Proposed tax legislation targets asset management

Democrats are in the midst of negotiating a sweeping tax and spending bill and are considering a bevy of tax proposals aimed specifically at asset management. The provisions could have a dramatic impact on hedge funds, private equity funds, mutual funds, exchange traded funds, real estate investment trusts, business development companies and other investment structures.

Negotiators are drawing from a wide range of proposals—including the tax title from the reconciliation bill recently approved by the House Committee on Ways and Means Committee—in addition to several discussions drafts and bills authored by Senate Finance Committee Chair Ron Wyden, D-Ore.

While many of these proposals are likely to change in the coming weeks and months—and certain proposals and bills may not ultimately become law—Democratic leaders are seeking to enact major legislation containing many of these proposals before the end of this year. Asset managers have an opportunity to perform pre-emptive planning, seize rate arbitrage opportunities and mitigate the impact of unfavorable proposals.

Capital gains rate increase

The House reconciliation bill would raise the top rate on long-term capital gains and qualified dividends from 20% to 25%. A 3% surtax would also apply to the extent capital gains income increase AGI above a $5 million threshold. The 25% rate would generally apply to gain from transactions occurring and dividends paid after Sept. 13, 2021. There is a grandfathering rule for transactions pursuant to a written binding contract in place on or before Sept. 13, 2021, and which is not modified in any "material respect."

The statutory language does not specifically define "written binding contract," but this phrase has been used in transition rules before. The bonus depreciation regulations generally defined a written binding contract as a contract that is enforceable under state law and does not limit damages to a specified amount.

Grant Thornton Insight: Democrats have retreated significantly from President Joe Biden's 39.6% proposed capital gains rate, but an increase of five percentage points still cuts significantly into after-tax proceeds of many investments. Investors may want to emphasize gain offset planning, including harvesting tax losses, leveraging charitable deductions, and using deferral or gain exclusion strategies such as opportunity zones or like-kind exchanges. If the effective date of the proposed rate increase is delayed during negotiations, taxpayers could also consider accelerating gains.

Carried interest

The House bill would amend Section 1061 to increase the holding period from three years to five years to receive long-term capital gains treatment on certain carried interests in investment services partnerships. Taxpayers of all filing statutes with AGI of $400,000 or less (except estates and trusts) would retain the three-year holding period. In addition, the bill would make meaningful changes to the start date for the holding period.

Specifically, under the proposal, the holding period would be measured from the later of the date on which (1) the taxpayer acquires "substantially all" of the partnership interests or (2) the date on which the partnership acquires "substantially all" of the assets. Note, however, the proposal does not define "substantially all."

Grant Thornton Insight: The House bill does not seek to recharacterize all gain from profits interests in investment services partnerships, as Democrats have previously proposed. This provision instead builds off a Tax Cuts and Jobs Act (TCJA) change made by Republicans, which increased the holding period from one to three years. However, the changes to the rules for measuring the holding period could still have the effect of eliminating the capital gains treatment for many partners in investment funds. Because it can take years for a fund to fully acquire and spend their funds, the proposed modifications could delay the start date for holding period significantly and even affect investment strategies and fund life cycles. Progressive lawmakers will undoubtedly seek an even stronger carried interest provision than this, while the investment industry will seek to curb this version. Senate Majority Leader Chuck Schumer, D-N.Y., remains sympathetic to the financial industry, while Wyden has proposed the most aggressive carried interest proposal to date, which would create deemed compensation income before a realization event.

Portfolio interest exemption

The House reconciliation bill would narrow the portfolio interest exemption currently available for interest received by any corporate shareholder owning less than 10% of the combined voting power of all classes of such corporation. For partnerships, the 10% shareholder requirement is measured by capital or profits interest.

The reconciliation bill would generally expand the definition of a 10% shareholder of a corporation to include 10% ownership of total stock value. This proposal would apply to obligations issued after the date of enactment of the bill.

Grant Thornton Insight: The portfolio interest exemption is useful for non-U.S. investors looking to earn a return on their U.S.-based investments. The reconciliation proposal would narrow the eligibility for the exemption by preventing taxpayers from availing themselves of the exemption simply by providing a class of stock without voting power. In addition, this proposal could have an impact on foreign investors in offshore credit funds. Debt issued prior to enactment of the bill would be grandfathered, thus taxpayers should be careful when modifying any debt that could cause the debt to lose its grandfathered protection.

Corporate rate

Biden has proposed a 28% rate, and the House reconciliation bill offered a 26.5% rate, but it is likely a final rate increase will need to be capped at 25% to survive the Senate. Democrats are generally proposing to make the rate increases effective for tax years beginning after 2021.

Grant Thornton Insight: The prospective effective date of the proposal means there is a potential window of opportunity for portfolio companies to plan in front of changes, seizing rate arbitrage opportunities by accelerating income and deferring deductions.

International proposals

Democrats are discussing significant changes to the tax on global low-taxed income (GILTI), the deduction for foreign derived intangible income (FDII), and the base erosion and anti-abuse tax (BEAT). Although the details are still being negotiated, Democrats are generally proposing to significantly raise the current 10.5% GILTI rate, repeal or limit the exemption for a return on tangible property, and require it to be calculated on a country-by-country basis. Similarly, FDII benefits would be reduced or even repealed altogether, while BEAT could be expanded deny related-party deductions for inventory and other indirect costs.

