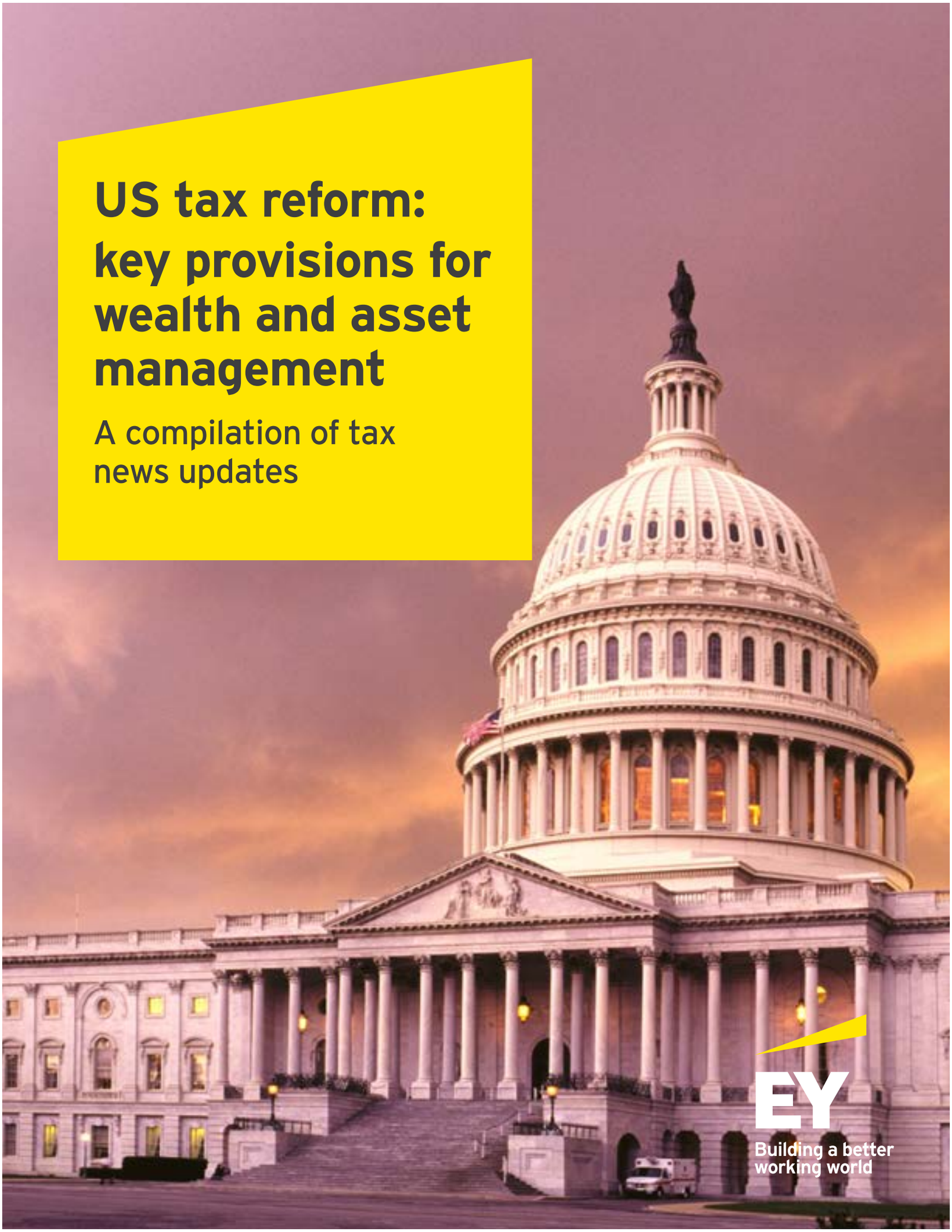
US tax reform: key provisions for wealth and asset management

A compilation of tax news updates



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US tax reform enacted — key provisions for private equity and alternative asset management industry

On December 22, 2017, the President signed into law the Tax Cuts and Jobs Act (H.R. 1, the Act) following passage in the House and Senate earlier in the week. This alert highlights the key aspects of the Act with a focus on the provisions that could impact the private equity (PE) and alternative asset management industry. The alert summarizes the issues affecting funds, transactions, portfolio companies and fund principals and investment professionals.

The House and Senate conferees for H.R. 1 were able to reconcile the earlier House and Senate bills and reach agreement on the legislative language in the Act less than a month after the House of Representatives passed its version of the Tax Cuts and Jobs Act on November 16 (the House Bill), and less than two weeks after the Senate passed its tax reform bill on December 2 (the Senate Bill). A Joint Explanatory Statement of the Conference Committee was issued along with the Conference Agreement. For a detailed discussion of the House and Senate Bill provisions relevant for the PE and alternative asset management industry, see Tax Alerts **2017-1891** and **2017-1945**, respectively.

For a general discussion of the provisions included in the Act, see Tax Alert **2017-2130**.

Highlights

The Act largely adheres to the framework of the Senate Bill, but also reflects significant compromises between the House and the Senate. With respect to business taxes, the Act generally adopts the Senate approach to pass-through, corporate and individual income taxation, with the following rates:

- 20% deduction for qualified pass-through business income
- 21% top corporate income tax rate, effective beginning in 2018
- 37% top individual income tax rate, resulting in a reduced overall top tax rate for individual earners

The Act also limits the deduction for business net interest expense by amending Section 163(j). The revised limitation is on net interest expense that exceeds 30% of adjusted taxable income (ATI). For the first four years, ATI is computed without regard to depreciation, amortization or depletion. Beginning in 2022, ATI is decreased by those items, which could further limit interest deductibility. In addition, unlike the House and the Senate Bills, the Act drops the additional interest expense limitation that would have been imposed through a worldwide debt cap under what would have been Section 163(n).

Fund-level issues

1. Investment income

The Act retains preferential tax rates for investment income. Net long-term capital gains and qualified dividend income continue to be taxed at current rates (i.e., a top rate of 20%) and continue to be subject to the 3.8% net investment income tax.

2. Pass-through income: special 20% deduction

The Act largely adopts the Senate approach but provides individual owners — as well as trusts and estates — with a 20% (rather than 23%) deduction on domestic qualified pass-through income. A special rule allows the deduction for otherwise ineligible service-related pass-through income for taxpayers with taxable income below certain thresholds. In addition, the deduction generally is restricted to the greater of 50% of W-2 wages paid, or the sum of 25% of wages paid plus a capital allowance, with relief from wage restriction for individuals with taxable income below certain thresholds. The income threshold is $315,000 for joint filers. The Act maintains carve-outs for investment income.

Under the Act, a "specified service trade or business" means any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade or business whose principal asset is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests or commodities.

The pass-through provisions under the Act could apply as follows:

- **Private equity funds.** Investment income from a PE fund that is treated as an investor, which is not engaged in a trade or business, generally should not be eligible for the 20% deduction.
- **Hedge funds and other alternative funds.** It is possible that limited types of non-investment income earned by a trader fund could be net business income potentially eligible to be taxed as qualified business income (QBI). However, in addition to the "specified service business" limitations, the Act adopts the Senate's 50% W-2 wage limitation (with a new alternative limit based on 25% of wages paid plus a capital allowance), which should begin to phase in for an individual with taxable income of over $315,000 (for joint filers).
- ***Tiered fund structures.*** Although the Act does not include any specific tiering rules or guidance on how unblocked income flows up through a fund structure, regulatory authority is provided to address the application of the pass-through rules in the case of tiered entities. Subject to any implementing guidance, presumably qualifying income generally should retain its character:

  General partnership (GP). It seems that income of a partnership allocated to a GP entity should retain its underlying character that flows up from a fund.

  Fund of funds. Depending on the character of income allocated from underlying portfolio funds, it seems that upper-tier fund of funds should have consistent treatment.

  Pass-through portfolio companies. Operating pass-through income should be eligible for QBI. It is unclear how such income, if eligible for QBI at the operating partnership level, would flow through one or more pass-throughs, but presumably the income should retain its eligibility as it tiers up through a fund structure.
- **Management companies.** The Act closely tracks the Senate Bill. Management activities may be a "specified service business," and "the trade or business of performing services as an employee" is not a "qualified trade or business." A specified service business is defined broadly (e.g., to include "consulting," "financial services," and a business whose principal asset is the reputation or skill of one or more of its employees or owner). If a management company is considered an ineligible services business, the 20% deduction is phased out for high-income taxpayers.
- **Master limited partnerships (MLPs).** The Act allows a 20% deduction for certain income allocated to an individual partner of a publicly traded partnership (PTP) that is taxable as a partnership because it qualifies for the passive income exception of Section 7704(c). This should primarily benefit MLP/PTPs in the energy space, rather than PE/asset management PTPs, based on nature of the income they earn.

3. State and local tax (SALT) deduction for pass-throughs

Unlike individuals, under the Act, pass-through entities retain the ability to deduct entity-level state and local taxes.

4. Carried interest

The Act adopts the same three-year minimum asset holding period for service providers to qualify for long-term capital gain treatment. No further changes were made to expand this provision, e.g., to cover other types of income or gain.

5. Self-employment tax for limited partners

The Act maintains the status quo for investment professionals who are limited partners in a state law limited partnership who claim an exemption from self-employment tax.

6. Sales of partnership interests by foreign partners
The Act adopts the Senate approach and codifies Revenue Ruling 91-32, effectively reversing the Grecian Magnesite decision (see Tax Alert **2017-1156**). Gain or loss on the disposition of a partnership by a foreign partner is treated as effectively connected income (ECI) and subject to taxation in the US if the gain or loss from the sale of the underlying assets held by the partnership is treated as ECI. In addition, a withholding tax obligation is imposed on the purchaser/transferee unless the transferor certifies it is not a foreign person (similar to the operation of the Foreign Investment in Real Property Act of 1980 (FIRPTA) rules applicable to sales of US real estate by foreign owners). This provision has potential implications for pass-through investments at the portfolio-company, fund and limited-partner level (including for fund of fund investors) and for certain management company sale transactions. The proposal applies to sales or exchanges occurring on or after November 27, 2017. Taxpayers considering filing refund claims for open tax years before 2017 should consider this legislative provision, as well as the IRS' recent choice to appeal the **Grecian Magnesite** decision.

