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U.S. Tax Reform: Provisions Of Relevance To Hedge Funds

On December 22, 2017, President Trump signed into law new tax legislation commonly referred to as the "Tax Cuts and Jobs Act" (the "Act"). Below is a brief summary of selected provisions of the Act that are of relevance to the hedge fund industry. Unless otherwise noted, all section references herein are to the U.S. Internal Revenue Code.

Extended Holding Period for Carried Interest

The Act added a new Section 1061, which extends the holding period for partnership interests held in connection with the performance of services (so-called "carried interests"), in order for the holders of such interests to obtain the benefit of long-term capital gain rates. Section 1061 is effective for taxable years beginning after December 31, 2017, and applies to taxpayers receiving "applicable partnership interests" in connection with the performance of substantial services in any applicable trade or business consisting of: (i) raising or returning capital; and either (ii) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition); or (iii) developing specified assets. "Specified assets" generally means securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing.

The Act provides that (i) a service provider that is issued an applicable partnership interest must hold such interest for over three years (versus over one year under prior law) in order to receive long-term capital gain treatment on the sale or disposition of such applicable partnership interest; and (ii) the assets of a partnership that issues applicable partnership interests must be held for over three years in order for a holder of an applicable partnership interest in such partnership to claim long-term capital gain treatment on such holder's distributive share of any gain on the partnership's disposition of such assets. If the foregoing is not met, then (x) a holder's gain on the disposition of an applicable partnership interest will be treated as short-term capital gain (subject to ordinary income recharacterization to the extent of the partnership's "hot assets"); and (y) a holder's distributive share of any gain on the disposition of partnership assets will be treated as short-term capital gain.

The fact that a holder may have included an amount in income upon the acquisition of an applicable partnership interest, or that such holder may have made a "Section 83(b) election" with respect to such applicable partnership interest, does not change the application of Section 1061.

Section 1061 does not apply to any interests held directly or indirectly in a partnership by a corporation.

Hedge fund industry relevance: ***Hedge funds that typically hold their positions for less than one year, and which did not historically benefit from long-term capital gain treatment, generally should not be significantly impacted by Section 1061. Hedge funds that are not in the foregoing category, however (which may include hedge funds that follow credit and distressed strategies, and activist strategies (as such hedge funds sometimes hold investments for up to 2 years)) will now need to ensure the more-than-3-year holding requirement is satisfied in order for hedge fund managers to receive long-term capital gain treatment on the disposition of applicable partnership interests as well as on their distributive shares of a partnership's gains.***

Please note that on March 1, 2018, the Internal Revenue Service and the U.S. Department of Treasury issued Notice 2018-18, which announced that regulations will be issued that aim to shut down perceived attempts by taxpayers to use "S" corporations to avoid Section 1061. These regulations are expected to clarify that (i) for purposes of the exception in Section 1061 for interests held directly or indirectly in a partnership by a corporation, the term "corporation" does not apply to S corporations; and (ii) the term "applicable partnership interest" for purposes of Section 1061 includes a partnership interest directly or indirectly held by an S corporation. Accordingly, these regulations are intended to deter taxpayers from establishing S corporations to circumvent the new carried interest rule. Please also note that carried interest tax reform may occur at the state level as well; for example, New York's governor has proposed imposing additional taxes on the compensation of hedge fund managers.

20% Business Deduction with Respect to Passthrough Entities

The Act provides for a new Section 199A, pursuant to which a non-corporate taxpayer is generally entitled to a 20% deduction for "qualified business income" from a partnership, S corporation or sole proprietorship. Qualified business income includes income generated from a qualifying U.S. trade or business (but excludes items such as dividends, income equivalent to a dividend, or payments in lieu of dividends, as well as interest income (other than that which is properly allocable to a trade or business)). A qualifying trade or business is any trade or business other than (1) a "specified service trade or business"; and (2) the trade or business of performing services as an employee. A specified trade or business is expressly defined to include: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees. Additionally, a specified trade or business includes the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. However, engineering and architectural services are excepted from the list of specified services that are denied the deduction.

