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ASSET MANAGEMENT **INSIGHTS**

IMPACT OF TAX REFORM ON HEDGE FUNDS – 2018 YEAR-END UPDATE

The Tax Cuts and Jobs Act ("TCJA") was signed into law about a year ago, but its impact on the hedge fund industry is still being sorted out. While many questions remain unanswered, the IRS has begun to address some of them. Following is a recap of five key tax reform implementation updates for the industry during 2018.

CARRIED INTEREST

The TCJA introduced a new Code section 1061 changing the tax treatment of carried interest from a one-year to a three-year holding period. There was some discussion in the industry of converting General Partner entities (carry vehicles) to S corporations to benefit from an exception to the three-year holding period rule for unspecified "corporations." However, the IRS subsequently issued a **Notice** in March 2018 clarifying that the exception only applies to C corporations. The IRS also announced it would be issuing additional regulations governing carried interest. There are still several open questions about the new law—for example, how it applies to earnings on reinvested carry from earlier years transferred to a limited partner account for asset protection purposes. The forthcoming regulations will hopefully provide some much-needed clarity.

STATE AND LOCAL TAX (SALT) DEDUCTIONS

In response to the TCJA limitations on SALT deductions, several states have attempted to enact "workaround" provisions to allow their residents to deduct state and local income and property taxes. For example, some states attempted to establish trusts that would allow SALT deductions to be recharacterized as charitable donation deductions. However, the IRS issued guidance over the summer that effectively shut this path down. One other path states are pursuing is creating entity–level taxes on partnerships and other pass-through entities. The objective would be to shift the SALT deduction from the individual owners to the partnership entity, which is not subject to the same SALT deduction limits. The pass-through owners would then receive a state tax credit. Connecticut enacted such a provision, and New York State has proposed one. It is unclear whether the IRS will ultimately permit this type of workaround, but the guidance to date does not specifically shut it down.

INTEREST EXPENSE LIMITATIONS

The TCJA imposes significant limitations on the deductibility of "business interest expense." The limitation, which comes into play for "trader" funds, is generally tied to the fund's interest income plus 30 percent of EBITDA. Initially, most interpreted this provision to mean that only general partners in "trader" hedge funds would be subject to the

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limitation, since interest expense from a trader fund is business interest in their hands, but not in the hands of limited partners, for whom it is investment interest expense. However, based on recently proposed regulations, it now appears that even limited partners in trader hedge funds could be subject to the limitations.

OPPORTUNITY ZONES

The TCJA's "Investment in Opportunity Act" established newly created Federal Opportunity Zones ("O-Zones") intended to revitalize distressed communities by attracting private investment. This provision has been generating significant interest in the industry, especially in light of recent guidance. If structured properly, Opportunity Zone Funds can allow the deferral of capital gains. What's more, if they meet special holding period requirements, **Opportunity Zone Funds** can exclude all or a portion of gains from investments in Qualified Opportunity Zones. [Read more about opportunity zones **here**]

UNRELATED BUSINESS TAXABLE INCOME (UBTI)

The TCJA included a provision that would limit the ability of tax-exempt investors to combine net gains and losses from separate activities. This "silo" rule could affect tax-exempt investors in hedge funds and other investment partnerships that generate UBTI from debt financing or other activities. The IRS issued a **Notice** granting some relief in these types of scenarios on an interim and transitional basis. The relief, which allows tax-exempt investors to aggregate and net their partnership interests, is generally only available where the tax-exempt investor has a de minimis (no more than 2 percent of the profits interest and no more than 2 percent of the capital interest) or non-controlling interest (no more than 20 percent of the capital interest with no influence over fund management). Tax-exempt investors in so-called "funds of one" will typically not be eligible for this relief provision. However, there is another relief provision available for certain grandfathered partnership interests acquired prior to the issuance of the Notice on Aug. 21, 2018, regardless of ownership or control.

CONCLUSION

The IRS and Treasury Department have been very busy issuing proposed regulations and other guidance. But given the scope of tax reform, their job is far from complete. There are many areas that still need to be addressed before compliance and planning under the new law can be fully implemented. The IRS will continue to issue new guidance on TCJA implementation over the next few months. Hedge funds need to proactively consider what guidance is still pending and continually reassess their tax strategies as new developments impacting the industry and their investors unfold.

HOW DO I GET MORE INFORMATION?

ADAM BROWN
National Assurance Managing Partner
Dallas
214-665-0673 / abrown@bdo.com

JIN KOO
National Assurance Partner
Dallas
214-243-2941 / jkoo@bdo.com

JOE PACELLO
Tax Partner
New York
212-885-7375 / jpacello@bdo.com

IGNACIO GRIEGO
Assurance Partner
San Francisco
415-490-3182 / igriego@bdo.com

JONATHAN SCHMELTZ
Tax Partner
New York
212-885-8170 / jschmeltz@bdo.com

SAMUEL SEAMAN
Tax Partner
San Francisco
415-490-3157 / sseaman@bdo.com

NICK MAROULES
Assurance Partner
Chicago
312-730-1332 / nmaroules@bdo.com

KEITH MCGOWAN
Assurance Partner
New York
212-885-8037 / kmcgowan@bdo.com

MATHEW DEMONG
Tax Partner
Boston
617-422-7575 / mdemong@bdo.com

DALE THOMPSON
Partner, Financial Services
New York
212-885-7318 / dthompson@bdo.com

STEPHEN CUNEO
Director, National Financial Services
San Francisco
415-490-3071 / scuneo@bdo.com

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