7. Partnership terminations
Under Section 708(b)(1)(B) of current law, a sale or exchange of 50% or more of interests in partnership capital and profits within 12 months causes a "technical termination" of the partnership. The Act repeals Section 708(b)(1)(B) for partnership tax years beginning after December 31, 2017.

8. Tax-exempt investors
The Act adopts the Senate approach to impose a new 1.4% excise tax on the net investment income of private colleges and universities with aggregate assets (other than those used directly in carrying out the institution's educational purpose) of at least $500,000 per full-time student.

It also adopts the Senate's approach to require a tax-exempt investor to calculate separately the net unrelated taxable income of each trade or business, beginning in 2018.

The Act includes no provision that would subject super tax-exempt investors (including state and local entities and pension plans) to unrelated business income tax.

9. Computing basis in securities
The Senate Bill would have required the cost and holding period of any specified security disposed of on or after January 1, 2018, to be determined on a first-in, first-out (FIFO) basis. Following extensive lobbying and negotiations during the reconciliation process, this provision was not included in the Act.

10. Private activity bonds
The Act does not adopt the provision in the House Bill to repeal the exclusion from gross income for interest on qualified private activity bonds.

11. Recognition of income
The Senate Bill included a book/tax conformity rule, which was narrowed through amendments, that addressed satisfaction of the "all events test" in certain circumstances. As adopted, the rule generally requires a taxpayer to recognize income at the earlier of when recognized for tax purposes under Section 451 or when taken into account on an applicable financial statement (effectively requiring tax recognition at the earlier of earned, due, received or recognized for financial statement purposes). The provision directs taxpayers to follow the income recognition rules under Section 451 before applying the rules under part V of Subchapter P, which includes the original issue discount (OID) rules. In its final form, the provision appears less likely to potentially require the acceleration of fee and incentive payments, but questions remain as to how the new provision will impact funds that hold market discount and other debt securities.

12. Other tax issues, including real estate
The Act makes no changes to the tax treatment of MLPs or PTPs, except as previously described in relation to the pass-through deduction.

The Act makes no changes to FIRPTA. However, it adopts the Senate Bill provision under which a real property trade or business can elect out of the interest expense deduction limitation (discussed later) and use the alternative depreciation system to depreciate real estate.

The Act also provides that the nonrecognition of gain in the case of like-kind exchanges is limited to those involving real property. Current law continues to apply for like-kind exchanges if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before December 31, 2017.

Transaction and portfolio company issues

For a portfolio company structured as a C corporation, the reduced 21% corporate tax rate beginning in 2018 and tax shield resulting from immediate capital expensing should increase free cash flow. When compared to current law, these proposals generally should mitigate the effects of any potential limitation to interest deductibility and, except in limited circumstances (e.g., in the case of certain cyclical businesses), result in cash tax savings. The interplay of these provisions will be top of mind for deal professionals as they model tax for prospective transactions and potential impact on existing portfolio companies.

Domestic corporate tax

1. Reduction in corporate income tax
The Act calls for a permanent tax rate reduction to 21%, effective January 1, 2018. The special rate for personal service corporations is eliminated.

2. Corporate alternative minimum tax (AMT)
Like the House Bill, the Act repeals the corporate AMT. For a corporation, the Act allows the AMT credit to offset the regular tax liability for any tax year. The AMT credit is refundable for any tax year beginning after 2017 and before 2022 in an amount equal to 50% (100% for tax years beginning in 2021) of the excess of the minimum tax credit for the tax year over the amount of the credit allowable for the year against regular tax liability.

3. Interest deductibility limitation
Regarding the 30% of ATI limitation, the Act adopts a compromise approach between the House and Senate Bills. Beginning in 2018, business net interest deductions are limited to 30% of ATI, which will be a tax EBITDA-based calculation for 2018 through 2021. After 2021, similar to the Senate Bill, an EBIT-based calculation is used to determine ATI. After 2021, when depreciation, amortization and depletion are NOT permitted to be added back in calculating ATI, the interest limit will likely become significantly lower, which could have a negative cash tax impact on leveraged deals.

Under the Act, disallowed amounts may be carried forward indefinitely. An exclusion is provided for taxpayers that meet a $25 million gross receipts test and certain regulated public utilities and electing real property trades or businesses.

4. Immediate capital expensing for qualified property
The Act adopts the Senate Bill's 100% bonus depreciation approach and provides full expensing for qualified property placed in service after September 27, 2017, and before January 1, 2023. The 100% bonus deprecation for qualified property is phased down after 2022 as follows:

- 80% for property placed in service during 2023
- 60% for property placed in service during 2024
- 40% for property placed in service during 2025
- 20% for property placed in service during 2026

The Act follows the House Bill in permitting immediate expensing for both new and used (i.e., first use) qualified property. This is important for asset deals or deemed asset deals in which capital property is acquired from a third party. In addition, it appears that pre-existing depreciable assets would be recovered under their current cost recovery method.

No provision in the Act permits the immediate expensing of amortizable intangible assets, including goodwill and other Section 197 assets.

5. Net operating losses (NOLs)
A corporation's NOL deduction is limited to 80% of taxable income (determined without regard to the NOL deduction) for losses arising in tax years beginning after 2017. NOL carryback provisions are repealed, and an indefinite carryforward is allowed. Among other things, these changes could impact the tax shield of certain PE portfolio company investments.

6. Dividends received deduction (DRD)
The deduction for dividends received from a domestic corporation is lowered to conform the DRD in light of the new 21% corporate tax rate (from 70% to 50%, and from 80% to 65% for 20%-or-greater-owned domestic corporations). The Act does not include a mechanism for so-called corporate integration.

US international tax
The Act largely adheres to the Senate Bill and significantly modifies the current US international tax system, including by: (1) implementing a territorial tax system for business income; (2) imposing a one-time transition tax on accumulated foreign earnings; and (3) introducing new anti-base erosion rules.

7. 100% exemption for foreign-source dividends
Like the Senate Bill, the Act provides a 100% exemption for foreign-source dividends received by a US corporation from a 10%-or-greater-owned foreign corporation. The deduction is not available for "hybrid dividends," and a one-year holding period in the stock of the foreign corporation is required. The Act allows an exemption for a US corporation's distributive share of a dividend received by a partnership in which the US corporation is a partner if the dividend would have been eligible for the exemption had the US corporation directly owned stock in the foreign corporation.

8. Deemed repatriation tax
The Act imposes a one-time transition tax on a US shareholder's pro rata share of the undistributed, non-previously taxed post-1986 earnings of a controlled foreign corporation (CFC) or other "specified foreign corporation," at an effective rate of either 15.5% (to the extent of cash or other liquid assets) or 8% (for illiquid assets) by applying a new participation exemption deduction provided in Section 965(c). A US shareholder can elect to pay the tax over a period of up to eight years, with larger payments due in the last three years.

The Act contains some clarifications for specified foreign corporations held through partnerships. First, the Act explains that, for a foreign corporation that is not a CFC, there must be at least one US shareholder that is a domestic corporation for the foreign corporation to be a specified foreign corporation whose earnings are subject to the transition tax. Second, the Act clarifies that appropriate basis adjustments will be made to increase a partner or S corporation shareholder's outside basis in her partnership or S corporation interest respectively to reflect the full inclusion amount.

9. Worldwide interest limitation
The worldwide interest limitation provision was struck by the Conference Committee, thereby removing a potential impediment to accessing foreign debt financing for certain multinational portfolio companies.

10. Anti-base erosion — intangible assets
The Act follows the Senate Bill and imposes a tax on a US shareholder's aggregate net CFC income that is treated as global intangible low-taxed income (GILTI). GILTI is gross income in excess of extraordinary returns from tangible depreciable assets excluding effectively connected income (ECI), subpart F income, high-taxed income, dividends from related parties, and foreign oil and gas extraction income. The extraordinary return base equals 10% of the CFCs' aggregate adjusted basis in depreciable tangible property. Only 80% of the foreign taxes paid on the income are allowed as a foreign tax credit. All CFCs are aggregated for purposes of the computation. For tax years beginning after December 31, 2017, and before January 1, 2026, the highest effective tax rate on GILTI is 10.5%. For tax years beginning after December 31, 2025, the effective tax rate on GILTI is 13.125%.

The Act maintains the tax incentive in the Senate Bill for US companies to earn intangible income from US intangibles abroad. Income from foreign-derived intangible income (FDII) for tax years beginning after December 31, 2017, and before January 1, 2026, is provided an effective tax rate of 13.125%. For tax years beginning after December 31, 2025, the effective tax rate on FDII is 16.406%. Eligible income does not include, among other items, financial services income under Section 904(d)(2)(D).

11. Base erosion and anti-abuse tax
The Act adopts the Senate Bill's new base erosion anti-abuse tax (BEAT) provision. The BEAT applies to corporations (other than RICs, REITs, or S-corporations) that are subject to US net income tax with average annual gross receipts of at least $500 million and that have made related-party deductible payments totaling 3% (2% for banks and certain security dealers) or more of the corporation's total deductions for the year. A corporation subject to the tax generally determines the amount of tax owed under the provision (if any) by adding back to its adjusted taxable income for the year all deductible payments

made to a foreign affiliate (base erosion payments) for the year (the modified taxable income). Base erosion payments do not include cost of goods sold, certain amounts paid with respect to services, and certain qualified derivative payments. The excess of 10% (5% for one tax year for base erosion payments paid or accrued in tax years beginning after December 31, 2017) of the corporation's modified taxable income over its regular tax liability for the year (net of an adjusted amount of tax credits allowed) is the base erosion minimum tax amount that is owed. For tax years beginning after December 31, 2025, the rate increases from 10% to 12.5%.

