November 8, 2017

Tax Reform: Hedge Funds/Commodity Funds/ Fund Managers

House Republicans released their draft tax bill on November 2, representing their opening bid in the drive to reach agreement on a comprehensive tax reform bill that can be presented to the House for a vote before the Thanksgiving recess. The provisions of the House bill can be expected to change as the bill undergoes markup by members of the House Ways and Means Committee, and we plan to provide you with periodic updates of significant developments during the slog to enact tax reform. Below are the highlights of the bill—to be made effective for taxable years beginning after 2017—that should be of interest to hedge fund and commodity fund managers and investors.

1. **Top Tax Rate Maintained; Itemized Deduction Phase-Out and AMT Eliminated; State Income Tax Deduction Eliminated.** The top federal income tax rate on ordinary income of individuals remains at 39.6% (and the special 20% maximum tax rate applicable to qualifying dividends and long-term capital gains is retained). An individual's investment expenses are still non-deductible except to the extent they exceed 2% of the individual's adjusted gross income (AGI), but the 3% phase-out of itemized deductions for individuals whose AGI exceeds certain threshold amounts is eliminated, as is the alternative minimum tax (AMT). Accordingly, while it is still important to determine whether a fund is a "trader" or merely an "investor" for federal income tax purposes, an individual is now somewhat more likely to be able to deduct fund expenses that are reported as investment expenses. However, the impact of state tax limitations on the deductibility of investment expenses and investment interest is, if anything, increased, particularly for investors in high-tax states that impose such limitations, because the bill eliminates the federal income tax deduction for state income taxes. The "trader" vs. "investor" distinction remains particularly important for residents of states such as New York and California that limit the deduction of investment expenses.

2. **25% Tax Rate on Pass-Through Business Income.** A special 25% maximum federal income tax rate applies to at least a portion of certain business income of individuals. However, the special rate does not apply to income earned from providing financial or brokerage services, and also does not apply to investment income such as short-term capital gains, dividends, foreign currency gains and income and gain from derivatives. Accordingly, the special 25% tax rate is generally not applicable to fund managers and their investors (as to income and gain earned from investments in hedge and commodity funds). The good news is that there is no provision treating gain from "carried interests" as ordinary income.

3. **Self-Employment Tax.** The statutory exemption from self-employment tax for amounts allocated to a limited partner (other than amounts treated as guaranteed payments for services) is eliminated. This change will affect management companies that are structured as limited partnerships.

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4. **Net Investment Income (3.8%) Tax.** The 3.8% net investment income tax is retained.

5. **Investment Interest; Business Interest.** The deduction for investment interest is retained in its current form and is not affected by other limitations imposed on the deduction of "business" interest. Accordingly, investors generally should be able to continue to deduct their share of a fund's interest expense to the same extent as under current law. However, fund managers may be affected by limitations imposed on the deduction of "business" interest in any year in which their average annual gross receipts for that year and the preceding two taxable years exceeds $25 million. In that event, interest expense incurred in connection with their management business cannot be deducted currently to the extent it exceeds 30% of their "adjusted" taxable income, but may be carried forward for up to five years and deducted in those years subject to the same limitation.

6. **Unrelated Business Taxable Income.** State pension plans can no longer take the position that they are government-sponsored entities and, as such, are not subject to the rules taxing unrelated business taxable income (UBTI) of tax-exempt investors. Instead, they are subject to the UBTI rules generally applicable to tax-exempt investors.

7. **25% Tax Rate for REIT Dividends.** Regular (ordinary) real estate investment trust (REIT) dividends paid to individuals are generally taxed at a special 25% maximum federal income tax rate, rather than the 39.6% tax rate applicable to ordinary non-qualified dividend income.

8. **Non-Qualified Deferred Compensation.** Sections 409A and 457A are repealed. Instead, all deferred compensation is immediately taxable unless receipt of the compensation is subject to a substantial risk of forfeiture requiring the continued performance of services. Management and performance fees payable by domestic (as well as offshore) funds with respect to illiquid (side-pocketed) investments are taxable as earned, even if payment is deferred until the investments are sold or otherwise become liquid. Performance-based compensation is not treated as subject to a substantial risk of forfeiture merely by virtue of being contingent on the achievement of thresholds or milestones.