May 28, 2008

Moderator - Matthew Stevens
Panelists - Jim Croker ▪ Andy Immerman
Tim Selby ▪ Carolyn Smith
Laura Thatcher ▪ Chuck Wheeler

Overview

- Basic Hedge Fund Structuring
- Compensating Managers and Advisors
- Allocating Gains and Losses for U.S. Tax Purposes
- Structuring Investments into Hedge Funds
- Avoiding problems under ERISA

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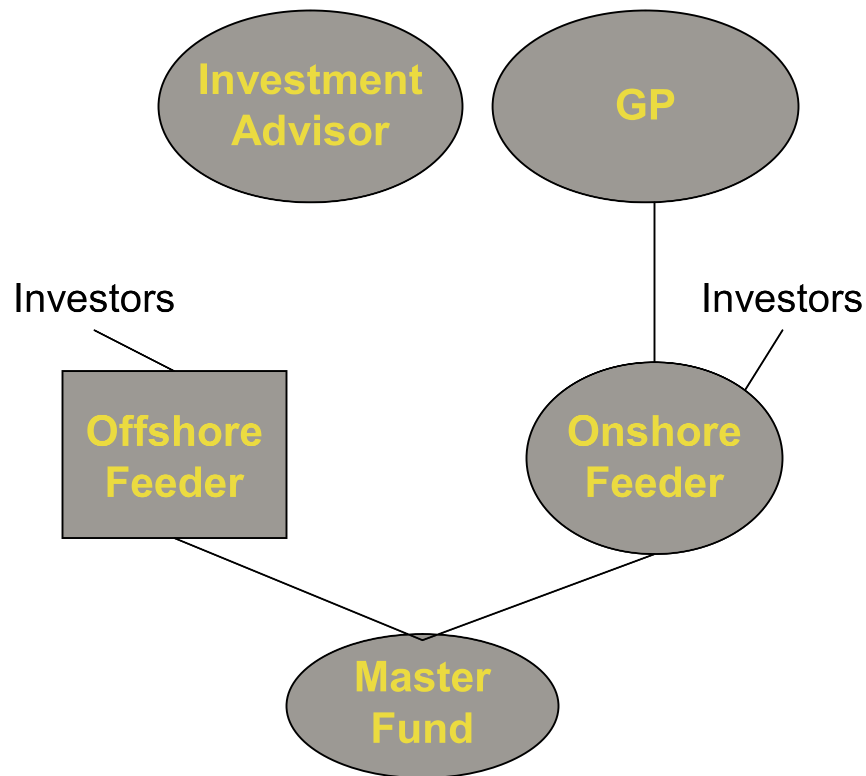
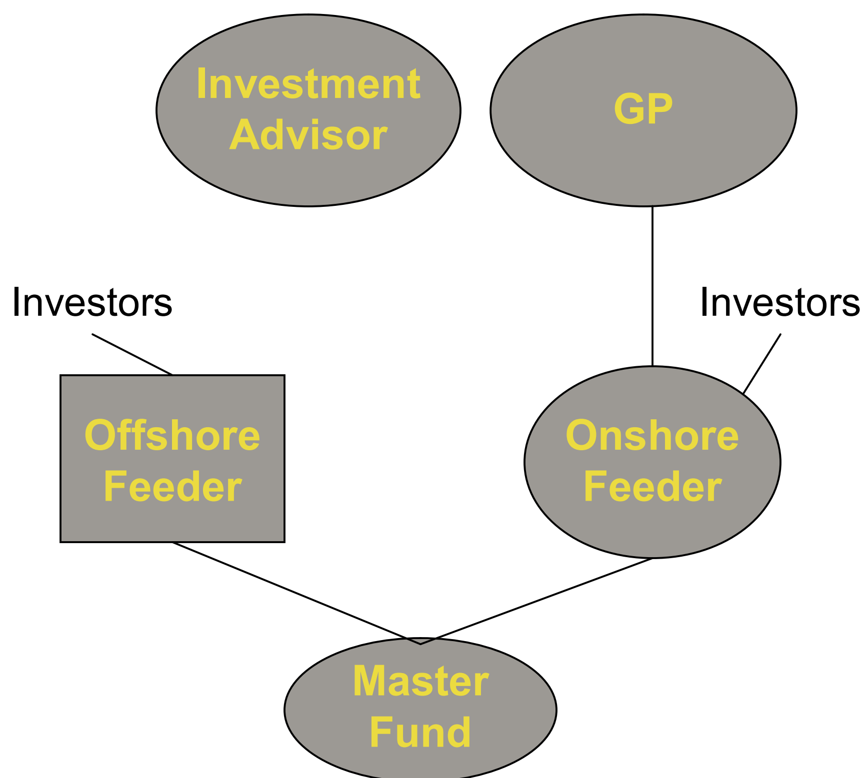
Basic Hedge Fund Structuring: Overview



