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IMPLICATIONS OF US TAX REFORM

FOR HEDGE FUNDS, INVESTORS, AND MANAGERS

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AGENDA

- Implications for hedge fund managers
- Implications for hedge funds
- Implications for taxable US investors
- Effect on blocker entities
- Effect on US tax-exempt investors

SECTION 01

IMPLICATIONS FOR HEDGE FUND MANAGERS

New § 1061 changes the tax treatment of carried interests

- A three-year holding period is now required for capital gains “with respect to” “applicable partnership interests” to qualify for long-term capital gains rates
 - Gain recharacterized under this rule is now treated as short-term capital gain
- A manager’s carried interest in a hedge fund generally will be subject to this rule
 - The effect of this rule can depend on the investment strategy of the hedge fund in which the manager holds a carried interest

Other rules under new § 1061

- Limitation does not apply to partnership interests held by corporations
 - Literal language of new Code Section 1061 exempts any corporation from this rule
 - Treasury Secretary Steven Mnuchin has stated that the IRS will issue guidance to prevent fund managers from using S corporations to avoid this limitation
 - In conjunction with new lower corporate tax rate (21% flat rate), managers may consider incorporating their businesses as C corporations
- Transfers to “related parties” are also covered
 - Not clear whether regulations are intended to make this provision applicable notwithstanding any nonrecognition rules in the Code
- Does not appear to apply to long-term capital gains (regardless of holding period) attributable to Section 1256 contracts or to qualified dividend income

Practical observations – new § 1061

- The effect of this limitation on a hedge fund manager may depend on the hedge fund's investment strategy

Fund with Section 475 mark-to-market election	Fund that rarely holds assets for over one year	Fund that holds some assets for over one year
No applicability with respect to taxable income earned in ordinary course of fund's business	Applicability is limited and likely insignificant with respect to taxable income earned in ordinary course of fund's business	Applicability could be material, depending on percentage of assets held one to three years

Practical observations – new § 1061

- However, regardless of the investment strategy of a hedge fund, the new carried interest three-year holding period rule could impact the fund's manager in the context of the sale of the fund management business
 - Specific application to sale of carried interest is unclear

Potential structuring opportunity – new § 1061

Funds that do not produce any or significant amounts of long-term capital gains

- Consider restructuring performance allocation into a performance fee
 - For US individual fund managers, the tax rate is the same (37%) for short-term capital gain and ordinary income
 - Allocated short-term capital gains are subject to the 3.8% Medicare contribution tax
 - Performance fee income is not subject to the 3.8% Medicare contribution tax
 - FICA/FUTA implications of performance fee need to be considered (parallel management fee treatment)
 - Issues with respect to restructuring
 - Code Section 409A/457A issues could arise if the performance fee is deferred for, in general, 12 months or more
 - For a New York City based manager, a performance fee would be subject to unincorporated business tax, unlike carried interest

Potential structuring opportunity – new § 1061

Effect of restructuring on taxable US investors

- Change in structure would put more pressure on the question of whether a fund is, in fact, a trader rather than an investor
- If the fund is engaged in a trade or business, there is likely little harm to US taxable investors
 - Arguably, the only harm that could result from the change in characterization of the performance allocation would be to the extent there are gains that otherwise would be allocated that reflect capital assets held for more than a year
 - The performance fee would be viewed as a deductible business expense under Code Section 162 and not a (now) nondeductible investment expense under Code Section 212
- For funds not engaged in a trade or business, US taxable investors likely will not get a deduction until taxable years beginning after December 31, 2025

Exception to new § 1061 for noncarried interests

- The three-year holding period does not apply with respect to capital interest in a fund, giving the manager the right to share in the fund's capital commensurate with the amount of capital contributed (as of the time the interest was received)
 - This exception may require actual capital contributions
 - Fund managers that accrue increased interest in a fund's capital, attributable to a carried interest, are typically not reflected by an actual separate contribution
 - Of potential importance for funds expected to generate some long-term gains

