduct of a banking, financing, or similar activity.

In many cases, the individual investment professionals who manage a fund form two entities, each treated as a partnership for U.S. federal income tax purposes: (i) the investment management vehicle, which receives investment management fees in exchange for managing the fund; and (ii) the general partner, which receives incentive compensation in the form of a ''carried interest.'' The individual investment professionals will not benefit from the House proposal with respect to fee income that the investment management vehicle allocates to them, because this income is paid in respect of a financial services or consulting business.

However, the general partner does not have any employees, and thus arguably receives its carried interest as a passive investor. Moreover, the individual investment professionals who hold limited partnership interests in the general partner do not provide any services to the general partner, but instead provide services to the investment management vehicle. Accordingly, these individual investment professionals could take the position that they benefit from the House proposal with respect to their share of the carried interest, to the extent that the carried interest consists of ordinary business income and not capital gains or financial services income. While subject to uncertainty, this position would be consistent with the position that many individual investment professionals take under current law with respect to self-employment tax and the New York City unincorporated business tax — namely, that the fee income paid to the investment management vehicle is subject to self-employment tax and the New York City unincorporated business tax, while the carried interest paid to the general partner is not. (Part 2, below, further discusses self-employment tax on investment management fees paid to the investment management vehicle.)

B. Senate Proposal

Under §11011 of the Senate proposal, for taxable years beginning before 2026, an individual investor in a partnership generally may deduct 23% of his or her allocable share of the partnership's ''qualified business income'' — which is defined generally as the partnership's ordinary income from the conduct of a trade or business within the U.S., other than wage-type income or income from a law, accounting, consulting, financial services, or other services business — to the extent of 50% of the investor's *pro rata* share of ''W-2 wages'' paid by the partnership.

Funds typically do not have employees and thus do not pay W-2 wages. Accordingly, the Senate proposal generally does not apply to funds.

2. SELF-EMPLOYMENT TAX ON FUND INVESTMENT PROFESSIONALS

As initially drafted, §1004 of the House proposal also would have repealed current tax code §1402(a)(13), which exempts a limited partner's distributive share of income from self-employment tax. Although the repeal of tax code §1402(a)(13) was removed from the version of the bill that the House passed on November 16, 2017, we describe this proposal here because, if ultimately revived, it could significantly affect the taxation of investment professionals and certain U.S. investors.

Under current law, investment professionals are subject to a 15.30% self-employment tax on their first $127,200 of fee income each year (indexed for inflation), plus 2.9% of all fee income thereafter. However, because a limited partner's distributive share of income from a limited partnership is not subject to the self-employment tax, many investment management vehicles currently are organized as limited partnerships that allocate substantially all (e.g., 99%) of their fee income to their limited partners and the remainder of their fee income to the general partner (which, in turn, is owned by the limited partners). The management personnel take the position that their allocation from the investment management vehicle is not subject to the self-employment tax because they are receiving the allocation as limited partners, and that only the allocation to the investment management vehicle's general partner is subject to the self-employment tax.

The original House proposal would eliminate the ''limited partner exception'' from self-employment tax discussed above. Accordingly, under the original House proposal, investment management professionals generally would be subject to self-employment tax on all of the investment management vehicle's fee income.

In certain situations, the original House proposal's repeal of the ''limited partner exception'' from self-employment tax also could subject passive U.S. investors to the self-employment tax on their entire allocable share of a partnership's net business income. As mentioned above, many real estate funds and loan origination funds are treated as partnerships that are engaged in a trade or business for U.S. federal income tax purposes. Under the original House proposal, the self-employment tax applies to the ''labor percent-

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age'' of any partner's allocable share of the partnership's net trade or business income. A partner's ''labor percentage'' is defined as 100% less the partner's ''capital percentage,'' which is defined by reference to a section of the proposal that addresses ''active'' business income. Passive limited partners do not earn any ''active'' business income, so their entire allocable share of the partnership's net trade or business income arguably would be subject to the self-employment tax.

The Senate proposal would not repeal tax code §1402(a)(13).