12. Intangible property
The Senate Bill's proposal to permit a CFC to distribute on a tax-free basis certain eligible intangible property to any corporate US shareholder was not included in the Act.

The Act adopts the House Bill's provision to no longer treat certain self-created assets — including patents, inventions or processes — as a capital asset, effective for dispositions after December 31, 2017. As such, gain or loss from the disposition of the property is ordinary in character. Those items of property also are excluded from the definition of property used in the trade or business under Section 1231.

13. Ownership and attribution rules for CFC status
Like the House and Senate Bills, the Act repeals Section 958(b)(4), effective for the 2017 tax year. In addition, beginning in 2018, the definition of "US shareholder" is extended to US persons that owned 10% or more of the voting power or value of a CFC. These expanded ownership and attribution rules could cause significant changes for many investment structures, particularly when the current-law rules prevent CFC status for foreign subsidiaries owned through foreign vehicles. Managers should consider any potential impact on the one-time transition tax determination, on fund reporting, and whether certain portfolio companies could become subject to anti-deferral or anti-base erosion measures.

Other portfolio company issues
14. Executive compensation limits (Section 162(m))
The Act follows the Senate Bill and expands the $1 million deduction limit that applies to compensation paid to top executives of publicly traded companies. Once an individual is named as a covered employee, the $1 million deduction limitation applies to compensation (including performance-based compensation) paid to that individual at any point in the future. These changes could impact portfolio company management teams.

15. Business credits
The Act preserves the research tax credit without modification. Similar to the House and Senate Bills, it requires the capitalization and five-year amortization of domestic qualified research and experimental (R&E) expenditures (15 years for R&E conducted outside the US), but only for such expenditures incurred in tax years after 2021.

Regarding the Section 199 domestic production activities deduction, the Act follows the House Bill and repeals the Section 199 deduction for tax years beginning after 2017.

The Act retains current law with respect to the Work Opportunity Tax Credit, which expires after 2019. In addition, the Act does not adopt the Senate Bill's changes to the Low-Income Housing Credit. Further, under the Act, the deduction for certain unused business credits is not repealed.

PE and alternative fund principals and deal professionals

The provisions of the Act could have some adverse impact on PE and alternative asset management principals, as the tax cuts are focused on middle-class tax relief. The provisions will almost certainly disproportionately impact individuals living in expensive metropolitan areas, including in the Northeast Corridor, California and Illinois.

1. Individual income tax rates
The Act preserves seven tax brackets, with a top rate of 37% for income starting at $600,000 for joint filers. The new individual tax rate structure sunsets for tax years beginning after December 31, 2025.

Individual AMT. The Act preserves the individual AMT, but temporarily increases both the exemption amount (to $109,400 for joint filers) and the exemption amount phaseout thresholds (to $1 million for joint filers).

2. State and local taxes
The Act provides a state and local tax deduction capped at $10,000, a combined limit for property taxes and state and local income or sales taxes. The Act explicitly prohibits an individual from claiming an itemized deduction in 2017 on a pre-payment of income tax for a future tax year to avoid the new $10,000 limitation.

3. Mortgage interest deduction
The Act splits the difference between the House and the Senate Bills and provides an interest deduction on mortgage debt of up to $750,000 for newly purchased homes. In addition, the deduction for home equity debt interest is suspended for the 2018 through 2025 tax years. Further, the Act does not modify the current law exclusion of gain on the sale of a principal residence.

4. Medical expense deduction
Under the Act, the itemized deduction for medical expenses is retained and applies to expenses that exceed 7.5% of AGI in 2017 and 2018, and expenses that exceed 10% of AGI thereafter.

5. Affordable Care Act
The Act effectively repeals the "individual mandate" under the Affordable Care Act by reducing to zero the tax that applies to individuals who fail to purchase health insurance, beginning in 2019.

6. Estate tax
The Act does not repeal the estate tax. In line with the Senate Bill, the Act doubles the amount of the estate, gift and generation-skipping transfer tax exemption (from $5 million to $10 million per individual) for the 2018 through 2025 tax years. The $10 million amount is indexed for inflation occurring after 2011.

7. Nonqualified deferred compensation
The Act does not change Section 409A, except to exclude the receipt of certain private company qualified stock by an employee as a nonqualified deferred compensation plan for purposes of Section 409A.

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January 2, 2018

Tax Cuts and Jobs Act contains provisions that may affect RICs

The Tax Cuts and Jobs Act (the Act), which the President signed on December 22, 2017, contains a number of provisions that may affect regulated investment companies (RICs). Because these provisions generally apply to tax years beginning after December 31, 2017, RIC complexes should determine the impact of the new legislation as quickly as possible.

As a threshold matter, it is important to note what is not in the Act — specifically, mandatory first-in, first-out (FIFO) lot selection. The Senate bill generally required taxpayers to use FIFO. That bill provided an exception for RICs; RIC shareholders, however, would have had to select lots using either FIFO or average cost. The final legislation contains no such provision. Accordingly, the lot selection rules that existed prior to the legislation (including the use of specific identification) remain in effect.

Key provisions for RICs

Accelerated inclusion of gross income. The Act generally requires accrual-basis taxpayers, including RICs, to recognize certain items of gross income no later than the tax year in which that gross income is taken into account under generally accepted accounting principles (GAAP). The provision may only require immediate inclusion of some types of loan-related and credit-card-related fee income or it may be far broader. For example, the provision may require current inclusion in income of market discount. Although most RICs elect current inclusion of market discount on taxable bonds, they tend not to make this election for municipal bonds, since market discount on municipal bonds is taxable. The provision similarly may require accelerated inclusion of income on instruments that are classified as debt for GAAP purposes and equity for tax purposes, such as some types of preferred stock. The exact scope of the provision is uncertain at this time, and additional clarification is being sought. The Conference Committee Statement on the Act does indicate that the provision is not intended to impose a general mark-to-market regime on securities.

No pass-through of new partial deduction for REIT dividends and master limited partnership (MLP) income. The law generally allows non-corporate taxpayers to deduct 20% of the REIT dividends they receive (other than capital gain dividends and dividends taxable as qualified dividend income) and the MLP income they are allocated. As a corporation, a RIC is ineligible for this deduction. In addition, it appears that RICs cannot pass the deduction to their non-corporate shareholders. It is possible that a technical correction will address this deficiency, since there is no policy reason to deny RIC shareholders the REIT and MLP deduction.

Limitation on deduction for business interest. The Act generally limits the deductibility of net business interest expense to 30% of "adjusted taxable income." Although open-end RICs generally do not incur debt, business development companies (BDCs) and some closed-end RICs do borrow. The limitation should not be relevant to these entities if a significant portion of their assets consists of debt instruments, since their interest income likely will exceed their interest expense, resulting in no net interest expense. BDCs and closed-end RICs that borrow and invest in other asset classes, however, will need to consider whether the limitation applies to them. It currently is unclear whether RICs and BDCs are engaged in a business for purposes of the limitation.

Dividend exclusion, additional income inclusions for 10% shareholders of certain foreign corporations. The Act generally exempts 100% of the foreign-source portion of dividends a US corporation receives from a foreign corporation (other than a passive foreign investment company (PFIC) that is not also a controlled foreign corporation (CFC)) in which the US corporation owns at least a 10% interest (Specified 10%-Owned Foreign Corporation), assuming certain requirements are met. RICs (and REITs) are not eligible for this favorable exclusion. RICs, however, rarely own 10% or more of foreign corporations other than wholly owned investment entities, and the Act does not change the rules requiring current inclusion of subpart F income from these entities. If a RIC (or other applicable taxpayer) does own 10% or more of a Specified 10% Foreign Owned Corporation or CFC in that foreign corporation's final tax year beginning before January 1, 2018, the RIC (like taxpayers to which the 100% exclusion applies) will be subject to a toll charge in the form of an income inclusion based on the RIC's pro rata share of the foreign corporation's post-1986 tax-deferred earnings (that is, earnings that previously were not subject to US tax) during the period the foreign corporation was a CFC or had a 10%-or-greater US corporate shareholder. In addition, for tax years beginning after December 31, 2017, RICs (and other taxpayers) that are 10%-or-greater shareholders of CFCs may have to include a new category of subpart F income, global intangible low-taxed income (GILTI). Again, this provision should not affect the tax treatment of a RIC's wholly owned investment subsidiaries, since RICs already include subpart F income from these subsidiaries on a current basis. If a RIC is subject to this provision for other investments, however, the RIC cannot claim the 50% exclusion for GILTI income that is available for most US corporations.

Taxability of municipal bonds issued for pre-refundings. RICs that invest in municipal bonds often hold bonds that have been defeased (or pre-refunded) — that is, bonds for which a municipality has issued a new "advance refunding bond" and set aside the new-bond proceeds in escrow to pay principal and interest on the original bond. The municipality usually invests the escrow in US government securities, such as Treasuries, and the original bond is treated as a government security for purposes of the RIC asset diversification (there is no limit on investments in US government securities under the test). The Act makes interest on advance refunding bonds taxable — interest on the original bond, however, remains tax-exempt (assuming it was tax-exempt at issuance). This change applies to advance refunding bonds issued after December 31, 2017. RICs that invest in pre-refunded bonds to facilitate compliance with the asset diversification test should be aware that the number of advance refundings could decline as a result of this new rule.

More stringent insurance business exception to PFIC status. The Act modifies the insurance business exception to PFIC status so that it applies only if a foreign corporation would be taxed as an insurance company if it were a US corporation and if its applicable insurance liabilities constitute: (1) more than 25% of the foreign company's assets; or (2) at least 10% of the entity's assets if the decline below 25% is due to temporary circumstances. This change applies to tax years beginning after December 31, 2017. Under current law, the test for the exception is based on whether a corporation is predominantly engaged in an insurance business (the IRS has indicated that it analyzes whether risks assumed under contracts issued by a foreign company organized as an insurer are truly insurance risks, whether the risks are limited under the terms of the contracts, and the status of the company as an insurance company). RICs will need to modify their PFIC-identification procedures accordingly.