The Section 199A deduction is equal to the sum of:

1. The lesser of (A) the taxpayer's "combined qualified business income amount" or (B) 20% of the excess of the taxpayer's taxable income for the taxable year, over any net capital gain plus the aggregate amount of qualified cooperative dividends, plus

2. The lesser of (A) 20% of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year or (B) the taxpayer's taxable income (reduced by the net capital gain).

A taxpayer's "combined qualified business income" amount is generally equal to (i) the sum of the deductible amounts determined for each qualified trade or business (see below), plus (ii) 20% of the aggregate amount of qualified real estate investment trust dividends and qualified publicly traded partnership income. The deductible amount for a qualified trade or business is the lesser of (x) 20% of the taxpayer's qualified business income with respect to the qualified trade or business, or (y) the greater of (1) 50% of the W-2 wages with respect to the qualified trade or business, or (2) the sum of 25% of the W-2 wages with respect to the qualified trade or business and 2.5% of the unadjusted basis immediately after acquisition of all qualified property. The foregoing wage limitation does not apply to taxpayers with taxable income not exceeding the following threshold amounts: $315,000 for joint filers and $157,500 for other filers. The limitation is phased in for taxpayers with taxable income exceeding the threshold amounts over ranges of $100,000 and $50,000, respectively. Finally, the limitation applies fully for taxpayers with taxable income in excess of the applicable threshold amount plus $50,000 ($100,000 in the case of a joint return).

The Section 199A deduction will effectively reduce the maximum marginal non-corporate tax rate from 37% to 29.6% (*i.e.,* 80% x 37%).

The Section 199A deduction is effective for taxable years beginning after December 31, 2017 and ending before January 1, 2026.

Hedge fund industry relevance: For hedge funds that generate investment income and thus income that is not qualified business income, Section 199A may not have a significant impact. However, trader hedge funds that generate non-investment income may be entitled to the passthrough deduction, but they should be aware of the wage limitation rules. Additionally, unless Congress makes the Section 199A deduction permanent, it is important to keep in mind that such deduction will sunset as of January 1, 2026.

Interest Expense Deduction

Effective for taxable years beginning after December 31, 2017, the deduction for business interest under amended Section 163(j) is limited to the sum of (i) business interest income; (ii) 30% of the adjusted taxable income of a taxpayer for the taxable year (computed without regard to deductions allowable for depreciation, amortization, or depletion for taxable years beginning after December 31, 2017 and before January 1, 2022); and (iii) the floor plan financing interest (*i.e.,* interest incurred on indebtedness used to finance the acquisition of motor vehicles held for sale to retail customers and secured by the inventory so

acquired) of the taxpayer for the taxable year. Disallowed interest may be carried forward indefinitely.

The business interest limitation is applied at the partnership level for purposes of determining each partner's distributive share of net income. The newly-amended Section 163(j) provides a formula for allocating to each partner a share of the business interest subject to the limitation, that the partner is eligible to carry forward.

On April 2, 2018, the U.S. Department of Treasury and the Internal Revenue Service issued Notice 2018-28, which announced their intent to issue proposed regulations providing guidance regarding Section 163(j), as amended by the Act. These regulations are expected to address whether and to what extent interest paid, accrued or includible in gross income by a non-corporate entity (e.g., a partnership) in which a C corporation holds an interest, is properly characterized to such C corporation as business interest or business interest income. These regulations are also expected to provide that, for purposes of calculating a partner's annual deduction for business interest, a partner cannot include such partner's share of the partnership's business interest income for the tax year except to the extent of the partner's share of the excess of (i) the partnership's business interest income over (ii) the partnership's business interest expense (not including floor plan financing).