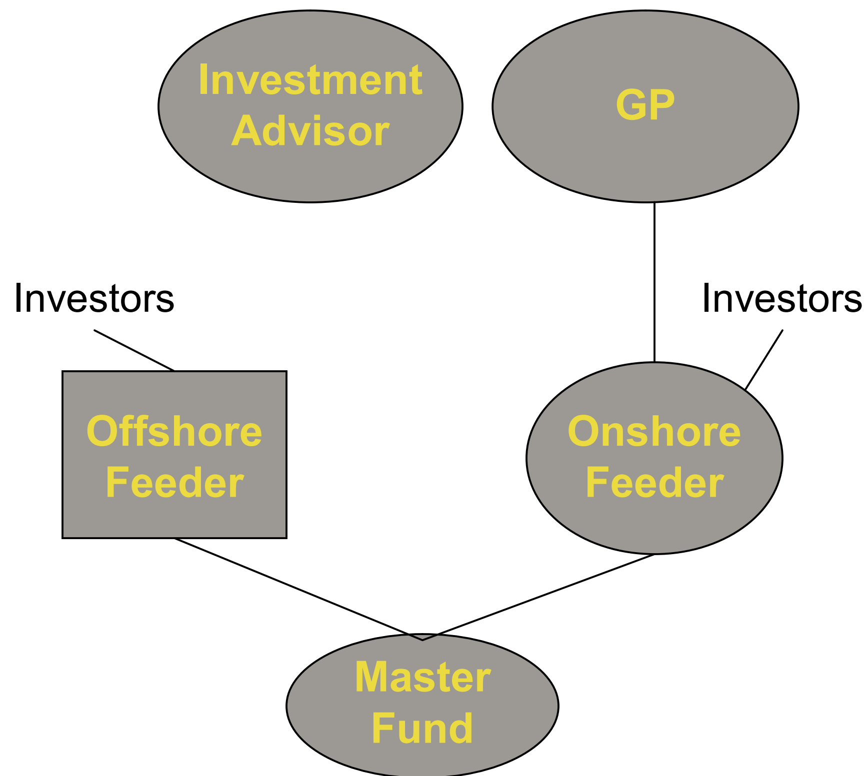
- Typical structure for a US-managed hedge fund
- As explained below, the fund structure is driven by tax positions of fund sponsors and investors
- Some funds may be single entity funds or use mini-master or parallel fund structure

Basic Hedge Fund Structuring: Master Fund



- Classified as a partnership for US tax purposes
- If non-US entity, likely to need to file check-the-box election
  - Typically organized as an offshore limited liability company or corporation that would be classified as a corporation for US tax purposes absent an election

Basic Hedge Fund Structuring: Master Fund (cont.)



- Partnership classification avoids PFIC status for non-US master fund
- Partnership classification allows character pass-through (e.g., long-term capital gains).
  - Frequent trading may limit long-term capital gains.
  - 1256 contracts – 60% long-term capital gain; 40% short-term capital gains

