FACING NEW TAX UNFRIENDLY PROPOSALS

WITH US COMPANIES FACING INCREASING CHALLENGES FROM TAX PROPOSALS, **MAURY CARTINE** OF **MARCUM, LLP** TAKES A LOOK AT WHETHER THE GLASS IS HALF FULL OR HALF EMPTY FOR INVESTORS AND MANAGERS

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As the summer comes to a close, we can look back at some stalled 2013 tax proposals that just might be a sign of things to come. Earlier this year, Senator Carl Levin introduced legislation entitled as the Cut Unjustified Tax Loopholes Act (S. 268, introduced on 11 February 2013; also known as the CUT Loopholes Act). This ominous sounding legislation includes many provisions designed to make investment managers and their investors less wealthy or perhaps poorer depending on your view of the glass as either half full or half empty.

One key provision of the CUT Loopholes Act is the revival of the attack on carried interests. Title VI of the Act is entitled "Ending the Carried Interest Loophole", but the very first provision of Title VI states that it may be cited as the Carried Interest Fairness Act of 2012. Hmm – is that glass half empty or half full? In either case, this title does exactly what it was intended to do. Investment managers would lose the benefits of the lower tax rates applicable to long-term capital gains and qualified dividends as all taxable income attributable to the carried interest would be re-characterised as ordinary income and subject to self-employment tax. The carried interest is referred to in the proposed statute as the 'investment services partnership interest'. Private equity fund managers and real estate operators would, as in previous versions of the proposed legislation, become less wealthy faster than hedge fund managers who traditionally realise less long-term capital gains. As might be expected, the statutory language has advanced over the years and now effectively eliminates virtually all loophole strategies to avoid the ordinary income result in favour of the more beneficial long-term capital gain treatment. However, investment managers will still receive the benefits of the lower tax rates applicable to long-term capital gains and qualified dividends attributable to their own capital contributions. The portion of the investment manager's interest that is attributable to capital contributions is referred to as the 'capital interest'. What is not so clear is how an investment manager moves realised ordinary income from an investment services partnership interest to a qualified capital interest. As silly as it might seem, a partnership might have to distribute cash representing

the realised taxable income from the investment partnership services interest to the investment manager and the investment manager may have to re-contribute the cash to the qualified capital interest to avoid any additional ordinary income that is not attributable to the carried interest itself. Congress appears to be hopelessly bogged down with petty party line disputes and a split in control over both houses. Nonetheless, the proposed legislation to end the benefits of the carried interest keeps reappearing year after year since it was first introduced in 2007. Will the current carried interest treatment prevail? Is your glass half full or is it half empty?

Another provision in the CUT Loopholes Act changes the tax treatment of Section 1256 Contracts. A Section 1256 contract is a regulated futures contract (e.g. the classic commodity such as orange juice made famous in the movies) and other specifically defined contracts. Under Section 1256, gain or loss is marked to market at the end of the year and all net gain or loss from all Section 1256 contracts (contracts sold during the taxable year and contracts marked to market at the end of the taxable year) is treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss for federal income tax purposes. Under the CUT Loopholes Act, all net gain or loss from a Section 1256 contract would be treated as short-term capital gain or loss. Some proponents of the proposed legislation would argue that the 60%-40% treatment was originally enacted without much merit as part of a Congressional deal. While this may be true, the original income tax was also part of a deal and some might say that the recent tax increases are part of a deal that has little merit too! It is hard to predict where this proposal is headed.

The CUT Loopholes Act would also source swap contract payments to the location of the payer. Thus, swap payments made by a US person to a foreign person that represent fixed or determinable, annual or periodic income would be subject to income tax withholding. This provision makes sense to anyone familiar with the attempts to shield substitute dividend payments from income tax withholding.

Following a pattern consistent with previous legislation introduced by Senator Levin, the CUT Loopholes Act would attempt to strengthen Fatca in a variety of ways under Title I entitled "Ending Offshore Tax Abuses". Several of the Fatca proposals will increase the burdens of compliance and may strengthen enforcement. However, one provision stands out as particularly adverse to offshore funds that presently enjoy the protection afforded by the trading in securities or commodities exclusion from trade or business income under Section 864(b) of the Internal Revenue Code. Under Title I, Section 103 of the CUT Loopholes Act, a foreign corporation that is managed and controlled in the US would be treated as a domestic corporation if the assets of the corporation exceed US$50m, the assets are being managed on behalf of investors and the decisions on how to invest the assets are made in the US. New proposed Section 7701(p) of the Internal Revenue Code would apparently trump the aforementioned exclusion from trade or business income and cause offshore funds organised as corporations to be subject to US income tax. Furthermore, tax-exempt entities would indirectly pay income tax on their share of profits from an offshore fund organised as a foreign corporation in a tax haven jurisdiction. This provision could have a very adverse impact on the US markets and would also reduce tax revenue by forcing offshore funds to find investment managers offshore. In 1997, when Section 864(b) of the Internal Revenue Code was revised to expand the exclusion to offshore funds with some nexus to the US, Congress predicted that tax revenues would be enhanced by the expansion. To undo the benefits of increased revenue now makes little sense. This proposed legislation is substantially similar to Senator Levin's ill-fated proposal in 2009 which would have caused tax-exempt entities to indirectly pay income tax on their share of profits from an offshore corporation or face the unhappy alternative of investing directly through a domestic partnership that could result in the imposition of the unrelated business income tax. In today's economic environment, the glass is already half empty for tax-exempt pension plans.

> "IN TODAY'S ECONOMIC ENVIRONMENT, THE GLASS IS ALREADY HALF EMPTY FOR TAX-EXEMPT PENSION PLANS"

Two other bills introduced earlier this year would change the due dates and extended due dates of partnership and corporation returns. S. 420 and H.R. 901 introduced on 28 February 2013 would accelerate the original due dates for calendar partnership and S corporation returns to 31 March from 15 April. The original due date for calendar year C corporation returns would be deferred from 15 March to 15 April. The final extended due dates for calendar year partnerships and S corporations would be 30 September. The final extended due date for calendar year C corporation returns would be 15 October. Under both bills, the due date for the Report of Foreign Bank and Financial Accounts would be accelerated to 15 April from 30 June, but a six-month extension would be permitted.

While the new accelerated dates make sense, it is hard to imagine that investment managers, fund administrators and accountants will be able to meet the accelerated deadlines without some serious self-reflection. Is your glass half full or half empty? ■