Conclusion

The Act makes a number of changes that could significantly affect RICs. The scope of several of these changes is unclear at the present time, so it will be important to monitor for clarifications and guidance as the Act's provisions take effect.

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February 2, 2018

Tax Cuts and Jobs Act significantly affects US private companies with outbound investments

US and foreign individuals who conduct business and invest both in the United States and globally may be significantly affected by the international tax provisions contained in the recently enacted Tax Cuts and Jobs Act (the Act).

The Act changes the taxation of US persons that own foreign businesses and includes new requirements with respect to foreign income inclusion and deduction items. Specifically, the Act reduces the top corporate tax rate to 21% and establishes a mandatory one-time transition tax to facilitate the transition toward a substantially modified system of international taxation. The constructive ownership rules of the US controlled foreign corporation (CFC)[1] regime have also been amended and will have a significant impact on how US private companies must analyze ownership of foreign corporations.

This alert also highlights other provisions of the Act that have an immediate impact on the foreign corporate stock ownership of US private companies. This includes an overview of the global intangible low-taxed income (GILTI) and foreign-derived intangible income (FDII) regimes, as well as a few other provisions applicable to private companies.

Overview of relevant outbound US tax reform rules

Changes to stock attribution rules affecting US private companies
The Act repealed Section 958(b)(4), which generally prevented stock owned by a foreign shareholder from being attributed downward to a domestic subsidiary. As a result, the stock attribution rules under the Act now permit treating a US person as constructively owning certain stock of a foreign corporation that is held by a foreign shareholder (downward attribution).[2] Accordingly, a US partnership, estate, trust, or corporation can be attributed ownership of a foreign corporation from a foreign partner, beneficiary or shareholder for purposes of determining CFC status. For example, pre-Act, if a foreign parent owned 51% of a foreign subsidiary and a US subsidiary (of the foreign parent) owned the remaining 49%, the foreign subsidiary would not be a CFC because Section 958(b)(4) prevented the US subsidiary from being attributed ownership of the foreign parent's 51% interest. As a result of the repeal of this limitation, under these facts, the US subsidiary would, for purposes of determining US shareholder and CFC status, be treated as owning all of the foreign parent's stock in the foreign subsidiary, causing the foreign subsidiary to be a CFC. The US subsidiary's inclusion of any subpart F income, however, still would be limited to its directly held stock, and any stock indirectly held through foreign entities as determined under Section 958(a).

Some of the lesser-known consequences of the stock attribution rules are:
Constructive ownership rules. The constructive ownership rules under Section 958(b) apply the constructive ownership rules of Section 318. Under Section 318(a)(3), stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.[3] As a result, in the event the downward attribution rule applies to treat a foreign corporation as a CFC, there is concern that all US partners of the partnership will have a corresponding inclusion for both the transition tax and GILTI. However, the IRS issued Notice 2018-13, stating that it intends to amend the instructions for Form 5471 to provide an exception from Category 5 filing (the CFC filing requirement) for a US person that is a US shareholder with respect to a CFC if no United States shareholder (including such United States person) owns, within the meaning of Section 958(a), stock in such CFC, and the foreign corporation is a CFC solely because such United States person is considered to own the stock of the CFC owned by a foreign person under Section 318(a)(3).

US tax ownership rules. The US tax ownership rules are applied to options in a manner to cause the option holder to be treated as a US shareholder and the foreign corporation to be treated as a CFC. For example, if options are held by a US and a non-US person, the US options are deemed exercised and the non-US options are deemed not to be exercised if this will cause the US person to be treated as a US shareholder. It does not matter if options are out of the money. However, the transition inclusion to the US person will be based on their actual share interest (not including unexercised options).

Non-voting preferred stock. In general, non-voting preferred stock will not cause someone to be treated as a 10%-or-greater voting interest owner (a US shareholder) but this ownership will be relevant for inclusion purposes because accrued and unpaid dividends of preferred stock held by a US shareholder should receive priority allocation of deferred foreign earnings.

Convertible debt. Convertible debt that is convertible into voting stock should be treated similar to options for purposes of determining if the bondholder is a US shareholder, but the amount of the transition tax inclusion will be limited to the actual ownership interest in the foreign corporation's outstanding voting and non-voting share classes at December 31, 2017.

The stock attribution rules under the Act apply to the last tax year of foreign corporations beginning before January 1, 2018, and all subsequent years, and to tax years of US shareholders in which such tax years of foreign corporations end.

The repeal of Section 958(b)(4) greatly expands the application of subpart F, by broadening the scope of entities subject to GILTI and the mandatory transition tax, as discussed further below. As a result, private companies need to do a comprehensive analysis of their offshore ownership structures to determine the impact this repeal has on their subpart F status. The CFC ownership rules are now more complex.

Application of transition tax to US individuals and trusts, their pass-through entities and closely held C corporations
Section 965 of the Act treats as subpart F income US shareholders' pro rata share of a specified foreign corporation's (SFC) post-1986 deferred foreign income and levies the transition tax, at reduced rates, on such US shareholders' share of such amounts. An SFC is defined as either: (1) a CFC, or (2) any other foreign corporation (other than a passive foreign investment company (PFIC)) in which a domestic corporation is a 10%-or-greater US shareholder.[4] An SFC of a US shareholder, which has accumulated post-1986 deferred foreign income, is referred to as a deferred foreign income corporation (DFIC). A DFIC's post-1986 deferred foreign income subject to the transition tax will be the greater of its earnings and profits as of November 2, 2017, or December 31, 2017, attributable to periods during which it was an SFC. The US Treasury Department and Internal Revenue Service issued Notice 2018-07 (Notice), providing guidance for computing the transition tax. The Notice describes regulations that the Treasury Department and the IRS intend to issue, effective for the last tax year of a foreign corporation that begins before January 1, 2018, and with respect to US shareholders, for the tax years in which tax years of the foreign corporations end.

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[1] Section 957(a) of the Code defines a CFC as any foreign corporation in which US shareholders own more than 50% of the value or voting power of the foreign corporation on any day during the tax year.

[2] Note, a related person relationship is required for an actual inclusion. The legislative history indicates that the repeal of Section 958(b)(4) is not intended to result in downward attribution of ownership (under Section 318(a)(3)) to an unrelated US person as defined under Section 954(d).

[3] S corporations are treated as partnerships for purposes of Section 318.

[4] In the context of the transition tax, the pre-2018 definition of US shareholder applies: any US shareholder that owns 10% or more of the voting stock in the CFC. As discussed below, for tax years beginning after January 1, 2018, the definition of US shareholder has been amended to include a US person who owns 10% or more of the voting stock or value of a foreign corporation.

US shareholders are subject to the transition tax at reduced rates depending on whether earnings are held in cash and cash equivalents or other assets. The reduced rates are achieved by allowing a deduction against the mandatory inclusion amount. The amount of the deduction depends on the inclusion year of the taxpayer. For C corporations, the deduction percentages result in a 15.5% tax rate on the aggregate foreign cash position and 8% for the remainder.[5] However, the formula for calculating the deduction to reduce the effective rate under the transition tax is based on the highest pre-Act corporate tax rate of 35%, which is 4.6% lower than the highest pre-Act individual rate.[6] Consequently, although unclear until further guidance is provided, the effective transition tax rates for individuals and trusts, whether direct US shareholders in DFICs or indirect US shareholders through S corporations, partnerships or LLCs, are expected to be higher than the stated 15.5% and 8% applicable to C corporations.

In general, taxpayers must pay transition tax on the date when the tax return for the last tax year beginning before January 1, 2018, is due, without regard to any extensions. A US shareholder can elect to pay the net tax liability under the transition tax in installments over eight years (8% of the tax liability for the first five payments; 15% for the sixth payment; 20% for the seventh payment; and 25% for the final payment) with no interest charge. Taxpayers should consider paying their estimated tax based on 110% of their 2016 tax liability. Those who opt to still pay based on their anticipated 2017 taxable income should carefully review the annualized income installment method calculations and consider the possible underpayment penalties and interest. This election to pay the net tax liability over time should be made no later than the due date of the 2017 income tax return. Details related to who may make the election, how the election is made, and how the net tax liability is calculated need to be addressed in future guidance from the Treasury and IRS.

The Act provides a special deferral rule for S corporation shareholders. Each shareholder of an S corporation is eligible to make an election to defer payment of the transition tax until a "triggering event" occurs, as defined under the Act.[7] An S shareholder's deferral election is due on a timely filed return, which includes the close of the S corporation's tax year where there is a mandatory inclusion (i.e., due date of 2017 tax returns for calendar year taxpayers).

Once the full amount of the transition tax has been determined, regardless of whether a deferral election has been made by a taxpayer, the deferred foreign income subject to the tax will qualify as PTI so that distributions of those amounts will not be subject to additional US income tax.[8] Furthermore, if a taxpayer has made a deferral election, distributions in excess of the amounts of deferred foreign income on which tax already has been paid do not accelerate the payment of outstanding deferred transition tax. Further clarification is needed with respect to taking PTI into account for basis purposes where a taxpayer holds CFC interests indirectly through other entities. For example, it is currently not clear whether the basis of a partnership interest could be adjusted to account for transition tax PTI. This issue needs to be carefully monitored.

Beginning in 2018, the US shareholders of an SFC may be subject to the GILTI regime with respect to future foreign earnings of such SFC, as discussed in more detail below.

Example: Mr. X owns 80% of a DFIC. The DFIC's post-1986 tax-deferred earnings is $15,000,000 as of November 2, 2017, and $14,000,000 as of December 31, 2017. The DFIC distributed $1,000,000 on December 1, 2017. For purposes of determining the DFIC's post-1986 tax-deferred earnings that will be subject to the transition tax, the distribution of $1,000,000 is ignored. As a result, for the 2017 tax year, Mr. X has a mandatory subpart F inclusion of $12,000,000 (80% of $15,000,000), since the DFIC's November 2 E&P was greater than its December 31 E&P. Assuming the DFIC's remaining assets are cash and cash equivalents, Mr. X's transition tax liability will be $2,104,800 ($12,000,000 x 17.54%[9]). If Mr. X elects to defer the payment of the transition tax, he will pay $168,384 of the net tax liability for the first five payments; $315,720 of the net tax liability for the sixth payment; $420,960 for the seventh payment; and $526,200 for the final payment. The $1,000,000 distribution on December 1 will be nontaxable because it was subject to the transition tax and, therefore, will be treated as previously taxed income.

