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Mar. 08, 2018

The war of words between the Trump administration and hedge fund managers isn't letting up. In the latest salvo, the Treasury Department has announced a new ruling preventing use of S corporations to avoid tax law crackdown for "carried interest," but the move is being challenged by some tax practitioners (IRS Notice 2018-8, 3/1/18).

Prior to enactment of the new tax law, the Tax Cuts and Jobs Act (TCJA), managers of private equity funds could benefit from the usual capital gains rules for carried interest, the portion of a fund's returns paid to managers. Unlike ordinary income rates, which previously reached as high as 39.6%, favorable capital gains rates of 15%, or 20% for certain high-income taxpayers, apply to long-term gains on assets held longer than one year. The TCJA lowered the top ordinary income tax rate to 37%, beginning in 2018.

During his campaign for the White House, President Trump repeatedly voiced his displeasure over the carried interest tax break for fund managers, vowing to repeal it. Ultimately, a compromise was ironed out in the TCJA, limiting the favorable capital gains rates to gains on assets held longer than three years, instead of the usual one-year holding period.

Now the Treasury Department has moved to short-circuit a way to avoid this longer holding period by using the S corporation form of business ownership. The TCJA includes a vaguely worded exception for corporations, but many tax experts believe it was designed to benefit only C corporations (i.e., not for S corporations). In the new ruling, the Treasury advises taxpayers it will soon implement restrictive regulations that will be retroactive to January 1, 2018.

“We worked expeditiously to take this first step to clarify that S corporations are

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*Journal* (“Treasury to Close Carried Interest Loophole,” 3/ 8/2018, Steve Rosenthal, a tax attorney at the Tax Policy Center in Washington D.C., states that the notice is “skimpy” and argues that it flies in the face of the actual wording in the law.

“Would I be given pause by this if I were advising clients,” Rosenthal asks. “No. I would tell clients, disclose and be ready for challenge. But in the end you're likely to win.”

It is expected that a technical corrections act will eventually clarify many unanswered questions and some of the language found in the TCJA. But it's going to take some more time to unravel all the riddles in the massive new law.

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