MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

PASS-THROUGH TAXATION

Overview

Pass through taxation allocates the income of a partnership among all the partners, generally in proportion to their interests in the partnership. In the case of many businesses (including hedge funds), some partners provide cash equity and others provide "sweat equity." In these business structures, the partnership form and pass through taxation aligns the interests of all partners. By aligning the interests of all the partners in a partnership, pass through taxation promotes strong risk management and discourages excessive risk taking. Partnerships generally are not themselves taxable entities. Changing the tax treatment of partnerships would subject entrepreneurs to two levels of taxation. This double tax would have a negative impact on millions of businesses and the process of capital formation and job creation across the US, thereby threatening to further erode the soft housing market and discouraging capital investment in new or struggling companies.

Pass through taxation applies to millions of US businesses: real estate, oil & gas, venture capital, private equity, hedge funds, agriculture, family and small businesses and others.

Pass through tax treatment does not turn ordinary income or short term capital gains into long term capital gains. If the partnership's income is ordinary income or short term capital gains, as often is the case for hedge fund partnerships, then the partners pay tax at ordinary income rates, currently 39.6%.

MFA Comments on Key Issues Related to Taxation of Partnerships and Other Pass-Through Entities (Section references to Former Chairman Camp's bill, "The Tax Reform Act of 2014" (H.R. 1) unless specifically noted)

Mandatory basis adjustments to partnership property (Sections 3612-4)

Sections 3612 through 3614 require a mandatory adjustment of a partnership's basis in partnership property when a partner transfers his interest in a partnership or a partnership distributes property to a partner. This proposal is similar to one made in the pass-through entity discussion draft from 2013. Hedge funds generally do not make the basis adjustment election under current law as the administrative burden of tracking the basis adjustments is overwhelming where there is a large number of securities, lower tier entities, or LP transfers and redemptions. As such, this proposal likely will increase the complexity of funds' tax accounting. One approach policy makers could consider would be to provide an exemption for partnerships with a substantial portion of their assets, [*e.g.*, 90%], in marketable assets, which we believe do not present a risk of abuse with respect to transfers or distributions of partnership interests or property.

Qualifying income (Section 3620)

Section 3620 narrows the scope of the "publicly traded partnership" rules by narrowing the definition of "qualifying income" to include only income from activities relating to mining and natural resources. The likely objective of this provision is to require the publicly traded investment managers organized as MLPs to become subject to the corporate tax. However, this would also require domestic funds with more than 100 partners to restrict investor liquidity (while the limits on liquidity are not entirely clear, this change could limit fund liquidity to not more frequently than quarterly plus a notice period) in order to retain partnership tax status, or alternatively to restructure as offshore funds. Funds that are deemed "publicly traded partnerships" because they offer shorter redemption and/or notice periods would be taxed as C corporations.

Current pass-through restrictions under Section 7704 of the Internal Revenue Code (the "Code") limits the frequency of liquidity that private funds may offer without being characterized as a publicly traded partnership taxable at the corporate level, unless 90% or more of the partnership's annual gross income is "qualifying income" under Section 7704(d) of the Code. Although the IRS has adopted some safe harbors, the restrictions substantially limit redemptions and transfers. MFA supports changes to the statute or rules thereunder that would permit more frequent redemptions, shorter notice periods for redemption requests, and that would make it easier for investors to transfer fund interests relating to side-pocketed assets to third parties

Self-employment tax (Section 1502)

Under Section 1502, all active partners, including limited partners, and S corporation shareholders who also are employees would be subject to self-employment taxes on their share of income, including their distributive share of the partnership's/S corporation's income. Active partners and S corporation shareholders (*i.e.*, those who materially participate in the trade of business of the partnership) would be allowed a deduction that effectively would treat 70 percent of their combined compensation and distributive share of the entity's income as net earnings from self-employment (and thus subject to applicable self-employment taxes) and the remaining 30 percent as earnings on invested capital not subject to self-employment taxes. For partners and S corporation shareholders who do not materially participate in the trade or business (*i.e.*, passive investors), the effect of the deduction would be that no amount would be treated as net earnings from self-employment (and would be subject to the 3.8% net investment income tax). This change could lead to increased self-employment taxes for active limited partners of management companies structured as partnerships and limited liability companies and S corporation shareholders who are also employees of the S corporation. Because many small businesses are structured as partnerships, limited liability companies, or S corporations, we believe the increased tax on these small business owners could adversely impact job and economic growth from small businesses.