Immediate action steps

Private companies should review their non-US holdings to identify the impact of the new tax law by no later than January 31, 2018. Before the due date of the 2017 tax return, private companies should first determine if any of their entities are US shareholders (under the historic definition of US shareholder), and whether they directly, indirectly or constructively own interest in any SFCs (taking into account the downward attribution rules). This can be done by reviewing foreign filings (i.e., Form 5471, 8865, 8858) from prior years and reviewing updated ownership/structure charts and schedules of investments. Private companies also should perform a comprehensive analysis of ownership to determine whether a domestic corporation should be treated as a US shareholder under the new downward attribution rules.

As a next step, private companies should determine the amount, if any, of post-1986 deferred foreign income that will be subject to mandatory inclusion. Additionally, they should review the alternatives available to defer payment of the transition tax and the consequences of electing to defer on other planning/restructuring alternatives being considered in light of tax reform under the Act.

Private companies also should confirm whether there are any additional tax or reporting requirements for 2017 arising as a result of the transition tax. For example, the additional net tax liability arising from the transition tax will need to be properly reflected as subpart F income on the 2017 tax return, and will need to be reflected on the appropriate filings (i.e. Form 5471, 8865, 8858). Also, private companies should be mindful that there may be substantial state income tax issues for US persons who live in states with state income tax to consider.

Other international tax reform changes affecting US private companies

Other international tax provisions of the Act that might affect private companies with non-US interest include:

Definition of US shareholder. Currently, the definition of a "US shareholder" includes US persons who directly, indirectly or constructively own 10% or more of the total combined voting power of a foreign corporation. The Act expands the definition of a

US shareholder under Section 951(b) to include a US person who directly, indirectly or constructively owns 10% or more of the value of a foreign corporation.

Elimination of CFC 30-day rule. The Act repeals the exception from subpart F income inclusion for entities that were CFCs for 30 days or less. Under prior law, a US shareholder, as of the last day of the CFC's tax year, was required to recognize subpart F income with respect to a CFC only if that foreign corporation was a CFC for at least 30 consecutive days during its tax year. As a result of the elimination of the 30-day rule, a US shareholder will be required to recognize a subpart F inclusion with respect to a foreign corporation if the foreign corporation is a CFC at any time during the tax year.

100% exemption for foreign-source dividends. Under prior law, C corporations were allowed a foreign tax credit for foreign income taxes paid on the income out of which the dividend was paid, but generally only when the foreign earnings were distributed to the US or were otherwise subject to US taxation. The foreign tax credit generally was available to offset, in whole or in part, the US tax owed on foreign-source income.

The Act provides C corporations that are US shareholders of an SFC a 100% deduction for the foreign-source portion of dividends received by domestic corporations that are US shareholders of an SFC from specified 10%-owned foreign corporations.[10] Furthermore, any gain recognized by a C corporation on the sale or exchange of stock in a foreign corporation held for more than one year that is treated as a dividend under Section 1248, is treated as a dividend for purposes of the 100% deduction. No foreign tax credit (or deduction for foreign taxes paid with respect to qualifying dividends) is permitted for foreign taxes paid or accrued with respect to a qualifying dividend.

The 100% deduction for foreign-source dividends is only available to US C corporations. Individuals, S corporations, partners and LLC members that are not US C corporations do not qualify for this deduction.

GILTI and FDII. Under the new GILTI rules, a US shareholder of any CFC has to include in gross income for a tax year its GILTI in a manner similar to inclusions of subpart F income. GILTI is gross income in excess of extraordinary returns from tangible depreciable assets excluding effectively connected income, subpart F income, high-taxed income, dividends from related parties, and foreign oil and gas extraction income. The definition of GILTI is broad enough to capture income that is not necessarily related to intangibles, such as fees for services.

Generally, FDII is the portion of a domestic corporation's deemed intangible income, determined on a formulaic basis, which is derived from non-US sources.[11]

The Act provides a C corporation with deductions with respect to both GILTI and FDII income inclusions, which results in reduced rates of US tax on GILTI and FDII. As a result, for a domestic corporation with tax years beginning after December 31, 2017, and before January 1, 2026, the highest effective tax rate on GILTI is 10.5% (so that if the CFC pays corporate tax of at least 10.5% in its local jurisdiction, a C corporation should not be subject to further US tax on the GILTI of that CFC). For tax years beginning after December 31, 2025, the effective tax rate on GILTI is 13.125%.[12]

FDII for a domestic corporation with tax years beginning after December 31, 2017, and before January 1, 2026, is provided an effective tax rate of 13.125% (so that if the C corporation has paid at least 13.125% corporate tax in the jurisdiction where its FDII is sourced, it should not be subject to further US tax on such FDII). For tax years beginning after December 31, 2025, the effective tax rate on FDII is 16.406%.

These GILTI and FDII deductions are only available to US C corporations. Individuals, S corporations, partners and LLC members that are not US C corporations do not qualify for these deductions.

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[5] Section 962 allows a US shareholder who is an individual to make an election to be treated as a domestic corporation for purposes of determining: (1) the individual's gross income, and (2) the foreign tax credit. The regulations provide that a shareholder must file a statement "with his return for the [tax] year with respect to which the election is made." It is unclear whether the election is allowed with a return subject to an extension. Further, a Section 962 election is an annual election. Accordingly, an individual taxpayer can make the election when it will provide favorable results. For transition tax purposes, making the election results in effective tax rates of 15.5% on cash and cash equivalents and 8% on other assets. The potential tax impact of making a Section 962 election should be modeled out or reviewed before making any planning decisions. Potential advantages of the election are not without doubt, pending Treasury's clarification on qualified dividend income and "previously taxed income" (PTI) treatment for electing individuals.

[6] The corporate rate is reduced to 21% in 2018 and the transition tax deductions are correspondingly reduced, creating a 16% spread between the highest corporate rate and the highest marginal rate on individuals. Thus, this issue is even more problematic for fiscal year SFCs where there is a mandatory inclusion under the transition tax in 2018.

[7] S corporation triggering events include: (1) the corporation ceasing to be an S corporation; (2) a liquidation or other ceasing of the corporation's existence, sale of substantially all the corporate assets, cessation of the business, or similar circumstances, and (3) deferring a shareholder's transfer of any shares in the S corporation, including by death (a triggering event only on a proportionate basis). Note that only US citizens and green card holders are eligible to be shareholders in an S corporation — admitting a foreigner or a temporary resident may cause the S corporation to cease and trigger the tax.

[8] Note, a non-CFC is treated like a CFC for purposes of Section 951 and Section 961 only.

[9] Although the prevailing view, based on the current mechanics of the Act, is that the effective transition tax rate applicable for individuals, trusts, whether direct US shareholders in DFICs or indirect US shareholders through S corporations, partnerships, or LLCs is 17.54% (cash and cash equivalents) and 9.05% (other assets), this is unclear until further guidance is provided.

[10] Note, the 100% deduction is not available for dividends received from a CFC that receives a deduction or other tax benefit under foreign tax law for the dividend (hybrid dividend).

[11] A domestic corporation's FDII for a tax year is the amount that bears the same ratio to its "deemed intangible income" as its "foreign-derived deduction eligible income" bears to its "deduction eligible income." These are defined terms in the Act. If the sum of a domestic corporation's FDII and GILTI amounts exceeds its taxable income determined without regard to the FDII and GILTI provisions, then the amount of FDII and GILTI for which a deduction is allowed is reduced by an amount determined by such excess. The reduction in FDII for which a deduction is allowed equals such excess multiplied by a percentage equal to the corporation's FDII divided by the sum of its FDII and GILTI. The reduction in GILTI for which a deduction is allowed equals the remainder of such excess.