Hedge fund industry relevance: A common hedge fund structure consists of a "master" fund vehicle treated as a partnership for U.S. federal income tax purposes, and which has (i) a domestic "feeder" limited partner ("Domestic Feeder") in the form of a U.S. limited partnership treated as a partnership for U.S. federal income tax purposes and (ii) a foreign "feeder" limited partner ("Foreign Feeder") in the form of a foreign corporation (or a foreign limited partnership that elects to be treated as a corporation for U.S. federal income tax purposes). The Domestic Feeder is generally tailored to U.S. taxable investors, while the Foreign Feeder is generally tailored to foreign investors that are sensitive to incurring "effectively connected income," and U.S. tax-exempt investors that are sensitive to incurring "unrelated business taxable income." To the extent of any debt at the level of a master hedge fund vehicle or a Domestic Feeder (both of which are passthrough entities for U.S. federal income tax purposes), the 30% limitation will need to be calculated at the partnership level. Any excess interest expense is not carried over by the partnership, but instead is required to be allocated to each partner. As a result of the new Section 163(j) rules and their application to partnerships, leveraged hedge funds, along with their investors, will have additional calculation obligations and reporting obligations that were not existent under pre-Act law.

Dispositions by Foreign Persons of Interests in Partnerships that Conduct a U.S. Trade or Business

In Revenue Ruling 91-32, the Internal Revenue Service took the position that a foreign partner's gain from the sale of a partnership interest would be treated as income effectively connected with a U.S. trade or business ("ECI") to the extent the seller would have received an allocation of ECI from the partnership if the

partnership had disposed of its assets. In 2017, the United States Tax Court (in *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commissioner*, 149 T.C. No. 3) disagreed with the Internal Revenue Service and held that a foreign partner's gain on the disposition of its partnership interest (to the extent the gain is not attributable to "United States real property interests," or USRPIs) is not ECI.

The Act codifies Revenue Ruling 91-32. Under Section 864(c)(8), gain or loss from the sale or exchange of a partnership interest by a foreign person is effectively connected with a U.S. trade or business to the extent the transferor would have had effectively connected gain or loss if the partnership sold its assets at fair market value as of the date of the sale or exchange. Additionally, a new withholding rule (Section 1446(f)) has been enacted that requires the transferee of a partnership interest to withhold 10% of the amount realized on the sale or exchange of the partnership interest, absent certification that the transferor is not a foreign person. As a back-up enforcement mechanism, if a transferee partner fails to withhold the 10%, the partnership itself becomes obligated to deduct and withhold from distributions to the transferee partner the amounts that should have been withheld by the transferee partner.

Section 864(c)(8) applies to all partnership interests disposed of, sold or exchanged on or after November 27, 2017, while Section 1446(f) applies to partnership interests disposed of sold or exchanged after December 31, 2017.

On April 2, 2018, the U.S. Department of Treasury and the Internal Revenue Service issued Notice 2018-29, which provides that regulations, rules and procedures will be issued relating to the qualification for exemptions from withholding or reductions in the amount of withholding under Section 1446(f). Notice 2018-29 also provides interim guidance on withholding procedures under Section 1446(f); many of these procedures follow the forms and procedures relating to withholding on dispositions of USRPIs under the "Foreign Investment in Real Property Tax Act of 1980", or FIRPTA, rules in Section 1445 (which require a transferee of a partnership interest to withhold 15% if the partnership interest were itself a USRPI). For example, until regulations on certifications of non-foreign status under Section 1446(f) are issued, a transferor may issue a non-foreign person certificate similar to that required under Treasury Regulations Section 1.1445-2(b), as modified to take into account Section 1446(f). Additionally, until regulations, other guidance or forms and instructions have been issued under Section 1446(f), transferees required to withhold under Section 1446(f) must use the rules in Section 1445 and the Treasury Regulations thereunder for purposes of reporting and paying over the Section 1446(f) withholding tax. To that end, transferees must use Internal Revenue Service Form 8288 (U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests), and Internal Revenue Service Form 8288-A (Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests), as modified to include the statement "Section 1446(f)(1) withholding" at the top of both forms. In addition to the foregoing, Notice 2018-29 provides that regulations will be issued to the effect that the requirement for a partnership to withhold on distributions to a transferee partner will not apply until regulations or other guidance have been issued.

