

AN ALERT FROM THE BDO FINANCIAL SERVICES PRACTICE

# ASSET MANAGEMENT INSIGHTS

## HOW TAX REFORM WILL IMPACT HEDGE FUNDS

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act ("The Act"). The Act is a sweeping piece of tax legislation that is the most significant rewrite of the tax code in decades. The centerpiece of the legislation is a tax cut for corporations, but there are several provisions that will impact hedge funds, as well as their sponsors and investors. Following is a summary of the more significant provisions, which are generally effective starting in 2018.

### PROVISIONS IMPACTING MANAGEMENT COMPANIES AND GENERAL PARTNERS

- ▶ Tax treatment of carried interest is changed, to require a three year holding period on realized gains for the general partner to receive long-term capital gains treatment. It is unclear how this change will impact carry attributable to qualified dividends and section 1256 contracts, which are otherwise eligible for long-term capital gains treatment. The change to carried interest is not applicable for interests held by "a corporation." If the carry vehicle (GP) is a C-Corporation, it will not need to satisfy the three year holding period requirement. This will need to be clarified, but fund managers should consider converting the GP entity to a C-Corporation or potentially even an S-Corporation. This can be accomplished with a check the box election, which can be done retroactively to January 1, 2018, if filed by March 15, 2018.
- ▶ The 20 percent deduction for income from pass through entities would not apply to investment management firms unless the recipient of the income has taxable income of less than \$415,000 (for joint filers).
- ▶ Losses from management companies will be subject to limitations at the individual level. The Act contains a provision that caps "excess business losses" of non-corporate taxpayers at \$500,000 in the case of joint filers. The excess cannot offset investment income, such as income from a separate GP entity, but is permitted to be carried over to later years.
- ▶ Interest expense incurred by funds considered to be in a trade or business (i.e., "trader" funds) will likely be limited with respect to the general partner's share.
- ▶ Management companies structured as limited partnerships will still enable fund managers to potentially minimize self-employment taxes with respect to the limited partners. An early version of the bill repealed the exception, but it was later restored. There is also no change to the tax on net investment income (3.8 percent under Obamacare).



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- ▶ Entertainment expenses are disallowed. Meals are still deductible subject to the current 50 percent limitation.
- ▶ State and local tax deductions (SALT) for individuals are disallowed, subject to a \$10,000 allowance.
- ▶ All miscellaneous itemized deductions subject to the two percent of AGI floor have been repealed through 2025. This includes management fees and other portfolio deductions from “investor” funds.
- ▶ Fund managers should review their choice of entity in light of the changes to the carried interest rules, the reduction of corporate tax rates, and general unavailability of the favorable pass through treatment. Corporations are also allowed SALT deductions.

### PROVISIONS IMPACTING FUNDS:

- ▶ Certain income from Master Limited Partnerships (MLPs) and REIT dividends are eligible for the 20 percent pass through income deduction.
- ▶ Based on early versions of the Act, there was some possibility that income from funds that elect mark-to-market treatment under section 475(f) would be eligible for the 20 percent pass through income deduction. However, that is no longer the case in the final legislation.
- ▶ Revenue Ruling 91-32 is codified in the Senate version of the bill, overturning the recent favorable Grecian Magnesite Mining decision. As a result offshore funds that sell MLPs or other “ECI”-producing partnership interests could face U.S. tax on the sale of the partnership interest.

- ▶ Credit funds will be forced to conform to financial statement accounting for items of income, such as original issue discount (OID). This will result in taxable income being accelerated in many cases.
- ▶ Funds that invest in cryptocurrency such as Bitcoin cannot take advantage of the like-kind exchange rules (section 1031) to defer income on exchanges of one currency for another. The legislation only allows like-kind exchanges for real estate. There has been debate over this in the wake of Bitcoin's explosive price appreciation.

### CONSIDERATIONS FOR PORTFOLIO COMPANIES AND BLOCKERS:

- ▶ The maximum corporate rate is reduced to 21 percent from 35 percent.
- ▶ The corporate Alternative Minimum Tax (AMT) is repealed.
- ▶ Interest expense is subject to significant limitations for corporate entities such as leveraged blockers.
- ▶ Certain property is eligible for immediate expensing, as opposed to depreciation over a period of years.

### CONCLUSION

The Tax Cuts and Jobs Act will have an impact on every aspect of the hedge fund industry, and we are just beginning to comprehend its implications. Fund managers and their tax advisers will need to work together closely to address its challenges and opportunities.

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