Exception to new § 1061 for non-carried interests – possible solutions

- Consider –
 - making actual distribution of cash to the fund manager, reflecting its resulting capital account, and then having the fund manager recontribute the cash (as a limited partner) as a capital contribution
 - treatment of in-kind distributions to the fund manager and recontributions of the in-kind distributions by the fund manager to the fund for limited partner interests, thereby preserving (rather than triggering) built-in unrealized gains
 - the potential for special allocations of three-year capital gain items, or other items that are not subject to the three-year rule (and the risk, tied to need for economic substance of partnership allocations, if there are not sufficient items of this sort to support the future carry)

New § 1061 – state and local tax considerations

- State and local tax treatment may vary depending on the jurisdiction and whether there is any distinction between the taxation of short-term and long-term gains in that jurisdiction
- Treatment may also depend upon whether a state automatically conforms its tax laws to changes made to the Code (or whether the state expressly adopts the new tax law changes)

Executive compensation deduction – § 162(m)

- Code Section 162(m), which limits the deduction of “remunerations” paid to “covered employees” of “publicly held corporations” to \$1,000,000, was modified by the new tax bill
 - Revised the definition of “covered employee” and also provides that any individual that is a covered employee for a taxable year beginning after December 31, 2016 remains a covered employee for all future years
 - Expands the definition of “publicly held corporation” to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs
 - Eliminates the exceptions for commissions and performance-based compensation limit from the definition of remunerations subject to the \$1,000,000 cap
- Modifications of Code Section 162(m) should be considered by investment management teams within publicly traded management companies

Limited deduction for state and local taxes

- Individuals are now allowed to deduct only up to \$10,000 of state and local taxes
 - As drafted, the provision sunsets for taxable years beginning after December 31, 2025
 - Does not apply to taxes paid or accrued in carrying on a trade or business activity
- Hedge fund managers may consider moving from high-tax states to low-tax states

Tax treatment of sales of patents and trade secrets

- Code Section 1221(a)(3) was amended to exclude patents and trade secrets created and held by a taxpayer (or held by a taxpayer and acquired with a transferred basis from the creator of the property) from the definition of “capital asset”
 - The sale of any such item will now result in ordinary income
- Fund managers with valuable patents and trade secrets should focus on this rule in the context of sales of fund management businesses
 - Greater importance of purchase price allocation because capital gain treatment (subject to the three-year holding period rule, as applicable, and potential recapture) will continue to apply to goodwill, going concern value, and certain other intangible assets

SECTION 02

IMPLICATIONS FOR HEDGE FUNDS

Revised § 163(j) limits deductibility of business interest

- Generally limits the deduction for business interest to the sum of:
 - Business interest income, and
 - 30% of “adjustable taxable income.”
- “Adjusted taxable income” approximates
 - For 2018-2021, EBITDA, and
 - For 2022 and later, EBIT.
- Concept of limitation based on fixed percentage of EBITDA is consistent with OECD BEPS recommendations.

Additional rules – new § 163(j)

- Businesses with average annual gross receipts of \$25M or less (indexed to inflation) are generally exempt
- Disallowed business interest can be carried forward indefinitely
- Real property trades or businesses can generally elect out

Considerations – new § 163(j)

- The limitation on deductions of business interest could be potentially significant for leveraged hedge funds that engage in active trading
 - Limitation could reduce economic return to such funds and their investors
- Generally, the limitation is applied at the partnership level
 - “Excess business interest” of a fund, however, may be allocated to its investors and result in adjustments to the basis of interests held by investors
- The application of the limitation to tiered partnerships is complex

Tax accounting – FIFO provision not adopted

- A proposed provision in the Senate Amendment would have generally required that the cost of certain securities sold, exchanged, or otherwise disposed of be determined on a first-in, first-out (FIFO) basis
- This provision was not included in the law, and funds are therefore still permitted to specifically identify lots of securities sold

Tax accounting – book/tax conformity

- For taxable years beginning after December 31, 2017 (and December 31, 2018 for OID instruments), an accrual taxpayer may be required to take an item of gross income into account for tax purposes in the year the taxpayer takes the item into account as revenue in either –
 1. an applicable financial statement; or
 2. any such other financial statement specified by the IRS

