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House Bill and Senate Republicans' Bill: Impact on Hedge and Commodity Fund Investors and Managers

The "official" House tax reform bill was released by the House Ways and Means Committee on November 9. For the most part, the provisions summarized in Katten's advisory, "Tax Reform: Hedge Funds/Commodity Funds/Fund Managers," are unchanged, but the bill does include three changes of note.

1. **3-Year Holding Period for Carried Interests.** Capital gain realized with respect to carried interests continues to be treated as capital gain (rather than as ordinary income), and therefore can be offset by capital losses. However, a carried interest holder's net long-term capital gain from the partnership's sale of stock, securities or other assets (except section 1256 contracts, which retain their statutory 60% long-term/40% short-term capital gain treatment) is treated as short-term capital gain if the partnership did not hold the asset more than three years (as opposed to one year under current law) prior to the sale. The provision does not affect the tax treatment of net long-term capital losses, which continue to be treated as long-term capital losses based on the current law (more than one year) holding period. Amounts allocated to the carried interest holder that remain invested in the partnership after the allocation year ordinarily become capital interests, and lose their tax treatment as carried interests for these purposes. If the carried interest holder recognizes a long-term capital gain on a sale of the carried interest and has not held the carried interest for more than three years prior to the sale, the long-term capital gain is likewise subject to being recharacterized as short-term capital gain. It is not altogether clear from the bill whether "net long-term capital gain" from carried interests is determined separately for each partnership (as would seem logical) or by aggregating the holder's long-term capital gains and losses from all carried interests. The bill also exempts carried interests held by corporations from the three-year holding period rule, but does not limit this exemption to C corporations. It is also unknown whether or not the exemption from the three-year holding period rule is intended to apply to S corporations as well as C corporations.

2. **Self-Employment Tax.** The current law statutory exemption from self-employment tax for amounts (other than guaranteed payments) allocated to limited partners is retained.

3. **Non-Qualifying Deferred Compensation.** Sections 409A and 457A are not repealed, and deferred compensation generally continues to be taxed in the same manner as under current law.

Proceeding separately, Republican Senate Finance Committee Chairman Orrin Hatch also released on November 9 a description of the Senate Republicans' version of a tax reform bill, which is being discussed and negotiated by members of the Senate Finance

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Committee this week. (An actual bill, as opposed to the Chairman's summary of the bill and any amendments adopted along the way, is not expected to be released until the Senate Finance Committee is ready to report its version of tax reform legislation for consideration by the Senate.) As in the House bill, the changes described in the Senate Finance Committee Chairman's summary ("Hatch Summary") will apply to taxable years beginning after 2017 (except as otherwise indicated below). The Hatch Summary is, in general, not as unfavorable as the House bill in its treatment of hedge and commodity fund managers and investors, but includes some provisions affecting hedge and commodity fund investors and managers that are not in the House bill. Here is how the Hatch Summary compares with the House bill in terms of the provisions summarized in our prior advisory and the provisions described above:

1. **Top Tax Rate; Itemized Deductions; AMT.** The top federal income tax rate on ordinary income and short-term capital gains of individuals is reduced from 39.6% to 38.5%. The special 20% maximum federal income tax rate applicable to long-term capital gains and qualifying dividends is maintained. An individual's investment expenses are not deductible (as compared with the House bill, which allows investment expenses in excess of 2% of the individual's adjusted gross income to be deducted). Accordingly, the "trader" vs. "investor" distinction becomes even more important for fund investors, because expenses reported as investment income are not deductible by individuals for federal income tax purposes. As in the House bill, state and local income taxes are not deductible, and the alternative minimum tax is eliminated.

2. **Net Investment Income (3.8%) Tax.** As in the House bill, the 3.8% net investment income tax is retained.

3. **Pass-Through Business Income and REIT Dividends.** Individuals can deduct 17.4% of their qualified business income (including certain REIT dividends), which is equivalent to approximately a 31.8% maximum marginal federal income tax rate (as compared with the 25% maximum marginal federal income tax rate on such income provided in the House bill). Similar to the House bill, this deduction generally does not apply to investment-related income and income earned from providing financial or brokerage services.

4. **Carried Interests.** Unlike the House bill, no changes are proposed to the taxation of carried interests.

5. **Disallowance of Excess Business Losses.** A provision of limited applicability would disallow the current deduction of an individual's business losses from pass-through entities (generally, partnerships and S corporations) in excess of the sum of the individual's gross income or gain plus $500,000 for married individuals filing jointly ($250,000 for all other individuals). Excess losses could be carried forward to and deducted in future years, subject to certain additional limitations. The House bill does not include a comparable provision.

6. **Self-Employment Tax.** As in the House bill, the current law statutory exemption from self-employment tax for amounts (other than guaranteed payments) allocated to limited partners is retained.

7. **Investment Interest; Business Interest Disallowance.** As in the House bill, the deduction for investment interest is retained in its current form. Similar to the House bill, trade or business interest in excess of the sum of business interest income plus 30% of adjusted taxable income is not currently deductible. Unlike the House bill, depreciation deductions are not added back in calculating adjusted taxable income, making the limitation more likely to apply. Disallowed interest may be carried forward and deducted in future years (subject to the same limitation) indefinitely (the House bill limited the carry forward to five years). Any entity whose average annual gross receipts for the current and the two preceding years do not exceed a specified threshold is exempt, but the Hatch Summary reduces the threshold from $25 million (as proposed in the House bill) to $15 million.

8. **Identification of Securities Sold.** For post-2017 sales, brokers generally will be required to report the cost basis of stock or securities sold (where the seller owns more than one block of stock or securities in the same issuer) on a "first-in first-out" basis, eliminating the seller's ability under current law to designate particular shares or securities held in brokerage accounts.

9. **Non-Qualified Deferred Compensation.** As in the House Republicans' original proposal prior to amendment by the House Ways and Means Committee, deferred compensation is immediately taxable unless receipt of the compensation is subject to a substantial risk of forfeiture requiring the continued performance of services. Performance-based compensation is not treated as subject to a substantial risk of forfeiture merely by virtue of being contingent on the achievement of thresholds or milestones.

10. **Sale of Partnership Interests by Non-US Persons.** Consistent with the Internal Revenue Service's long-standing position, and contrary to a Tax Court decision earlier this year, a non-US person's gain on a sale of an interest in a partnership that is engaged in a US trade or business generally would be treated as income effectively connected with a US trade or business. This provision (which is not in the House bill) applies to sales or exchanges or partnership interests after 2017.

11. **Unrelated Business Taxable Income.** Unlike the House bill, there is no provision requiring state pension plans to be subject to the same rules taxing unrelated business taxable income as other tax-exempt organizations.

12. **Controlled Foreign Corporations—Definition of "US Shareholder."** Under current law, a foreign corporation becomes a "controlled foreign corporation" when more than 50% of its stock is owned by one or more US persons that each own 10% or more of the corporation's voting stock. Unlike the House bill, any US person owning 10% or more of the corporation's stock, whether voting or non-voting, counts in determining whether the 50% threshold is exceeded.

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