



US Tax Reform

Major tax issues impacting hedge funds



On December 22, 2017, President Trump signed H.R. 1 into law as Public Law 115-97 (the Act), which prescribes fundamental changes to the US federal income tax regime. The Act includes a number of provisions that impact asset managers and their investor base. In addition to reducing the rate of corporate tax, the Act also affects deductions, credits, and structures that have been commonly employed by asset managers. Each US state's tax regime must be considered as well. The Act includes uncertainties and will require corrections and guidance. However, many provisions are currently effective, and the Treasury and the IRS are beginning the process of implementing the law.

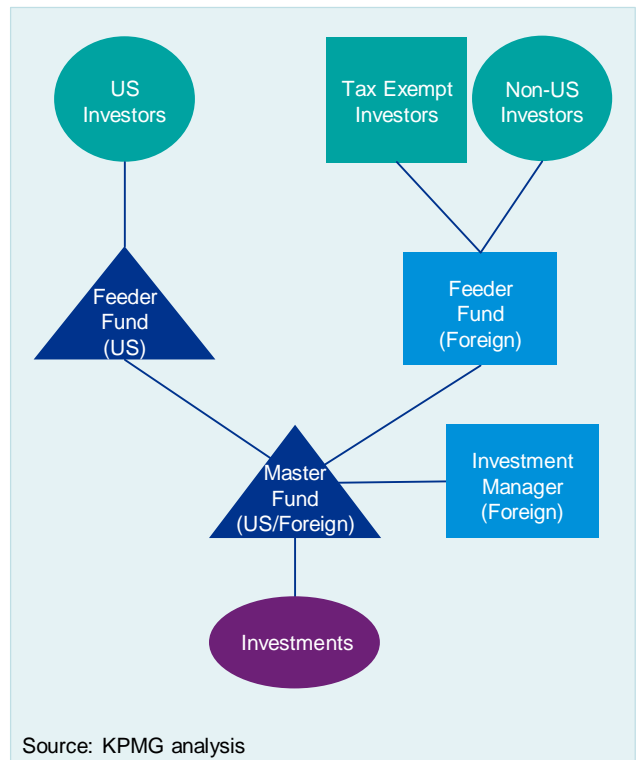
Time is of the essence for asset managers to implement the structural changes that may be needed to mitigate any negative impact of the Act. Even if structural changes are not required (or possible), fund managers are likely to need to update deal models to account for significant changes to US tax assumptions, as well as update processes to comply with enhanced 2018 tax reporting due to tax reform.

This brief is intended to provide a quick reference guide on a few key observations about the Act that may impact hedge funds, its investors, and fund managers.

What is a typical fund structure?

A typical fund structure (as depicted in the diagram below) would be a "master feeder" structure. This consists of a two-tiered investment structure in which investors invest their capital in a "feeder" fund, which in turn invests in a "master" fund that invests in the target investment.

Generally, the master feeder setup has one master fund with one US (or onshore) feeder and one Non-US (or offshore) feeder.



Source: KPMG analysis

What are the changes that potentially impact hedge funds, management companies and general partners?

Carried Interest

Owners of certain applicable partnership interests (held directly or indirectly) that sell their interest in such a partnership or partnerships that sell assets held less than three years may be subject to the new carried interest rule where gain would be considered short-term gain.

Itemised Deduction

All miscellaneous itemised deductions subject to the two percent AGI floor have been repealed through 2025. This includes management fees and other portfolio deductions from funds that are considered to be "investors". To remain competitive with other hedge funds, certain expenses may need to be restructured to provide US investors with expected tax benefits.

20% Deduction for Qualified Business Income

Non-corporate US owners (i.e. individuals, estates and trusts) of pass-through entities are allowed a deduction equal to 20% of Qualified Business Income with respect to the domestic qualified trade or business, subject to limitation based on allocable W-2 wages and the unadjusted basis of qualified property.

Foreign Constructive Ownership Rules

Increasing the scope of US shareholders results in US persons who are required to include amounts in income (as "dry income") under the Subpart F rules by:

- Expanding the population of US persons that are classified as US shareholders.
- Expanding the population of foreign corporations that are classified as Controlled Foreign Corporations or CFCs.
- Creating a new category of foreign corporation (i.e. Specified Foreign Corporation or SFC) that generates Subpart F to US Shareholders.

Business Loss Limitation for Taxpayers other than C-Corps

The new law effectively denies business deductions for taxpayers (other than C corporations) for any net business losses (i.e. from management companies or pass-through portfolio companies) in excess of US\$250,000 (or US\$500,000 in the case of joint return). To the extent the loss exceeds the threshold amount, it would become part of the taxpayer's Net Operating Loss (NOL) and carried forward under IRC Section 172 to subsequent years.

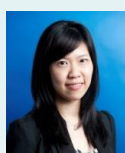
Other Noteworthy Provisions

- Personal tax brackets were revised, with the highest bracket decreasing to 37% (from 39.6%); no change to the 20% tax rate applicable to long-term capital gains and qualified dividend income; no change to the 3.8% tax on net investment income.
- The corporate tax rate reduced to 21% (from 35%); Post-2017 NOLs limited to 80% of taxable income with no carryback and indefinite carryforward.

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