Tax accounting – book/tax conformity

- “Applicable financial statement”: a financial statement certified as being prepared in accordance with GAAP, which is -
 - a 10-K or annual statement to shareholders required to be filed with the SEC;
 - an audited financial statement (if there is no statement described in the prior bullet) used for (i) credit purposes; (ii) reporting to shareholders, partners, other proprietors, or to beneficiaries; or (iii) any other substantial nontax purpose; or
 - filed with any other federal agency for nonfederal tax purposes (if there is no statement described in the prior two bullets)
- Also includes certain financial statements filed with certain foreign governmental agencies equivalent to the SEC
- Unclear what other financial statements, if any, the IRS will designate as applicable financial statements

Tax accounting – book/tax conformity implications

- This new rule could accelerate the recognition of taxable income by a fund that has applicable financial statements
 - For example, this new rule could apply with respect to accrued market discount on a debt security (even without an election to include market discount in income currently)

SECTION 03

IMPLICATIONS FOR TAXABLE US INVESTORS

Pass-through deduction

- Key change to basic tax treatment of income from pass-through entities –deduction of up to 20% for “qualified business income” allocated to noncorporate partners
 - Formula limitations on amount of deduction
 - “Specified service” businesses excluded, which would generally include the business of a hedge fund and the business of a hedge fund manager
- However, Code Section 199A makes it clear that that “qualified REIT dividends” and “qualified publicly traded partnership income” are not “qualified business income”
 - Investors may be eligible for a deduction with respect to their shares of any qualified REIT dividends and qualified publicly traded partnership income of a fund

Pass-through deduction

- “Qualified REIT dividends” includes ordinary REIT dividends, but excludes:
 - Capital gain dividends, and
 - Dividends designated as “qualified dividend income”
- “Qualified publicly traded partnership income” means, with respect to any qualified trade or business of a taxpayer, the sum of:
 - Certain qualified items of income (generally, certain income effectively connected with the conduct of a trade or business, but excluding certain types of passive income) from PTPs
 - Gain realized from the disposition of a PTP interest to the extent of Code Section 751(a) Property (unrealized receivables and inventory items)

Disallowance of miscellaneous itemized deductions

- Individual and certain other noncorporate taxpayers are not permitted to deduct miscellaneous itemized deductions for tax years beginning after December 31, 2017 and before January 1, 2026
- Fund expenses (such as management fees, performance fees, etc.) for nontrader funds likely treated as miscellaneous itemized deductions, the disallowance of which could reduce an investor's after-tax return

Disallowance of excess business deductions

- Under a new provision (Section 461(l) of the Code) applying to noncorporate taxpayers, if a trade or business activity generates losses in excess of a taxpayer's trade or business income, a maximum of \$250,000 (\$500,000 if filing a joint return) of the losses can be used to offset investment income for the year
- Any excess business losses that are disallowed by this provision cannot be used to offset tax liability on investment income, but rather will be carried forward as net operating losses (NOLs) that can be used in subsequent years, subject to a new 80% annual limitation on the use of carried forward NOLs
- Limitation applies to excess business deductions incurred in tax years beginning after December 31, 2017 and before January 1, 2026

SECTION 04

EFFECT ON BLOCKER ENTITIES

Effect of new rules on US and offshore blocker structures

- US “blocker” corporations are often used to shield non-US and US tax-exempt investors from direct US tax filing and payment obligations with respect to investments in operating partnerships and LLCs
- Such blockers may be capitalized with a combination of debt and equity of investors. The new tax law’s restrictions on interest deductions (in general terms, to 30% of a corporation’s taxable income) may reduce the blocker-level tax benefits of such leverage
- Leverage may still be helpful with respect to non-US investors as a means to allow distributions without US withholding tax of principal and interest (subject to eligibility of investors for the portfolio interest exemption or tax treaty benefits)

Effect of new rules on US and offshore blocker structures

- The US corporate tax leakage of a US blocker will be reduced, going forward, because of the now-reduced 21% federal corporate tax rate, as well as the potential for bonus depreciation and other tax benefits.
- Offshore blockers, in master-feeder structures, are also often used by hedge funds utilizing leverage to shield non-US investors from direct US tax reporting and US tax-exempt investors from tax on debt-financed income.
- Expansion of rules regarding determination of whether a foreign corporation is a CFC may result in treatment of these and other foreign corporations, even without significant US direct or indirect ownership, as being CFCs, and may require US tax reporting by US constructive owners (e.g., in circumstances with significant (direct or indirect) US ownership, sister US partnerships or corporations).