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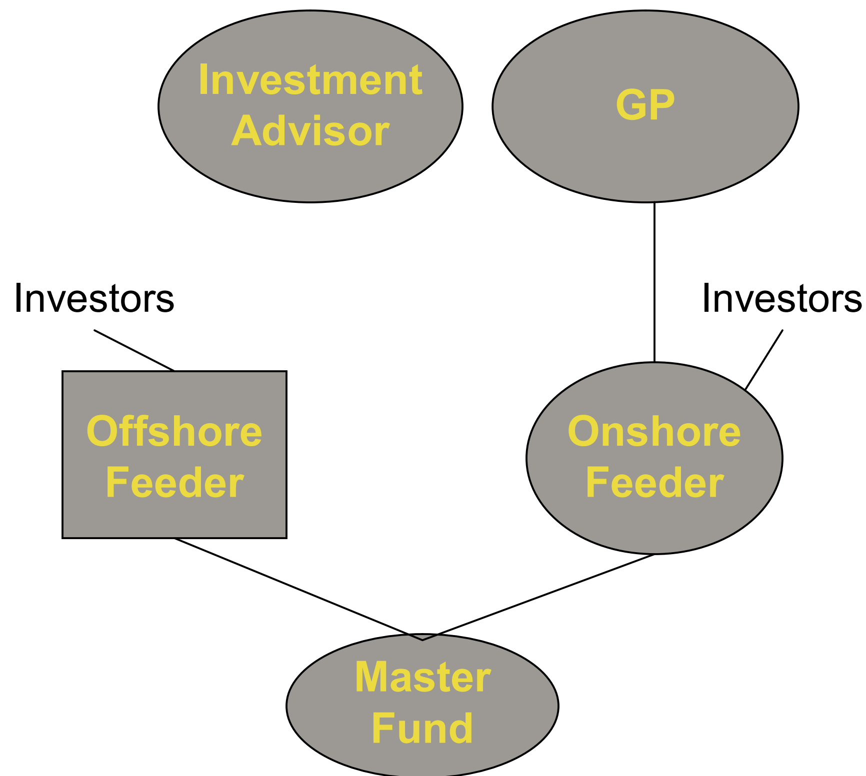
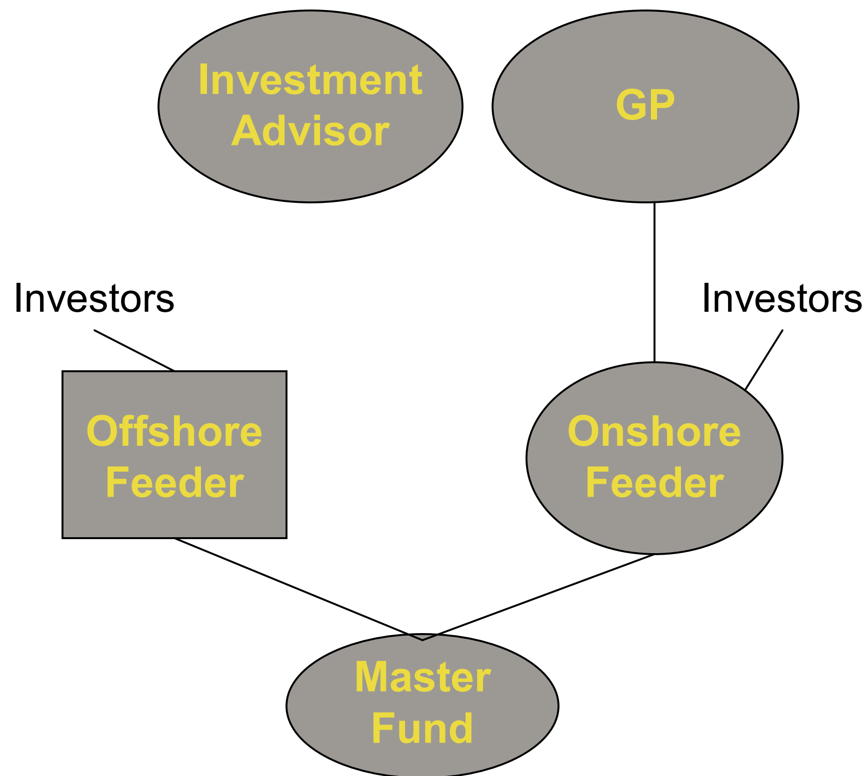
Basic Hedge Fund Structuring: Master Fund (cont.)



