TAX REFORM AND INVESTMENT MANAGEMENT: DOES THE FOREIGN-DERIVED INTANGIBLE INCOME PROVISION BENEFIT U.S. FUND MANAGERS?

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U.S. Tax Alert

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On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "Act"). In previous alerts, we have discussed how the Act made significant changes to the foreign provisions of the Internal Revenue Code (the "Code"). This alert, which is part of our series of alerts on the impact of the Act with respect to the investment management industry, will continue our discussion of the more important foreign provisions that apply to investment funds. Chief among these is new Section 250 of the Code, which permits a deduction for domestic C corporations that reduces the effective U.S. tax rate on certain types of foreign-derived income. As discussed below, this new deduction may provide a benefit to U.S. fund managers that provide investment management services to certain types of foreign investment funds.

The new Section 250, referred to as the Foreign-Derived Intangible Income ("FDII") regime, incentivizes domestic C corporations to maintain their onshore operations by allowing a deduction that reduces the effective U.S. tax rate on certain foreign-derived income (i.e., the corporation's FDII). Despite what its name suggests, the FDII regime does not apply solely to income that is attributable to intangibles but rather to "deemed" intangible income with respect to sales of goods, tangible and intangible property, and the provision of services.

The calculation of a U.S. corporation's FDII is complex but generally is that portion of income attributable to either (i) sales of goods to foreign persons or (ii) provision of services to foreign persons that exceeds a deemed rate of return on the U.S. company's tangible depreciable business assets that are related to sales of property to foreign persons or the provision of certain services to any person, or with respect to any property, that is located outside of the United States. The deduction is generally available for income that is derived from a domestic corporation's (i) sales of goods or provision of services to unrelated foreign persons and (ii) sales of goods or provision of services to related foreign persons, provided that such property is either resold or used in the sale of other property to an unrelated foreign person or, in the case of services, the related party does not provide substantially similar services to persons located in the United States. For taxable years 2018 through 2025, the deduction is equal to 37.5 percent of FDII (reduced to 21.875 percent in 2026). At the new 21 percent corporate income tax rate, this results in an effective U.S. federal income tax rate of 13.125 percent (increased to 16.41 percent in 2026) on FDII.

A domestic investment advisor may qualify for the FDII deduction where it provides investment management services to a foreign investment fund that is not a related person. In the case of many managers, they may have branded offshore funds to which they provide investment management services. These funds will need to be closely scrutinized to determine whether they are related persons with respect to the investment advisor. For example, if an investment advisor retains the right to appoint the board of directors of a foreign company that is an investment fund, that company may constitute a related party with respect to the investment advisor. Different rules apply to corporations and partnerships in determining whether they are related persons.

The FDII provisions became effective for taxable years beginning January 1, 2018.

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In light of the Act's significant ambiguities and uncertain application to a variety of industries and situations, the precise impact of the Act remains to be seen and likely will require interpretive guidance from the Internal Revenue Service. Congress may also consider corrections legislation to address issues that arise as implementation moves forward.

As more details emerge, we will continue to publish updates on the matters addressed in this alert and other aspects of the Act, all of which are addressed in the publications listed on our tax reform resources page.

We invite you to contact any member of our tax team to discuss the methods that may be of most benefit in your situation as well as the stumbling blocks you should be aware of in the Act.

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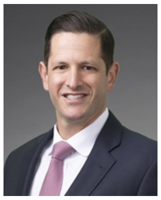

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