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Tax Update

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Recent Tax Developments Impacting Investment Funds

Tax Reform

The Tax Cuts and Jobs Act was signed into law in December 2017 and has been the subject of numerous 2018 and 2019 tax regulations and other Internal Revenue Service (IRS) guidance.¹ Many of the Act's changes have direct relevance for investors and investment funds. For taxable years through 2025, the Act reduced the top individual tax rate from 39.6 percent to 37 percent² and suspended various deductions for individuals, including miscellaneous itemized deductions, such as investment management fees and expenses, previously allowable above a floor equal to two percent of adjusted gross income.³

The Act added Internal Revenue Code Section 199A to provide a 20 percent deduction for investors receiving dividend income from REITs, taxable income from publicly traded partnerships (PTPs), and income from certain types of operating business.⁴ The text of the statute, however, did not provide direct authority to allow mutual funds, exchange-traded funds (ETFs), and other regulated investment companies (RICs) receiving such types of income to passthrough that 20 percent deduction to shareholders. In January 2019, in time for the

2018 year-end tax reporting cycle, the US Treasury Department and the IRS proposed new tax regulations providing immediate authority for RICs to pass through qualified REIT dividend income to shareholders.⁵ The pass-through of income from PTPs was left for a later day, as certain computational complexities were identified for which the IRS requested industry comments.⁶ In addition, income from certain types of operating businesses, generally intended to include small proprietorships other than those in professional services (meaning that law, accounting, investment management, consulting, and several others are excluded), will be considered eligible for the 20 percent deduction as well. The 20 percent deduction is only available for individual taxpayers below certain levels of annual income.

The Act also amended Code Section 451(b) to require taxpayers to recognize income for tax purposes no later than when income is recognized for financial reporting.⁷ This amendment created uncertainty for tax-exempt municipal bond funds and high-yield junk bond funds that generally recognize market discount for GAAP but not for tax purposes. However, in October 2018, the Internal Revenue Service announced that the Section 451(b) amendments will not apply to market discount.⁸

For corporations, the Act substantially revised numerous important domestic and international

tax rules. The Act lowered the corporate income tax rate significantly, from 35 percent to 21 percent.⁹ A net operating loss deduction is now limited to 80 percent of taxable income.¹⁰ The net operating loss carryback rules were repealed, but net operating loss carryforwards now carry over into future tax years without expiration.¹¹ Code Section 163(j), as amended by the Act, limits the interest expense deduction to an annual ceiling of 30 percent of the sum of interest income plus adjusted taxable income, which is calculated using methods that change over time and that are similar to earnings before interest, taxes, depreciation and amortization (EBITDA).¹² Unusable interest expense may be carried forward into later years.¹³ For most RICs, this limitation should not come into play often, with closed-end equity funds using leverage and earning little interest income as the most likely if any to be affected.

Investment Partnerships

In recent years, tax legislation and new IRS guidance have substantially revamped the IRS audit rules for partnerships, including many hedge funds, private equity funds, master-feeder funds, and publicly traded partnerships. The new IRS audit rules allow the IRS to directly pursue partnerships that are under IRS audit for underreporting of taxable income and for the partners' underpayment of income tax. Those audit rules also allow partnerships in certain circumstances to impute certain adjustments to taxable income to the relevant partners.¹⁴ Final tax regulations issued in January 2019 allow partnerships to modify an underpayment of income tax by excluding any adjustment that is attributable to a net decrease in a specified activity loss that is allocable to a specified type of partner.¹⁵ This provision means, for example, that a RIC invested in a publicly traded partnership may qualify under the statutory language¹⁶ as a specified partner, but because the final regulations do not make a parallel reference to the relevant Code section, such RIC may possibly not so qualify under the narrower regulatory definition.¹⁷ This could restrict a RIC from

Section 6225's imputed adjustment modification rule. This could mean, for instance, that a publicly traded partnership held by a RIC would not be able to minimize certain imputed IRS income adjustments to the extent of the RIC's investment.