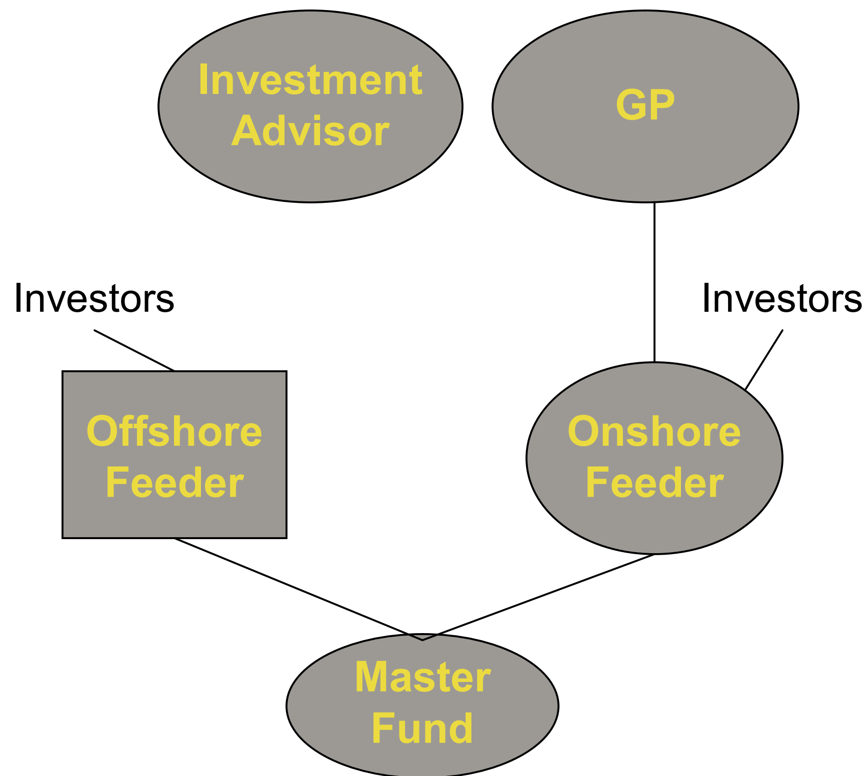
- May be US or non-US entity
  - Non-US master fund most common
  - US entity may simplify US withholding tax issues
  - If non-US entity, foreign withholding partnership rules may avoid over-withholding
  - Non-US entity reduces possibility that investee corporation treated as CFC

Basic Hedge Fund Structuring: Offshore Feeder



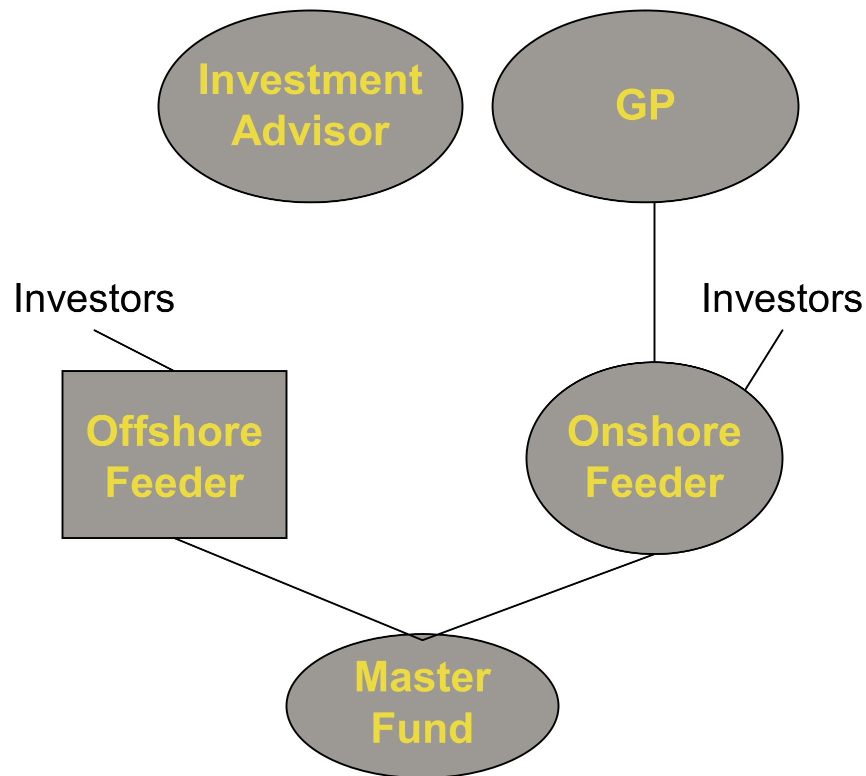
- Investment vehicle for US tax-exempt investors and non-US investors
  - Classified as corporation for US tax purposes.
  - Blocks UBTI for US tax-exempt investors
  - Blocks ECI for non-US investors
  - May incur US withholding taxes and US tax liability and branch profits tax on ECI

Basic Hedge Fund Structuring: Offshore Feeder (cont.)