Promoting Non-Discriminatory Tax Policy (Enterprise Value)

In past years, legislation has been introduced that would change the taxation of "enterprise value" and carried interest. This legislation would selectively change the tax treatment for a sale of a business' "enterprise value" – from a capital gains rate to the ordinary income rate – when the stake in the business belongs to an investment adviser.

MFA is opposed to this discriminatory tax, and believes that an entrepreneur who builds a business is entitled to the same tax treatment as anyone else when selling that business.

Carried Interest

Several proposals introduced in past Congresses have included a tax proposal that would tax a partner's carried interest in a partnership (or LLC) as ordinary income.

MFA urges policy makers to consider any change regarding the current tax treatment of the investment returns of advisers to private pools of capital as part of comprehensive tax reform, and encourages policy makers to support tax reform initiatives that promote economic growth, capital formation and investment.

Carried interest (Section 3621)

The Ways and Means Committee's summary of the carried interest proposal provides that Section 3621 is intended to apply to the sale of any partnership interest that is transferred, directly or indirectly, to a partner in connection with the performance of services by the partner, provided that the partnership is engaged in a trade or business conducted on a regular, continuous and substantial basis consisting of: (1) raising or returning capital, (2) identifying, investing in, or disposing of other trades or businesses, and (3) developing such trades or businesses. This approach is significantly different than the approach taken in prior carried interest bills from the past several years.

The three factor test to determine which partnerships are within the scope of change seems targeted at private equity and venture capital funds. As drafted, however, the provision could apply to certain hedge funds, to the extent they engage in activities more akin to private equity-like investing (for example, funds with regular side pocket activity, distressed, or activist investing), when the fund or its manager might be more likely to be engaged in activities with portfolio companies that could be deemed to be "developing such trades or businesses."

There is no explicit enterprise value carve-out in Section 3621; however, the proposal attempts to create a narrow definition of partnerships that are in scope and recharacterizes as ordinary income only carried interest up to an amount determined by reference to a complex formula based on multiplying: (1) a return rate (applicable federal rate + 10%) by (2) the carried interest percentage multiplied by the aggregate invested capital of the fund minus a partner's capital contribution to the fund. Carried interest payments in excess of the amount determined under the specified formula would continue to receive capital gains treatment. As such, to the extent a partnership interest in a management company or general partner of a fund is within the scope of the provision, much of the enterprise value realized upon sale may nonetheless remain capital gain.

MFA appreciates statements from the Obama Administration and policy makers in Congress that recognize any legislation that seeks to change the tax treatment of carried interest should not include a change in the tax treatment of enterprise value. We remain concerned that, despite policy makers' stated intent, under existing proposals many hedge funds would be subject to discriminatory treatment under the Code by having to pay ordinary income tax upon the sale of their businesses, including with respect to the enterprise value of those businesses. We recognize that the latest bills from Congressman Levin and Former Chairman Camp have both made efforts to address this issue and have; at least to some degree, mitigated the effect of the proposals on enterprise value. Both bills nonetheless continue to impact the tax treatment of enterprise value and MFA remains committed to working with Treasury and policy makers on the Hill to remove enterprise value from legislative proposals.

<u>High-income surtax (Section 1001)</u>

Under Section 1001, high-income taxpayers are subject to a 10% surtax on income, computed without the benefit of most itemized deductions. Investment-related expenses, such as interest expense from investment activities, and state taxes would not be deductible, resulting effectively in a 10% gross income surtax. While we are not advocating for a surtax, we believe it is important that any such surtax continue to permit deductions, particularly deductions that are intended to accurately measure income, such as interest expenses in connection with making investments.