Grant Thornton Insight: The drastic proposed overhaul of the international tax regime would dramatically increase taxes on assets invested abroad. Nevertheless, due to the prospective proposed effective dates, businesses have an opportunity to plan for potential rate arbitrage before the GILTI and FDII changes take effect.

Repeal of downward attribution

The reconciliation bill would retroactively restore the former exception to downward attribution rules under Section 958(b)(4). The TCJA repealed the exception for downward attribution under Section 958(b)(4) altogether, resulting in many foreign corporations being characterized as controlled foreign corporations and subject to tax even without direct U.S. shareholders exceeding ownership thresholds. The restoration of this exception would be effective for the last tax year of foreign corporations beginning before Jan. 1, 2018, and for each subsequent tax year of such foreign corporations.

Grant Thornton Insight: The retroactive nature of this change could provide refund opportunities for indirect shareholders of foreign corporations who paid tax on deemed inclusions from downward attribution from CFCs.

ETF gain recognition

Wyden recently released draft tax legislation proposing the repeal of Section 852(b)(6), which disregards the recognition of gain at the exchange-traded fund (ETF) or mutual fund level on a redemption-in-kind upon the demand of a shareholder.

Specifically, the proposal would repeal the Section 852(b)(6) exception for regulated investment companies (RICs), mandating that RICs follow the typical rule that gain be recognized upon distribution by a corporation of built-in gain property. The repeal would be effective for tax years beginning after Dec. 31, 2022.

Grant Thornton Insight: This proposal would have massive effects on the ETF space. Even though this proposal is not included in the reconciliation package at the moment, RICs should continue to monitor this proposal for potential impact.

Mark-to-market

Wyden also recently introduced a bill to require mark-to-market accounting on derivatives at the end of each year, with any gain or loss treated as ordinary gain or loss.

The bill represents a fairly robust reform of derivative taxation, with complex technical provisions that would affect the sourcing, timing, character, and definitions of derivatives. Similar to the Section 852(b)(6) proposal, this was not included in the reconciliation package and seems to have lost steam politically—however the breadth and depth of the potential impacts may necessitate further analysis from asset management companies.

Grant Thornton Insight: This proposal would represent a sea change for asset managers by accelerating taxable events by years. Individuals and funds could potentially be required to sell assets to pay the imposed tax, necessitating expanded tax planning and modelling—and potentially causing ripple effects in the marketplace.

Excise tax on stock buybacks

Wyden and Sen. Sherrod Brown, D-Ohio, have proposed legislation that would assess a 2% excise tax on the amount spent by a publicly traded company on buying back its own stock. The excise tax would not apply to the extent the stock buyback is an RIC redemption, is used to fund an employee pension plan, an ESOP, or similar vehicle, is used for employee stock plans, or is below a de minimis threshold. Specific rules address the treatment of foreign corporations, while inverted corporations are fully subject to the excise tax.

Grant Thornton Insight: This proposal was also not included in the Ways and Means Committee version of the reconciliation package, but given that the proposal could raise a significant amount of revenue to offset other expenditures in the package, there is potential for a version of this proposal to be included in the package moving forward. There does not seem to be broad Democratic support for the types of financial transaction taxes proposed by key Democrats such as Sens. Bernie Sanders, D-Vt., and Elizabeth Warren, D-Mass.

Common control

The House bill would expand the aggregation rules under Section 52(b) that treat groups of related entities as a single employer. The legislation would require the inclusion of research and experimentation activities and any trade or business activity under Section 212, which includes management, conservation, and maintenance of property held for the production of income.

Grant Thornton Insight: This proposal appears to specifically target traditional private equity structures, which often take the position that portfolio companies are not part of a common control group because the fund is not involved in a trade or business. This change could be meaningful, as the aggregation rules under Section 52 are used to determine limits on many credits and other code provisions.

Digital assets

The reconciliation package would add commodities, currencies and digital assets (including cryptocurrencies), to wash sale rules, which prohibit investors from claiming losses on certain assets repurchased within 30 days of a sale. Currently, cryptocurrencies are treated as property per IRS Notice 2014-21, and thus they are not subject to the wash sale rule.

In addition, the bipartisan infrastructure bill that has passed the Senate and currently is awaiting a vote in the House would expand information reporting requirements on digital assets. The proposals would expand broker reporting requirement to digital assets like cryptocurrency and add digital assets to current rules requiring businesses to report cash payments over $10,000.

Grant Thornton Insight: Digital assets remain one of the most hotly contested topics on Capitol Hill. The infrastructure package (and its broker requirements) still seems likely to eventually become law, though the definition of “broker” is quite vague and will require further clarification. If broadly defined, this could have wide-ranging impacts in the digital asset space, which a narrow definition focused primarily on centralized exchanges would have far less of an impact. The wash sale provisions included in the reconciliation package are more likely to face changes or pushback.

Next steps

Although the ultimate outlook for nearly all of these legislative proposals is not certain, some asset management firms may benefit from pre-emptive tax planning. Most of the proposals include prospective effective dates, meaning there is a potential window of opportunity to plan in front of changes, seizing rate arbitrage opportunities and blunting the impact of unfavorable proposals.

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