3. RECHARACTERIZATION OF PROFITS FROM CARRIED INTEREST

Both the House and Senate proposals would change the way that certain carried interests are taxed.

As mentioned above, individual investment professionals often hold interests in the general partner of the funds that they manage. The general partner receives incentive compensation in the form of a ''carried interest,'' which typically is entitled to a portion (often 20%) of the fund's net profits above a specified internal rate of return. For most hedge funds, which frequently trade their assets, these profits consist largely of short-term capital gains (i.e., gains derived from the sale of an asset held for one year or less). Short-term capital gains are taxed at ordinary rates under current law.

By contrast, for many private equity funds and venture capital funds, profits allocated under the carried interest can consist almost entirely of long-term capital gains (i.e., gains derived from the sale of an asset held for more than one year), because these profits often are recognized only upon a liquidity event, such as an initial public offering of a company within the fund's investment portfolio. Many commentators have argued that the carried interest should nevertheless be taxed at ordinary income rates on the basis that it is allocated to the investment professionals in connection with their performance of services.

Section 1061 of the House proposal and §13310 of the Senate proposal generally would recharacterize a partner's distributive share of a partnership's net long-term capital gain as short-term capital gain to the extent that the gain is attributable to the sale of assets held for three years or less if the partnership interest is directly or indirectly transferred to (or is held by) the partner in connection with the performance of substantial services in any investment management business.

Arguably, a carried interest held by a fund's general partner is indirectly held by the investment management personnel in connection with their investment management business, and thus is subject to these proposals. Nevertheless, the proposals are unlikely to have a significant effect. As mentioned above, the profits allocated to the carried interest by most hedge funds already consist largely of short-term capital gains. And the profits allocated to the carried interest by many private equity funds and venture capital funds are attributable to the sale of portfolio stock that has been held for more than three years, and are allocated to a carried interest that has been held for more than three years, and thus would still be treated as long-term capital gain under the proposals.

4. LIMITATIONS ON PARTNERSHIP BUSINESS INTEREST EXPENSE DEDUCTIONS

Both the House and Senate proposals would limit the ability of certain funds to deduct business interest expenses.

Under current law, business interest expenses of a fund that is treated as a partnership for U.S. federal income tax purposes generally ''flow through'' to the fund's investors, and can be used by U.S. investors to offset income earned from other sources.

Under the proposals, if a fund is treated as engaged in a trade or business for U.S. federal income tax purposes (other than real property or certain public utilities businesses), then the fund's annual business interest expense deductions would be limited to its business interest income plus 30% of the fund's adjusted taxable income from its trade or business (calculated without regard to business interest income and business interest expenses). This limitation generally would be determined at the fund level, so that U.S. investors generally could not use any disallowed business interest expense deductions to offset income earned from other sources.

Under §3301 of the House proposal, a fund would be able to carry forward disallowed interest expense deductions for up to five years. However, because the interest expense deduction would be determined at the fund level, it would be permanently disallowed upon the fund's liquidation. By contrast, under §13301 of the Senate proposal, U.S. investors would be able to carry forward any disallowed interest expense deduction of a fund for as long as they hold an interest in the fund (although their ability to use the interest expense deduction would continue to be limited by reference to the fund's income as described above) and, to the extent they do not use these interest expense deductions before they sell their interests in the fund or the fund liquidates, generally would be permitted to increase their basis in the interests immediately before the sale or liquidation (thereby resulting in less gain, or more loss, to the U.S. investors upon the sale or liquidation).

Many loan origination funds (including some middle-market loan CLOs) are treated as engaged in a

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trade or business for U.S. federal income tax purposes. If these funds incur outsized interest expense in later years, this interest expense generally would not be available to offset net income from other sources, and, under the House proposal, would be disallowed entirely if the fund liquidates before using the deductions.

5. TAXATION OF VOLUNTARY "KEEPWELL" CONTRIBUTIONS

Section 3304 of the House proposal would repeal tax code §118, which makes capital contributions tax-free to a recipient corporation.