SECTION 05

EFFECT ON US TAX-EXEMPT INVESTORS

Unrelated business taxable income (UBTI)

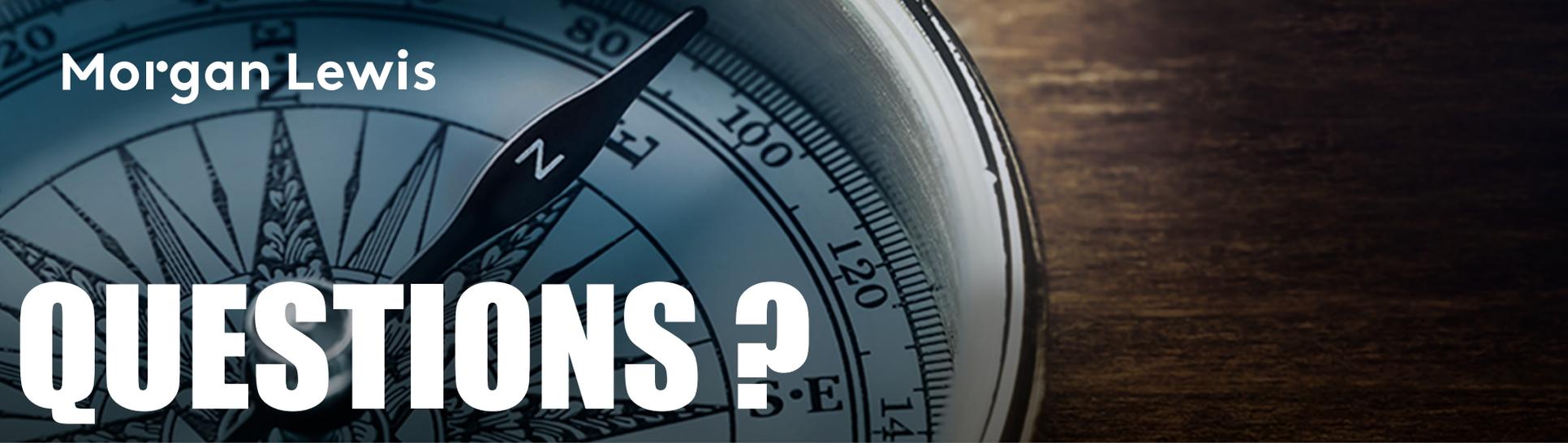
- Under the new law, a tax-exempt entity must calculate UBTI separately for each unrelated trade or business activity. Thus, a tax-exempt entity cannot offset expenses or losses from one trade or business with income derived from another trade or business. These changes are effective for taxable years beginning after December 31, 2017.
- There is, however, a transition rule that permits a tax-exempt entity to carry forward net operating losses that were generated by UBTI-producing investments in a taxable year prior to January 1, 2018, against UBTI-producing investments in later years. The new segregation provision may potentially affect the decision of some tax-exempt investors on whether to invest using blockers.
- We think additional guidance will be required to determine how to segregate separate unrelated trades or businesses, especially through pass-through investment vehicles.

Tax on “applicable educational institutions”

- Under the new law, a 1.4% tax will generally apply to the net investment income of “applicable educational institutions.”
 - Applicable educational institutions include, in general, accredited institutions of higher education (other than state colleges or universities) that had a daily average of at least 500 tuition-paying students during the preceding taxable year, more than half of whom are located in the United States, and assets (other than assets used directly in carrying out the institution’s exempt purpose) with an aggregate fair market value at the end of the preceding taxable year in excess of a per-student threshold
 - The assets and net investment income of certain organizations related to an applicable educational institution will generally be treated as the assets and net investment income of that institution, subject to certain limitations

Tax on “applicable educational institutions”

- In computing its net investment income for this purpose, an applicable education institution will generally take into account its allocable share of a hedge fund’s gross investment income and capital gain net income
- Net investment income for this purpose does not include any income or gain treated as UBTI



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QUESTIONS?

THANK YOU

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Jason P. Traue's practice focuses on federal tax matters. He works extensively with tax issues related to the formation and operation of registered and private investment funds. Jason also assists with merger and acquisition transactions, capital markets transactions, general corporate and partnership tax issues, and international tax issues. Jason has helped clients obtain numerous administrative rulings from the Internal Revenue Service and has assisted in federal and state tax controversy matters.

