

The background of the slide features a dark blue and black gradient with a glowing blue digital effect. A red rectangular box in the top left corner contains the text 'K&L GATES' in white. The background also includes a stylized bar chart with teal bars and a pink line graph, overlaid on a grid of binary code (0s and 1s) that appears to be floating or glowing.

K&L GATES

2017 BOSTON INVESTMENT MANAGEMENT CONFERENCE

# Tax Developments

Joel D. Almquist, Partner, Boston

## TAX CUTS AND JOBS ACT

- Bill passed by House of Representatives on November 16, 2017
- Bill reported out of Senate Finance Committee on November 16, 2017
- There are differences between the two versions

# TAX CUTS AND JOBS ACT

- Many of the changes proposed in the bill do not affect investment funds directly but will require fund action
- Tax disclosure in offering material will need to be revamped to reflect changes in the taxation of individuals
- Individual Tax Rate changes
- Repeal of Alternative Minimum Tax

# UBTI – CHANGES IMPACTING PUBLIC PENSION PLANS AND SIMILAR “NONTAXABLE” INVESTORS

- Certain investors – such as public pension plans – take the position that they are not subject to tax on UBTI because they are exempt as a branch of a State or political subdivision thereof performing an essential governmental function and, therefore, exempt under Section 115
- Section 5001 of the House version of the bill provides that all entities exempt from tax under Code section 501(a), notwithstanding the entity’s exemption under any other provision of the Code, would be subject to the UBTI rules.
- As drafted, this provision leaves uncertainty. What if public pension plan could seek exemption under section 501(a) but did not do so? Does the new treatment proposed by the House bill?
- The Senate version does not contain this provision, but it does have a proposal that UBTI-related expenses can be used to offset only the UBTI income resulting from same activities. UBTI-related expenses would no longer be generally deductible from UBTI income.

# CLARIFICATION OF EFFECTIVELY CONNECTED INCOME ISSUE

- Non-U.S. persons are subject to U.S. federal income tax on income and gain effectively connected with a U.S. trade or business (ECI), including if they receive the ECI as a partner in a partnership
- IRS has taken the position that the gain realized by a non-U.S. person upon the sale of an interest in a partnership that engaged in a U.S. trade or business would also be ECI
- A recent Tax Court decision held that the gain on the sale of such a partnership interest was not ECI
- Senate version of the bill effectively reverses the Tax Court and treats the sale of a partnership interest as if the partnership had sold all of its assets. If the sale of assets by the partnership would have produced ECI, then the sale of the partnership interest produces ECI.

# NEW RULE FOR DETERMINING COST BASIS ON SALE OF SECURITIES

- Under the Senate bill, the cost of any security sold on or after January 1, 2018, will be determined on a first-in first-out basis, except to the extent that the average cost basis method is otherwise allowed (as in the case of shares of a RIC). Current rules allow a taxpayer to choose from among a number of methods.
- RIC's themselves will not be subject to the FIFO method when they sell securities in their portfolios.

# CHANGES TO THE TAX TREATMENT OF A PARTNERSHIP CARRIED INTEREST

Under current rules, the tax character of income and gain of a partnership remains the same when allocated to the holder of a partnership carried interest. Accordingly, long-term capital gain recognized by a partnership is also treated as long-term capital gain in the hands of the carried interest holder.

Under the House bill, there is a three-year holding period requirement for qualification as long-term capital gain with respect to a carried interest in partnership. The new rule would apply to both partnership distributions and dispositions of partnership interests.

The new rule applies to partnerships that are investment funds, not to partnerships that operate businesses.



# OTHER CHANGES TO PARTNERSHIP TAXATION

- The House bill reduces the income tax on individuals with respect to allocations of certain types of income from partnerships.
- Maximum 25% rate applies to “business income” from pass-through entities. Business income is determined based on a deemed “capital percentage” of 30 percent or based on the facts and circumstances applicable to the business. The default capital percentage for certain personal services businesses is 0%, subject to modification based on the business’s actual capital investments.
- The Senate bill would provide businesses organized as pass-through entities with a deduction in the amount of 17.4% of the domestic qualified business income, subject to a limit equal to 50% of the applicable partner’s “W-2” compensation income.





Questions?

