U.S. Tax Reform Highlights: Investment Funds, S Corporations, and other Pass-Throughs

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The Tax Cuts & Jobs Act (the "Bill") released on Friday would, if adopted, significantly change the current rules relating to pass-through entities, such as partnerships and S corporations, and their owners. Pass-through entities are not taxable entities. Instead, their owners are generally required to take into account their respective shares of the income, gains, losses and deductions of such entities. The Bill includes new deductions and limitations applicable to pass-through entities and their owners. The Bill also includes new tax rules that would affect tax-exempt or foreign partners. In addition, the Bill modifies certain rules specifically relating to partnerships and S corporations.

The new rules are generally expected to significantly impact the manner in which pass-through entities and their owners conduct their businesses or make investments. The discussion below highlights some of the new rules and outlines their impact on affected taxpayers. It should be noted that many of the new rules are highly technical and that their impact on a particular taxpayer would need to be assessed on a case-by-case basis.

Key provisions include:

Taxation of Partners and Partnerships

Income Derived by Individuals from Partnerships

Under the Bill, for taxable years beginning after December 31, 2017 and before January 1, 2026, if a partnership has qualified business income (or certain other income such as qualified REIT dividends), a partner who is an individual, trust or estate may generally deduct 20% of the partner's share of such income up to a limitation calculated based on the partner's share of the W-2 wages with respect to the business and the partnership's basis in certain qualified depreciable business assets, subject to certain exceptions. This relaxes the Senate version of the W-2 wage limitation and may allow a deduction even if the W-2 wage amount with respect to the business is zero. Under this rule, it would appear that individual investors in tax equity partnerships and other partnerships that own depreciable property could qualify for the deduction. The deduction is generally unavailable to investment income, trading income, and income for certain services such as investment management.

The Bill also provides limitations regarding excess business losses and excess business interest deductions. Generally, the Bill limits the amount of business interest a taxpayer may deduct to the sum of the taxpayer's business interest income plus 30% of the taxpayer's adjusted income. In the case of a partnership, the Bill may allow a partner to deduct other business interest to the extent the partnership has excess business income

allocated to the partner. In addition, to the extent a partnership has excess business interest allocated to a partner, the partner's tax basis in the partnership interest will be reduced and the partner may carry forward the allocated loss to future years.

- *Investment funds that have interests in pass-through operating companies should consider carefully the impact in this regard.*

Income Derived by Tax-Exempt Organizations from Partnerships

Tax-exempt organizations are generally subject to federal income tax on unrelated business taxable income, including unrelated business taxable income derived from partnerships.

Under the Bill, a tax-exempt organization may be prohibited from using its deduction from one unrelated business to offset its income from another unrelated business. The Bill does not expressly address how a tax-exempt partner in a partnership should be treated for this purpose.

In addition, under the Bill, some universities with large endowments may be subject to a new 1.4% excise tax on their net investment income.

Income Derived by Foreign Persons from Partnerships

If a foreign person is a partner in a partnership that has income effectively connected with the conduct of a U.S. trade or business, the foreign person is generally subject to U.S. federal income tax on the person's share of such income. A foreign partner's share of a partnership's gain on a disposition of a U.S. real property interest (including stock in a corporation that is treated as U.S. real property interest) is also treated as income effectively connected with a U.S. trade or business. In addition, the partnership generally will have a tax withholding obligation in respect of the foreign partner's share of such income or gain.

Under the Bill, if a foreign person is a partner in a partnership that is engaged in a U.S. trade or business, the foreign partner's gain on the sale or exchange on or after November 27, 2017 of an interest in the partnership is also treated as income effectively connected with a U.S. trade or business subject to U.S. federal income tax. In that respect, the Bill reverses a recent Tax Court decision and codifies the longstanding position of the IRS.

Further, under the Bill, if the transferee of the partnership interest fails to withhold taxes where required, the partnership itself will be required to withhold from distributions to the transferee the tax which the transferee failed to withhold.

- *Private investment funds that use corporations as alternative investment vehicles for their investors should also carefully consider the impact of other provisions in the Bill, including the new 21% corporate income tax rate and limitations on deductions.*

Holding Period Requirement Relating to Carried Interests

Carried interests in partnerships are required to satisfy certain requirements set forth in published IRS guidance. Long-term capital gains of the partnership may be taken into account by the carried interest partner on a pass-through basis. Generally, the capital gain on the sale or exchange of a capital asset is long-term if the capital asset has been held for more than one year.

Under the Bill, in respect of such carried interests issued in exchange for services, the holding period required for long-term capital gains is extended to three years. The Bill also provides special rules applying to the transfer of carried interests to related persons. The Bill authorizes the Treasury to provide exceptions relating to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.

Reduced Basis Limitation on Allowance of Losses

A partner's distributive share of the partnership's loss is allowed only to the extent of the tax basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Under the Bill, such basis limitation will be reduced by the partner's share of the partnership's foreign taxes and charitable deductions (subject to certain limited exceptions).

Additional Mandatory Reduction on Partnership Basis in Property

Under the Bill, a partnership would be required to reduce its tax basis in its property when a partner transfers an interest in the partnership, if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all its assets. This expands the current law which already requires a mandatory basis reduction in the event that the partnership has a substantial built-in loss in its property.

Sale or Exchange of 50% or More of Partnership Interests

The Bill repeals the current law that a partnership is deemed terminated if, within any 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits.

"First-in First-out" and Other Tax Accounting Rules

Under the Bill, the cost of any specified security sold, exchanged or otherwise disposed of will generally be determined on a first-in first-out basis. The Bill also provides other new accounting rules that could affect the timing of income recognition.

- *Investment funds should consider carefully how these new accounting rules may affect their investment strategies.*

Taxation of S Corporations and Shareholders

Income Derived by Individual Shareholders from S Corporations

Under the Bill, for taxable years beginning after December 31, 2017 and before January 1, 2026, if an S corporation has qualified business income (or certain other income such as qualified REIT dividends), a shareholder may generally deduct 20% of the shareholder's share of such income up to a limitation calculated based on the shareholder's share of the W-2 wages with respect to the business and the S corporation's basis in certain qualified depreciable business assets, subject to certain exceptions. The deduction is generally unavailable to investment income, trading income, and income for certain services such as investment management.

The new rules in the Bill regarding excess business losses, excess business interests as well as the new accounting rules also generally apply to S corporations or their shareholders.

Expansion of Qualifying Trusts as Shareholders for S Corporations

An S corporation cannot have any foreign person as a shareholder. S corporations can only have shareholders who meet certain qualification requirements, including "electing small business trusts." Under current law, an electing small business trust also cannot have any foreign beneficiary since each potential current beneficiary of such trust will be treated as a shareholder for this purpose.

Under the Bill, an electing small business trust will be permitted to have foreign beneficiaries.

Treatment of S Corporation Conversions to C Corporations

The Bill also provides a transition rule regarding the tax treatment of an S corporation's conversion to a C corporation if the S corporation election is revoked during the 2-year period beginning on the date of the Bill.

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