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Jedd H. Wider focuses on global private investment funds and managed accounts, particularly global hedge, private equity, secondary, and venture capital funds. As co-leader of the global hedge funds practice, he represents leading financial institutions, fund managers, and institutional investors in their roles as fund sponsors, placement agents, and investment entities. He assists clients through all stages of product development and capital raising as well as customized arrangements, seed and lead investor arrangements, and joint ventures. He specializes in all aspects of secondary transactions, and complex financial structurings.

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Richard S. Zarin provides tax advice to sponsors of and investors in a wide range of onshore and offshore investment funds. In addition, working with businesses in industries such as financial services, aviation, education, media and shipping, Richard counsels clients on tax matters involving international and US transactions. He also advises clients on ongoing tax planning.

Biography



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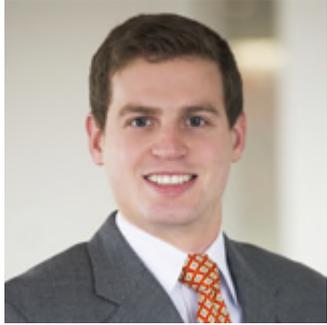
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William P. Zimmerman guides clients on the creation and operation of private and pooled investment vehicles, such as mutual funds, hedge funds, real estate investment trusts, and other investment-related vehicles. He also advises clients on general corporate and individual tax planning matters, including reorganizations, mergers, acquisitions, spinoffs, recapitalizations, and workouts. Additionally, Bill provides partnerships and limited liability companies with planning and operational guidance on tax-related issues.

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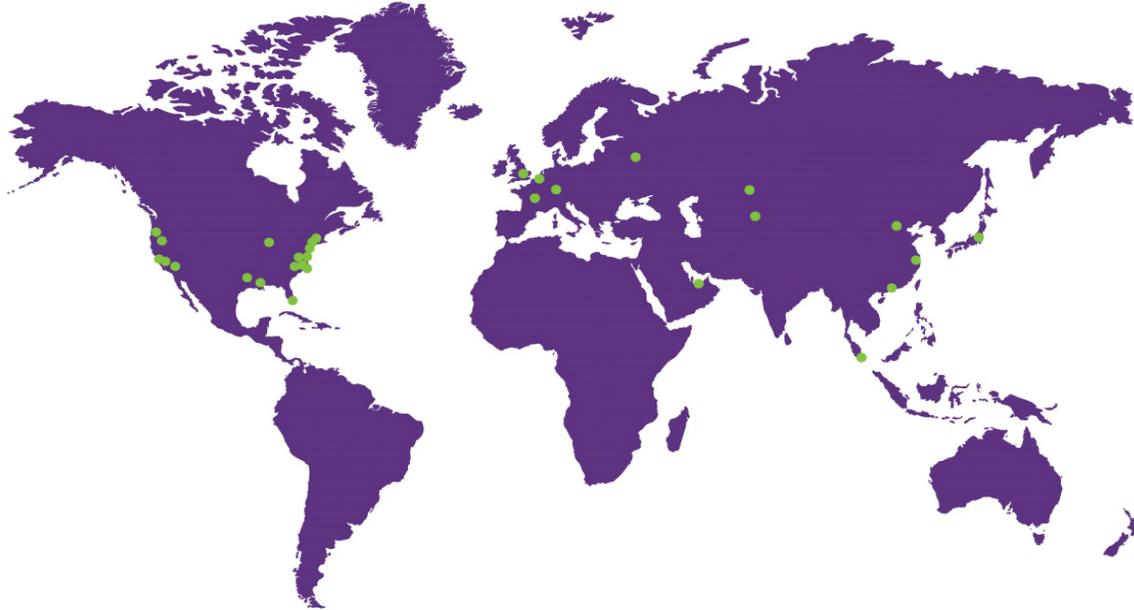
Adam M. Holmes's practice is focused on federal and state tax law. He has experience with the taxation of public and private investment funds; federal and state income tax controversies; and corporate transactions, including mergers and acquisitions, public offerings, and lending and financing transactions. In addition, he advises foreign and domestic entities of their increased obligations under legislation known as the Foreign Account Tax Compliance Act.

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