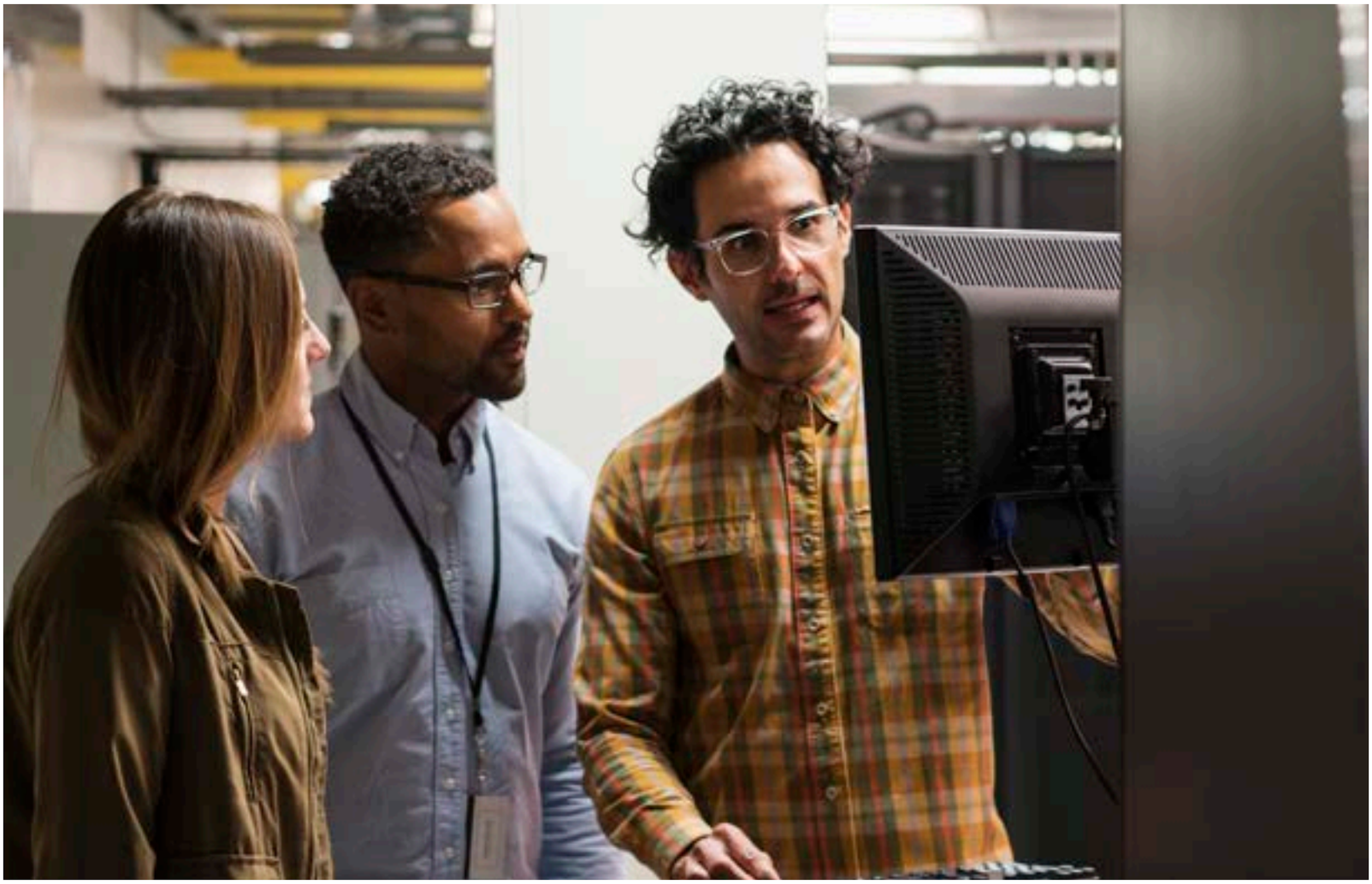
[12] Note, this is an estimated rate. Expense apportionment will impact the final rate. For example, the Section 78 gross-up may not be included in the same basket as the inclusion amount, which will have an impact on the final rate.

Immediate action steps

These new rules may cause private companies that previously were exempt from US reporting requirements and subpart F income inclusions to report GILTI and subpart F income. Private companies need to review all of their foreign holdings, even if they do not make any distributions or generate income, to determine whether they will be required to report GILTI and subpart F income on their 2018 tax return. Private companies also may be able to benefit from the FDII rate on non-US source income earned by a domestic corporation. In this regard, private companies should review the activities of each US entity in the organizational structure to determine whether there are any opportunities to apply the FDII rate.

Private companies also need to review existing structures for GILTI impact on Q1 estimated tax payments. Operational and structural changes may be needed to address additional tax burden. Private companies may want to reconsider the type of entity used in the US as the parent company of their foreign business since the potential impact of the GILTI may affect their effective tax rates differently depending on the type of entity chosen. Any entity choice advice, including incorporating a current pass-through structure, should be provided following a comprehensive modeling exercise prepared in collaboration with an international tax professional.

Private companies should also begin assessing and modeling the potential implications on income tax accounting. This will include developing a formal implementation plan across the company's finance and tax functions.



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What asset managers need to know to comply with the new full expensing and cost recovery provisions in the Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act (P.L. 115-97) (the Act), enacted December 22, 2017, changed certain elective expensing and cost recovery provisions of the Internal Revenue Code. This alert highlights the changes of interest to management companies in the private equity and alternative asset management industry.

Expansion of Section 179 expensing

Prior law

Before enactment of the Act, businesses could elect to immediately expense up to $510,000 of the cost of any Section[1] 179 property placed in service each tax year. This immediate expensing was subject to an investment limitation ($2,030,000 for 2017), after which it was reduced dollar for dollar to the extent that the expense exceeded the limit. Section 179 property included tangible personal property or certain computer software purchased for use in the active conduct of a trade or business, as well as certain "qualified real property," defined as qualified leasehold improvement property, qualified retail improvement property and qualified restaurant property that is depreciable and purchased for use in the active conduct of a trade or business.

Current law

For property placed in service in tax years beginning after December 31, 2017, the Act increases the expensing limitation under Section 179 from $510,000 to $1 million, with the investment limitation increased from $2,030,000 to $2.5 million, both of which are indexed for inflation. The Act also indexes the $25,000 sport utility vehicle limitation for inflation for tax years beginning after 2018.

The Act modifies the definition of qualified real property to: (1) eliminate references to qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, replacing such references with a reference to qualified improvement property; and (2) include the following improvements to nonresidential real property placed in service after the date the property was first placed in service: roofs, heating, ventilation and air-conditioning property, fire protection, and alarm systems and security systems.

Implications

The increased expense and investment limitation, coupled with the revised and expanded definition of "qualified real property," will provide additional immediate expensing opportunities to taxpayers that invest in personal and certain "qualified real property" as described in Section 179.

Bonus depreciation for qualified property

Prior law

Before the Act, taxpayers could claim additional depreciation (i.e., bonus depreciation) under Section 168(k) in the year in which qualified property (as described later) was placed in service through 2019 (with an additional year to place the property in service for qualified property with a longer production period, as well as certain aircraft). Bonus depreciation generally equaled 50% of the cost of the property placed in service in 2017 and phased down to 40% in 2018 and 30% in 2019. To be eligible for bonus depreciation, the original use of the property had to begin with the taxpayer (i.e., used property did not qualify).

Qualified property was defined as:

1. Modified accelerated cost recovery system (MACRS) property with a recovery period of 20 years or less
2. Certain computer software
3. Water utility property
4. Qualified improvement property

Prior to the Act, taxpayers could annually elect to not claim bonus depreciation with respect to qualified property under Section 168(k)(7). Alternatively, taxpayers could elect under Section 168(k)(4) to accelerate alternative minimum tax (AMT) credits (as refundable credits) in lieu of claiming bonus depreciation with respect to qualified property. Such election came with the added requirement to depreciate qualified property using a straight-line recovery method.

Current law

The Act extends the additional first-year depreciation deduction for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2027 (January 1, 2028, for certain qualified property with a longer production period, as well as certain aircraft).

The bonus depreciation percentage and phase-down schedule for most qualified property is as follows:

- 100% for property acquired and placed in service after September 27, 2017, and before January 1, 2023
- 80% for property placed in service after December 31, 2022, and before January 1, 2024
- 60% for property placed in service after December 31, 2023, and before January 1, 2025
- 40% for property placed in service after December 31, 2024, and before January 1, 2026
- 20% for property placed in service after December 31, 2025, and before January 1, 2027
- 0% (bonus expires) for property placed in service after December 31, 2026

For certain property with longer production periods, as well as certain aircraft, the end dates in the prior list are increased by one year. For example, bonus depreciation is 80% for long-production-period property or certain aircraft placed in service after December 31, 2023, and before January 1, 2025.

Under the Act, qualified property is defined as:

1. MACRS property with a recovery period of 20 years or less,
2. Certain computer software,
3. Water utility property, or
4. Qualified film, television or live theatrical productions as defined in Section 181.

[1] References to "Section" are to the relevant section or sections of the Internal Revenue Code of 1986, as amended (the IRC or Code)

The Act applies to property acquired and placed in service after September 27, 2017, as well as specified plants planted or grafted after that date. Property acquired before September 27, 2017, is subject to the bonus depreciation rules in place before the Act became law. Further, a transition rule allows a taxpayer to elect to utilize 50% bonus depreciation, instead of 100%, for qualified property placed in service during the first tax year ending after September 27, 2017.

Effective for otherwise bonus-eligible property acquired and placed in service after September 27, 2017, property previously used by an unrelated person may qualify for bonus depreciation if it meets certain additional acquisition requirements. The acquisition requirements are met if:

- The taxpayer did not use the property at any time before acquiring it
- The taxpayer acquired the property by purchase and not as part of certain carryover basis or related-party acquisition transactions

Furthermore, the Act repeals the election to accelerate AMT credits in lieu of bonus depreciation.

Implications

Immediate expensing or 100% bonus depreciation for property meeting the definition of "qualified property" under Section 168(k)(2) provides taxpayers acquiring such property with an immediate cash-tax benefit. Further, as the Act allows taxpayers to elect out of Section 168(k), consistent with prior law, taxpayers that are in a loss position and will not otherwise benefit from immediate expensing have the flexibility to elect not to apply Section 168(k) and, instead, utilize the depreciation provisions in Section 168 generally. Such election, along with other Section 168 elections to "slow down" depreciation (e.g., annual election to use the alternative depreciation system), will become more relevant in tax years beginning on or after January 1, 2022, when depreciation deductions will reduce "adjusted taxable income" for purposes of the 30% interest deduction limitation under Section 163(j). Thus, beginning with the 2022 tax year, companies will want to carefully model out the impact that depreciation elections will have on interest deductibility.

Asset managers should also consider the possible interaction between depreciation elections, which could generate losses, and the new limit on the deductibility of excess business losses. Although the new loss limitation rules apply at the individual level, asset managers should model whether particular depreciation elections could result in losses.

Further, Section 168(k)(4), which allowed taxpayers to elect to utilize straight-line depreciation associated with bonus-eligible property and monetize a portion of pre-2016 AMT credit carryforwards, was repealed by the Act. This repeal is largely due to the fact that the AMT repeal transition rules provide a mechanism for taxpayers to fully refund any unused AMT credits from 2018 through 2021.

As previously described, certain used property is now considered qualified property eligible for bonus depreciation. The ability to apply bonus depreciation to certain used property is a substantial benefit to taxpayers.

Qualified property acquired and/or placed in service on or before September 27, 2017, is, however, not subject to the immediate expensing bonus provisions detailed earlier but is eligible for the pre-Act bonus depreciation percentages.