CLOs and other securitization vehicles often permit an equity holder to contribute additional funds to the securitization vehicle to avoid the failure of a coverage test. These contributions typically do not change the contributor's entitlements under the securitization vehicles' payment waterfall, but instead increase the contributor's basis in its equity and thereby reduce the amount of gain (or increase the amount of loss) recognized by the contributor on a disposition of its equity.

U.S. equity holders in securitization vehicles typically are taxable annually on their pro rata share of the securitization vehicle's net income and gain (whether or not distributed). As a result of the House proposal's repeal of tax code §118, a contribution by an equity holder to a securitization vehicle would increase the securitization vehicle's gross income unless the contributor receives additional equity in exchange for the contribution or the contribution is made on a pro rata basis by all equity holders. As a result, U.S. equity holders could be subject to "phantom" taxable income upon a contribution.

The Senate proposal would not repeal current tax code §118.

6. LIMITATION ON "SUPER" TAX-EXEMPT STATUS, INCREASED UBTI EXPOSURE

Section 5001 of the House proposal purports to "clarify" that any tax-exempt organizations that are exempt from tax under tax code §501(a) are subject to tax on unrelated business taxable income (UBTI), even if they are also exempt from tax under tax code §115.

To avoid tax on UBTI, many tax-exempt investors prefer to invest in hedge funds and private equity funds through a "blocker" vehicle that is treated as a corporation for U.S. federal income tax purposes. However, some state pension plans take the position that they are not subject to tax on UBTI, under the theory that tax code §115 exempts from the definition of "gross income" any income derived from the exercise of an essential governmental function and accruing to a state or a political subdivision of a state. These state pension plans thus prefer instead to invest directly into the fund or through a domestic "feeder" vehicle that is treated as a partnership for U.S. federal income tax purposes.

Accordingly, if the House proposal is enacted, state pension plans investing in a fund that may generate UBTI likely will prefer to invest through a foreign blocker vehicle instead of investing directly into the fund or through a domestic feeder vehicle.

The Senate proposal does not contain an analog to §5001 of the House proposal.

7. TAX ON SALE BY FOREIGNERS OF CERTAIN PARTNERSHIP INTERESTS

Section 13501 of the Senate proposal would override the Tax Court's recent decision in *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017), and subject foreigners to U.S. net income tax on gain from the sale of a partnership that is engaged in a trade or business within the United States for U.S. federal income tax purposes. This tax would be enforced through a 10% withholding requirement for transferees.

The IRS concluded in Rev. Rul. 91-32 that foreigners are subject to U.S. net income tax on gain from the sale of a partnership that is engaged in a trade or business within the United States for U.S. federal income tax purposes to the extent that the gain is attributable to assets used or held for use in the partnership's U.S. trade or business. In *Grecian Magnesite*, the Tax Court rejected the conclusion in Rev. Rul. 91-32 and held that a foreigner was not subject to U.S. net income tax on gain from a redemption of a partnership interest (which is treated the same way as a sale) except to the extent that the gain was attributable to U.S. real estate assets, even though the partnership was engaged in a U.S. trade or business. It remains to be seen whether the IRS will appeal the Tax Court's decision.

Under the Senate proposal, a foreigner's gain or loss from the sale of a partnership interest would be treated as "effectively connected" with a U.S. trade or business (and thus subject to U.S. net income tax) to the extent that the foreigner would have recognized "effectively connected" income had the partnership sold all of its assets at fair market value of the date of the sale (disregarding any special allocations for this purpose).

A purchaser of a partnership interest would have to withhold 10% of the sale price unless the seller certifies that it is not foreign. If the purchaser does not

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withhold the right amount, then the partnership would have to recoup the right amount by withholding from distributions to the purchaser. On their face, these withholding requirements would be difficult (if not impossible) to enforce in the context of a sale of an interest in a ''master limited partnership.'' Because master limited partnership interests are sold on an exchange, their ownership changes frequently and purchasers do not know the sellers' identities. Tax code §1445(b)(6) currently exempts a purchaser of a master limited partnership interest from having to withhold on the seller when the master limited partnership interest includes a U.S. real property interest. The Senate proposal does not contain a similar exemption.

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