<u>Accrual method for determining taxes (Section 3301)</u>

Under Section 3301, businesses with revenues above $10 million would be required to use accrual basis accounting for tax purposes, rather than cash basis accounting. Under accrual basis accounting, a taxpayer would be deemed to accrue income (and thus owe taxes) when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under cash basis accounting, taxpayers generally recognize income when actually or constructively received and expenses when paid. This change could adversely affect taxpayers by requiring taxes to be paid even if the taxpayer has not received the income and could create additional complications to the extent there are subsequent adjustments to the accrued amount on which tax was paid.

<u>Partnership Audits (Section 3622)</u>

Section 3622 of the Tax Reform Act of 2014 would repeal the large partnership election rules and would generally require items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof) to be audited, any tax attributable thereto to be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share to be determined, at the partnership level for any partnership with more than 100 partners. While we recognize that some have raised concerns about the current audit rules for large partnerships, we are concerned that partnership level audits would be unduly burdensome and complex for many investment funds, particularly those with tiered structures. We encourage policy makers to consider alternative approaches to address concerns about the IRS' ability to effectively oversee large partnerships.

<u>Application of UBIT to pension funds investing in private investment funds (Section 5001)</u>

Generally, entities that are exempt from tax under Section 501(a) of the Code are subject to the unrelated business income tax (UBIT). It is unclear under current law whether state and local entities (such as state pension funds) are subject to UBIT because they also are exempt from taxes under a separate section of the Code. Section 5001 of the Tax Reform Proposal provides that all entities exempt under Section 501(a), including state and local entities that also may rely on other exemptions under the Code will be subject to UBIT.

Because UBIT applies to income earned from debt-financing, tax-exempt entities subject to UBIT generally do not invest in domestic hedge funds, particularly those that use leverage or other financing arrangements that could result in UBIT to tax-exempt limited partners (those entities instead typically invest in an offshore fund to avoid UBIT). Under this proposal state and local pension plans that currently invest in domestic funds likely would be forced to invest in offshore funds instead.

Congress clearly intended that U.S. tax-exempt entities not pay UBIT on their passive investment income. When a U.S. tax-exempt entity invests in a foreign hedge fund, it neither incurs debt to finance its investment, nor has potential liability for the debt incurred by the fund. In short, the U.S. tax-exempt entity receives only passive investment income (*i.e.,* dividends) and it has incurred no indebtedness in doing so.

Consistent with that policy, in 2007 and 2009, Congressman Sander Levin introduced bills intended to permit tax-exempt investors to invest in certain types of U.S. partnerships as limited partners without incurring UBIT liability, even if the investment partnership (*i.e.*, the hedge fund or other investment fund) used debt or other leverage in making investments. Though MFA had concerns with some of the technical details in those bills, we believe the approach underlying Congressman Levin's bills recognize the appropriateness of tax-exempt investors investing in hedge funds without being subject to UBIT. We encourage policy makers to amend the UBIT provisions so that debt incurred by an investment fund in which a tax-exempt investor is a passive investor not be attributed to the tax-exempt investor.

Avoiding income taxes by deferring compensation

We note that, on March 3, 2015, Senate Finance Committee Democratic staff released a report that proposed changes to limit the ability of employees to defer compensation and, thus defer the tax owed on that deferred income. Since Congress adopted Section 457A of the Code, we believe this is not likely to be of as much importance to hedge funds. It is important to note, however, that securities and banking regulators in the United States and in Europe are considering adopting, or have adopted, compensation requirements for certain financial institutions, which require that a certain portion of an employee's income be deferred for multiple years and also may require a certain portion of an employee's income be paid in stock, rather than cash. We believe that, in circumstances when the deferral arrangement is part of a policy which is required to comply with regulatory/directive requirements, the imposition of such taxes should be deferred to the time when a distribution is made.

Further, the comparison of the capped tax-deferred IRA and pension accounts to the uncapped deferred comp accounts is really not a valid comparison. IRA/pension accounts are usually funded with tax deductible amounts paid by the employer, so the government is subsidizing the arrangement by deferring the employee's tax liability. Deferred compensation is non-deductible by the employer until the employee takes the amount into income.