Cost recovery of real property

Prior law

Before the Act, Section 168(e) contained separate definitions for qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property, providing a 15-year recovery period for each type of property. Further, Section 168(k)(3) provided an additional definition for qualified improvement property (QIP). Specifically, QIP referred to certain improvements to the interior of a building that was nonresidential real property if the improvement was placed in service after the date the building was first placed in service. Further, QIP could be recovered under the general depreciation system over either 15 or 39 years, depending on whether such property also met the definition of qualified leasehold improvement property or nonresidential real property.

Current law

The Act makes the following changes related to MACRS recovery periods for real property, effective for property placed in service after December 31, 2017:

- The 15-year recovery period for qualified leasehold improvement property, qualified retail improvement property and qualified restaurant improvement property is eliminated.
- The ADS recovery period for residential rental property is reduced from 40 years to 30 years.
- The MACRS alternative depreciation system (ADS) must be used by an electing real property trade or business (as described in Section 163(j)) to depreciate residential rental property, nonresidential real property and qualified improvement property (effective for tax years beginning after December 31, 2017).

Important to note: The Act establishes a single definition for QIP under Section 168(e)(6), but does not specifically include QIP in Section 168(e)(3)(E) as having a 15-year recovery period. Although it appears that Congress intended to provide a 15-year recovery period to QIP under the MACRS general depreciation system, the Act's provisions do not currently provide a 15-year recovery period for QIP. As a result, QIP has a depreciable recovery period of 39 years, not 15 years, and does NOT qualify for 100% bonus expensing for property placed in service on or after January 1, 2018. See Tax Alert 2018-0012 for details. Since the definition of QIP does not take effect until January 1, 2018, qualified leasehold improvement property and qualified retail improvement property still have a 15-year recovery period and are eligible for 100% bonus depreciation if acquired and placed in service from September 28, 2017, to December 31, 2017.

Implications

To the extent that a technical correction of this provision is not adopted, managers with large current or anticipated spends in improvements (renovations) to nonresidential real property should consider further analysis, such as a cost segregation study that can determine shorter recovery periods for specified assets.

Practical examples

1. ABC Management LP incurs qualified leasehold improvement expenditures for renovations incurred and completed from September 28, 2017, through December 31, 2017.

Outcome: Taxpayer could fully expense the costs as a bonus depreciation allowance under Section 168 on its 2017 tax returns.

2. ABC Management LP incurs expenditures related to an office renovation; expenditures are incurred after January 1, 2018.

Outcome: The expenditures do not qualify for bonus depreciation, but may be deductible under Section 179 (depending upon whether those costs meet the definition of qualified real property under Section 179). The amount of the deduction is still subject to the limitations for 2018 set forth in Section 1789. If the Section 179 limitations are exceeded, then the remaining costs are recovered straight line over 39 years.

3. ABC Management LP leases office space in a recently constructed building and anticipates incurring expenditures related to office build-out in 2019 for an expected move in 2020.

Outcome: The expenditures are not currently eligible for bonus depreciation and must be depreciated over 39 years. Taxpayers may want to consider a cost segregation study in an effort to have certain expenditures reclassified to asset classes with a shorter recovery period (and potential bonus depreciation eligibility).

State tax considerations

Asset managers will want to monitor state conformity with the federal laws when it comes to fixed assets and depreciation changes under the Act. States with a rolling conformity date will automatically adopt these changes unless they specifically decouple, while states with a fixed date of conformity will have to update their date of conformity to the IRC in order to conform to these changes. In the past, many states have decoupled from the bonus depreciation provisions under Section 168(k), but coupled to the increased expensing provisions under Section 179. Whether states will conform to these new federal provisions will depend upon legislative determinations in each state and consequently, have to be determined on a state-by-state basis. Lack of state conformity not only would affect state taxable income but could also potentially affect state apportionment.

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March 7, 2018

Notice 2018-18 announces that S corporations will be subject to new carried interest holding period rule

In **Notice 2018-18**, the IRS announced its intention to issue regulations stating that carried interests held by S corporations will not qualify for the exception from the Tax Cuts and Jobs Act's carried interest provision for interests held by corporations. The term "carried interests" generally refers to profits interests issued by partnerships to service providers in connection with the performance of services, a common practice in a wide array of industries in the alternative fund sector (e.g., private equity, venture capital, hedge fund, real estate and energy). Newly enacted Section 1061 imposes a three-year holding period requirement for long-term capital gains treatment for certain carried interests. According to the notice, the regulations will, like Section 1061 itself, be effective for tax years beginning after December 31, 2017.

Background

Section 1061(a) generally provides that, if one or more applicable partnership interests are held by a taxpayer at any time during the tax year, the excess (if any) of (1) the taxpayer's net long-term capital gain with respect to such interests for such tax year, over (2) the taxpayer's net long-term capital gain with respect to such interests for such tax year computed by applying paragraphs (3) and (4) of Section 1222 by substituting "3 years" for "1 year," shall be treated as short-term capital gain. Such gain is taxable at the holder's marginal income tax rate, which may be as high as 37% (plus the 3.8% net investment income tax, if applicable).

Section 1061(c)(1) generally defines the term "applicable partnership interest" as any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the taxpayer's performance of substantial services, or any other related person, in any applicable trade or business. An "applicable trade or business" means any activity conducted on a regular, continuous and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of: (A) raising or returning capital, and (B) either: (i) investing in (or disposing of) specified assets (or identifying specified assets for such investment or disposition), or (ii) developing specified assets. The term "specified assets" means securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.

Section 1061(c)(4)(A) provides that the term "applicable partnership interest" does not include any interest in a partnership held directly or indirectly by a corporation.

Notice 2018-18

Notice 2018-18 states that the IRS and Treasury intend to issue regulations providing that the term "corporation" as used in Section 1061(c)(4)(A) does not include an S corporation. The regulations would be effective retroactively for tax years beginning after December 31, 2017, the same date on which new Section 1061 became effective.

Implications

The issuance of the notice follows congressional testimony from Treasury Secretary Mnuchin in mid-February in response to questions and reporting about the potential use of S corporations by certain alternative asset managers.

Since the passage of the Tax Cuts and Jobs Act (P.L. 115-97), there has been uncertainty as to whether the Section 1061(c)(4)(A) exception will apply to interests held by S corporations. Some taxpayers may have transferred their carried interests to S corporations in anticipation of claiming the benefit of the exception. Other taxpayers may have transferred their carried interests to limited liability companies, currently disregarded as separate entities for federal tax purposes, with a view to potentially causing the limited liability companies to elect retroactively to be treated as S corporations.

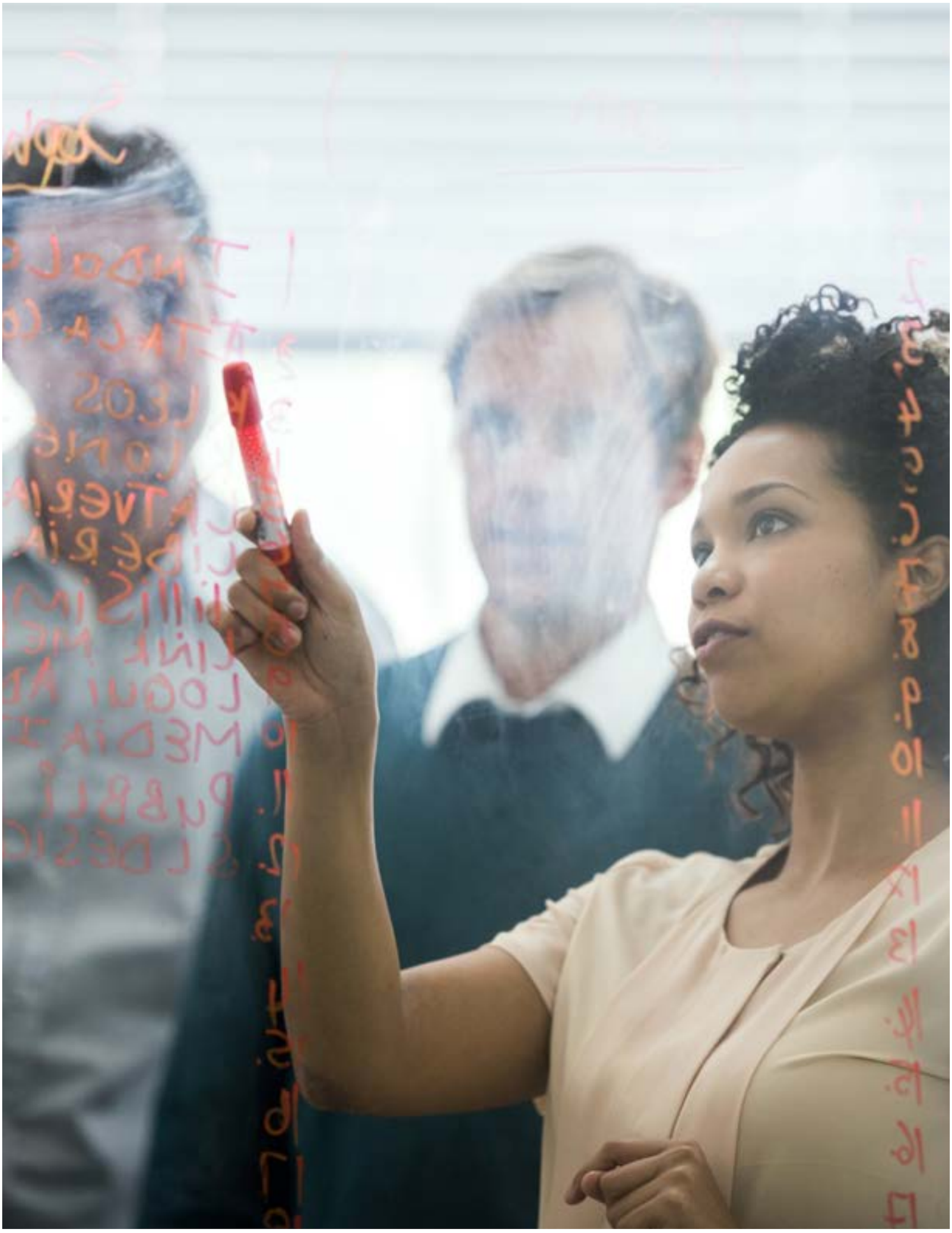
The statute itself does not explicitly limit the application of the Section 1061(c)(4)(A) exception to C corporations (which, under Section 1361(a)(2), generally include corporations other than S corporations).