Hedge fund industry relevance: Foreign persons that invest in a hedge fund that is treated as a partnership for U.S. federal income tax purposes,

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and which is engaged in a U.S. trade or business, will be impacted by this provision in that such foreign persons should be subject to U.S. tax if they were to transfer their interest in the hedge fund, whether the transfer is a taxable transfer or a transfer that is part of a non-recognition transaction. Notice 2018-29 offers very helpful interim guidance with respect to the withholding rules under Section 1446(f), but these withholding rules will likely nevertheless result in administrative challenges for both hedge funds and hedge fund investors. Transferees of hedge fund partnership interests that have a withholding obligation under Section 1446(f) will need to distinguish between (i) withholding 10% under Section 1446(f), and (ii) withholding 15% under Section 1445. Hedge funds will have more administrative obligations to the extent that they are required to withhold 10% from distributions to a transferee partner in the event such partner failed to withhold. Additional guidance, including regulations, will be forthcoming, however, which hopefully will provide more clarity and certainty.

Corporate Income Tax Rate Reduction

The Act reduces the corporate income tax rate to 21% for taxable years beginning after December 31, 2017. Additionally, the withholding provisions under FIRPTA are modified to reflect the reduced 21% corporate income tax rate for (i) gains from the disposition of USRPIs realized by U.S. partnerships, U.S. trusts or U.S. estates that are allocable to foreign persons who are partners or beneficiaries of such U.S. partnerships, U.S. trusts or U.S. estates, or are allocable to a portion of a trust treated as owned by a foreign person; (ii) distributions by foreign corporations to foreign persons of gain from the disposition of USRPIs; and (iii) distributions by regulated investment companies or real estate investment trusts to foreign persons of gain from the disposition of USRPIs.

Hedge fund industry relevance: The reduced 21% corporate federal income tax rate will have a positive impact on (i) U.S. corporate hedge fund partners; and (ii) Foreign Feeders, foreign corporate hedge fund partners and stand-alone hedge fund corporations, each of which derives ECI from underlying investments. Please note that while a foreign corporation with ECI will benefit from the reduced 21% corporate income tax rate on such ECI, such foreign corporation continues to be subject to a 30% "branch profits tax" on ECI (which tax may be reduced by an applicable income tax treaty). Accordingly, any foreign corporation in a hedge fund structure that derives ECI continues to potentially face branch profits tax liability in addition to corporate income tax liability.

Revision to Rules to Determine Controlled Foreign Corporation Status

A "controlled foreign corporation," or CFC, is any foreign corporation if more than 50% of (i) the total combined voting power of all classes of stock of such corporation entitled to vote; or (ii) the total value of the stock of such corporation, is owned by United States shareholders on any day during the taxable year of such foreign corporation. Under pre-Act law, a "United States shareholder" of a foreign corporation is a U.S. person who owns 10% or more of the total

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combined voting power of all classes of stock entitled to vote of such foreign corporation.

The Act expands the definition of "United States shareholder" to include any U.S. person who owns 10% or more of the total value of shares of all classes of stock of a foreign corporation. The foregoing is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

The Act also provides that certain stock of a foreign corporation owned by a foreign person is attributed to a related U.S. person for purposes of determining whether the related U.S. person is a U.S. shareholder of the foreign corporation and whether the foreign corporation is a CFC. This "downward attribution" provision is effective for the last taxable year of foreign corporations beginning before January 1, 2018 and each subsequent year of such foreign corporations, and for the taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

Finally, under pre-Act law a United States shareholder of a CFC is subject to U.S. tax on such shareholder's pro rata share of the CFC's "Subpart F income," but only if the CFC has been a CFC for at least 30 consecutive days during the taxable year. The Act eliminated this 30-day requirement. This provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

Hedge fund industry relevance: The foregoing provisions may significantly increase the number of hedge fund entities that are CFCs, and may inadvertently cause foreign investors in hedge fund structures to have one or more CFCs in their ownership chain. For example, if a foreign corporate investor invests in a Foreign Feeder, and such foreign corporate investor has a U.S. subsidiary, the foreign corporate investor's ownership of the Foreign Feeder may be attributed downward to the U.S. subsidiary, and cause the Foreign Feeder to be a CFC with respect to such U.S. subsidiary. Moreover, because the downward attribution rule is effective for the last taxable year of foreign corporations beginning before January 1, 2018, this rule has a retroactive effect as it technically applies to 2017. The foregoing may impact negotiations between hedge funds and their investors and result in an increase in investor demands for information delivery and sharing from hedge fund sponsors that did not exist under pre-Act law.