Investment partnerships with a carried interest will be subject to a three-year minimum holding period rule for long-term capital gain treatment allocated to the manager or an affiliate.

The Act also added certain international tax rules that provide both a new tax on income from controlled foreign corporations that are classified as global intangible low-taxed income (GILTI) and a new base erosion anti-abuse tax (BEAT) set of rules.

International Tax Issues

In December 2018, the IRS issued proposed tax regulations under Code Section 1473 that eliminate withholding on gross proceeds from the sale of certain US-based securities under the Foreign Account Tax Compliance Act (FATCA).¹⁸

Regarding sales by non-US persons of interests in partnerships with US trades or businesses, the Tax Cut and Jobs Act amended the Code so that gain realized from the offshore sale of an interest in a partnership with a US trade or business will itself be considered a taxable US trade or business income potentially subject to US income tax.¹⁹ The IRS proposed relevant tax regulations in December 2018.²⁰

For investment funds denominated in currencies other than the US dollar, on December 10, 2018, the US Treasury issued a request for comments on the tax rules for nonfunctional currencies, which are potentially applicable to investment funds reporting under US income tax rules but operating in a currency other than the US dollar.²¹ This request for comments supersedes IRS Notice 2018-57 extending the deferred applicability date of the final and related temporary regulations that the IRS issued under Code Section 987 in December 2016.²²

Also relevant to funds invested in non-US equities, in January 2019, the Treasury issued final tax

regulations under Code Section 965 clarifying how domestic corporations that are 10-percent-owners of certain types of foreign corporations need to include as income a pro rata share of such foreign corporations' undistributed foreign taxable income accumulated post-1986, beginning as of 2017.²³

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NOTES

- ¹ Tax Cuts and Jobs Act (TCJA), Pub. Law No. 115-97, 131 Stat. 2054 (2017).
- ² §11001, TCJA, 131 Stat. at 2054; Rev. Proc. 2018-18, section 3, Table 1.
- ³ Section 67(a), (c)(2), (g); §11045, TCJA, 131 Stat. at 2088.
- ⁴ §1111, TCJA, 131 Stat. at 2063.
- ⁵ 84 Fed. Reg. 3015 (Feb. 8, 2019)
- ⁶ *Id.* at 3018.
- ⁷ §13221, TCJA, 131 Stat. at 2113
- ⁸ IRS Notice 2018-80
- ⁹ §13001, TCJA, 131 Stat. at 2096
- ¹⁰ Section 172(a); §13302, TCJA, 131 Stat. at 2121.
- ¹¹ Section 172(b)(1)(A); §13302(b), TCJA, 131 Stat. at 2122.
- ¹² Section 163(j)(1).
- ¹³ Section 163(j)(2).
- ¹⁴ Bipartisan Budget Act of 2015, Pub. Law No. 114-74, §§6225-6227, 129 Stat. 584, 628-632 (2015).
- ¹⁵ 84 Fed. Reg. 6468 (Feb. 27, 2019).
- ¹⁶ Section 6225(c)(5)(C)(ii).
- ¹⁷ Treas. Reg. sec. 301.6225-4(d)(5)(ii).
- ¹⁸ 83 Fed. Reg. 64757 (proposed Dec. 18, 2018).
- ¹⁹ 19. Staff of Joint Comm. on Taxation, 115th Cong., General Explanation of Pub. L. 115-97, 220 (Comm. Print 2018) (citing *Grecian Magnesite Mining v. Comm'r*, 149 T.C. No. 3 (2017)); §13501, TCJA, 131 Stat. at 2138.
- ²⁰ 83 Fed. Reg. 66647 (Dec. 27, 2018).
- ²¹ 83 Fed. Reg. 63558.
- ²² 81 Fed. Reg. 88806 (Dec. 8, 2016).
- ²³ 84 Fed. Reg. 1838 (Feb. 5, 2019).

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