Section 1061(f) authorizes the Treasury to "issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of this section." The explanation of the House version of the legislation (which was substantially similar to the version ultimately enacted) provides as follows:

"The Treasury Department is directed to issue regulations or other guidance necessary to carry out the provision. Such guidance is to address prevention of the abuse of the purposes of the provision, including through the allocation of income to tax-indifferent parties. Guidance is also to provide for the application of the provision in the case of tiered structures of entities."

The IRS has in the past, in certain instances, asserted that provisions that generally apply to individuals (but not corporations) apply to S corporations. See, e.g., Revenue Ruling 93-36, 1993-1 CB 187 (ruling that the Section 166(d) nonbusiness bad deduction rules, although in general not applicable to corporations, nevertheless apply to S corporations, because Section 1363(b) generally requires an S corporation to compute its taxable income "in the same manner as in the case of an individual"). In some cases, however, courts have rejected arguments that an S corporation should be treated for tax purposes in the same manner as an individual. See, e.g., **Rath v. Commissioner**, 101 T.C. 196 (1993) (refusing to extend Section 1244 ordinary loss treatment, which by statute applies only to small business corporation stock sold by an individual or a partnership, to small business stock sold by an S corporation).

Because Notice 2018-18 does not indicate the basis on which the IRS and Treasury will seek to exclude S corporations from the Section 1061(c)(4)(A) exception, it may not end the debate over whether S corporations will qualify under the exception or whether such a change requires legislative action. The guidance has, however, put taxpayers on notice as to the IRS' and Treasury's position on the issue. For that reason, Notice 2018-18 may deter many taxpayers from claiming the benefit of the Section 1061(c)(4)(A) exception for interests held by S corporations.



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March 22, 2018

IRS reporting guidance on Section 965 transition tax has state tax implications

On March 13, 2018, the Internal Revenue Service (IRS) issued guidance[1] in the form of frequently asked questions (the 965 FAQs) for United States (US) shareholders to report the "transition tax" on the accumulated foreign earnings of their foreign subsidiaries on their 2017 US federal income tax returns. This action is prescribed by Internal Revenue Code (IRC) Section 965, which was enacted by Section 14103 of the Tax Cuts and Jobs Act (P.L. 115-97) (TCJA). The 965 FAQs will have implications for US state and local (collectively, state) personal, corporate and business tax reporting purposes, although such state implications are most significant for corporate taxpayers (i.e., C corporations). Accordingly, this alert focuses on the state corporate income tax implications of the guidance provided in the 965 FAQs.

Background

IRC Section 965(a) generally requires US shareholders to recognize as subpart F income, for the last tax year beginning before January 1, 2018, the accumulated foreign earnings of controlled foreign corporations and other foreign corporations with a 10% US domestic corporate shareholder. IRC Section 965(c) also provides taxpayers with a deduction for such recognized amounts that results in an effective tax rate of 15.5% for the portion of earnings held in cash and other listed assets (essentially cash equivalents and certain other short-term assets) or 8% for the remaining amount of earnings. In addition, IRC Section 965(h) provides taxpayers the opportunity to elect to pay the transition tax liability in eight annual installments.

Summary of 965 FAQs

The form of the transition tax guidance is somewhat unusual. Rather than issuing a notice, revenue procedure or proposed regulations, the IRS instead developed a series of "questions and answers" referenced through a web link in a news release it issued announcing the 965 FAQs (the 965 News Release). The 965 FAQs generally instruct a taxpayer to report the transition tax on a separate "IRC 965 Transition Tax Statement" attached to its 2017 federal income tax return (the 965 Statement).[2] The 965 FAQs list items that must be included in the 965 Statement, such as the amount included in the taxpayer's income under IRC Section 965(a), the amount of the taxpayer's total deduction under IRC Section 965(c), and the total net tax liability under IRC Section 965. They also provide a sample statement to make the election to pay the tax in installments over eight years. The 965 FAQs even contain a model "**IRC 965 Transition Tax Statement**" for further demonstrative guidance.

Perhaps most important for state purposes is that the 965 FAQs make clear that all of these determinations and the components of the transition tax for corporate taxpayers will essentially be reported in the 965 Statement and thus "off the return" since the IRC Section 965 amounts will not be included in the calculation of taxable income on Page 1 of the IRS Form 1120.[3] [4] Accordingly, it appears that neither the IRC Section 965(a) income nor the IRC Section 965(c) deduction will be reported as part of federal taxable income before the net operating loss deduction and special deductions (Line 28) or in federal taxable income (Line 30) and instead will be reported on the separate 965 Statement as previously described. In addition, the 965 FAQs indicate that the resulting net tax liability under IRC Section 965 as calculated on the 965 Statement will be reported on specified lines of Schedule J (Tax Computation and Payment) of the IRS Form 1120.

When paying 2017 federal income taxes, the 965 FAQs also instruct taxpayers to make two separate payments: one payment reflecting tax owed without regard to IRC Section 965, and a second, separate payment reflecting tax owed resulting from IRC Section 965 (the 965 Payment). Both payments must be paid by the due date of the applicable return (without extensions).[5] The 965 Payment may be for the full net tax liability or for the first installment (for taxpayers making an election to pay the net tax liability in installments under IRC Section 965(h)).

For more information on the US federal income tax treatment of the transition tax and the 965 FAQs, see Tax Alert **2018-0602**. For more information on the state tax implications of the transition tax, see Tax Alert **2017-2171**.

State corporate income tax implications

From a state corporate income tax perspective, the 965 FAQs raise yet another level of uncertainty for the preparation of 2017 state corporate income tax returns since, historically, the reporting of state tax calculations typically relied upon reference to specific lines of the IRS Form 1120, and such states' instructions were made either by administrative guidance or, in a few cases, directed by statute or regulations.

That said, the 965 FAQs do nothing to change the federal statute. Specifically, the 965 FAQs provide guidance on reporting relevant IRC Section 965 amounts rather than providing guidance on the application of the federal statute. Thus, the mandatory inclusion in federal gross income of the accumulated foreign earnings of relevant foreign subsidiaries of corporations that are US shareholders remains directed by IRC Section 965(a), and the associated deduction continues to be directed by IRC Section 965(c). In considering state conformity, such statutory provisions generally will continue to control over whatever reporting instructions the IRS has provided. Accordingly, in most states (but not necessarily all), such IRC Section 965 amounts will continue to impact the statutory state tax base for which a state's subtraction modification, dividends received deduction, exclusion or other deduction mechanisms will apply (as applicable).

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[1] IRS News Release IR-2018-53, *IRS provides additional details on section 965, transition tax; Deadlines approach for some 2017 filers* (March 13, 2018) (available **here** (last accessed March 21, 2018)) (the 965 News Release). The 965 News Release contains a hyperlink to the "FAQ" document that contains the actual IRS guidance, Questions and *Answers about Reporting Related to Section 965 on 2017 Tax Returns* (available **here** (last accessed March 21, 2018)) (the 965 FAQs).

[2] 965 FAQs #3.

[3] This reporting guidance for corporate taxpayers is unlike the guidance for individual taxpayers, which requires the net IRC Section 965 amount (i.e., IRC Section 965(a) income less IRC Section 965(c) deduction) to be reported on Line 21, Other Income, of the IRS Form 1040, in addition to being reported on the 965 Statement.

[4] That, in turn, means the IRC Section 965(a) income will not be reported in the corporate taxpayer's federal gross income (Line 11, Total Income), nor will the IRC Section 965(c) deduction be reported in federal deductions (Line 27, Total Deductions) or special deductions (Line 29b, Special Deductions), on the taxpayer's 2017 federal income tax return.

[5] 965 FAQs #10.

The state reporting ambiguity, however, remains: how does this release affect the filing of state corporate income tax returns that are affected by IRC Section 965? The IRS guidance in the 965 FAQs is new, and very few states have begun to respond to it.[6] Accordingly, taxpayers and their preparers alike await specific guidance from the states as to how they should report the transition tax amounts for state corporate income tax purposes. Perhaps some states might require taxpayers to attach to the return a reconciliation statement reflecting the addition of the IRC Section 965 amounts to the IRS Form 1120 Line 28 (or Line 30) amount before reporting the resulting adjusted federal taxable income amount as the starting point on the state return. Others might continue to tie the state starting point to the IRS Form 1120 Line 28 (or Line 30) but then mandate a state addition modification for the IRC Section 965 amounts (perhaps supported by a similar statement or even a new state form).

We expect the state taxing authorities will continue to issue guidance as to whether the state will conform to IRC Section 965 itself, as well as quickly begin issuing their own reporting guidance in response to the 965 FAQs. We are continually following the many active state legislative sessions in which state lawmakers, often with the help of state taxing authorities, are considering conformity to the TCJA provisions including, notably, the transition tax. As such, we will continue to monitor activity in the various states and will provide updates on their responses as they become available.

[6] The Illinois Department of Revenue (the Department), for example, recently provided taxpayers with reporting guidance in response to the 965 FAQs. In that guidance, the Department states that, "[d]ue to the separate nature of the [965 Statement], the income reported may not be included in federal taxable income; however, it must be included when determining Illinois base income. See the revised instructions associated with your specific return type for information on how to report IRC Section 965 net income. Taxpayers who have already filed a 2017 Illinois income tax return and did not include IRC Section 965 net income must amend their return to account for that income." *2017 Illinois Income Tax Guidance - Foreign Income Repatriation Transition Tax*, IDOR Informational Bulletin FY 2018-23 (Mar. 2018) (available **here** (last accessed March 21, 2018)).

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