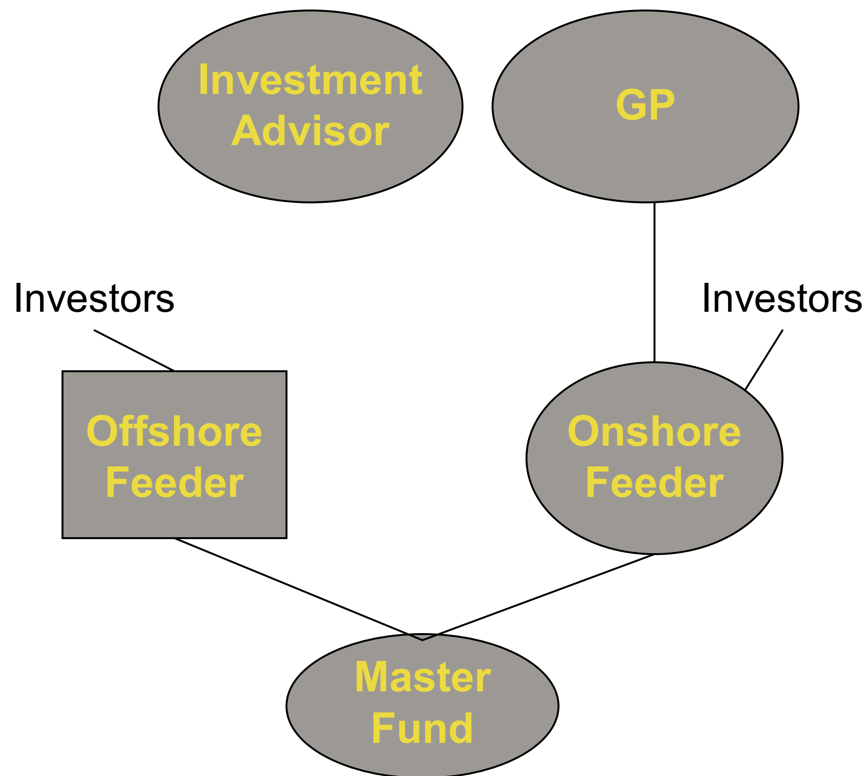
- UBTI blocker
  - Trade or business income
  - Debt-financed income
- ECI blocker
  - Trade or business income.
  - FIRPTA gains
  - Section 864 safe harbors for trading stocks, securities, commodities, and derivatives

Basic Hedge Fund Structuring: Offshore Feeder (cont.)



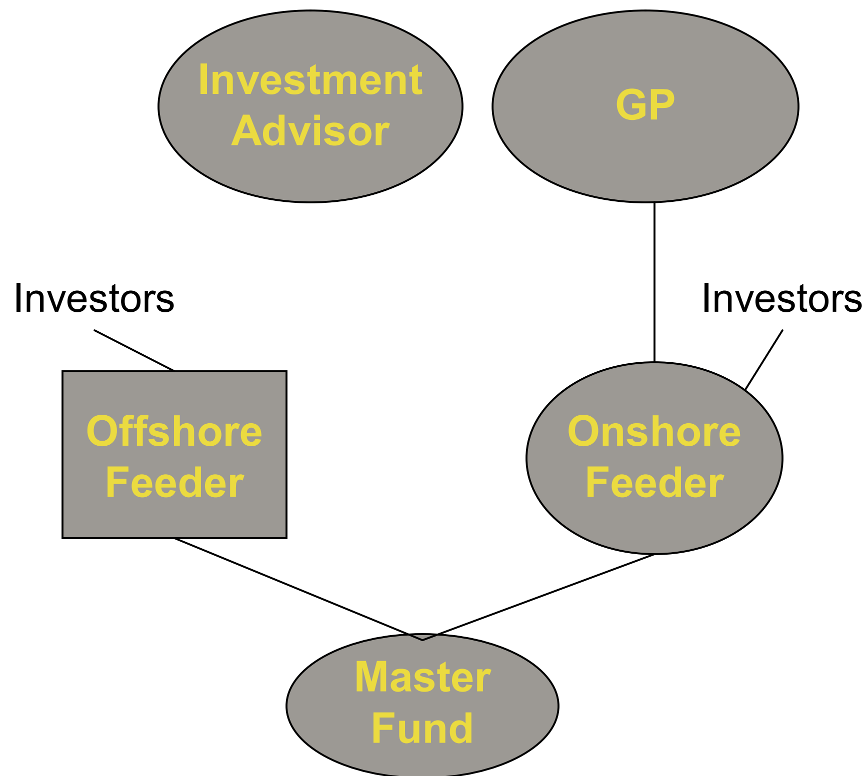
- Offshore feeder would be a PFIC and, accordingly, is generally considered unattractive to US taxable investors
- If US investor has access to sufficient information to make QEF election, may benefit from avoiding investment expense limitations

Basic Hedge Fund Structuring: Onshore Feeder



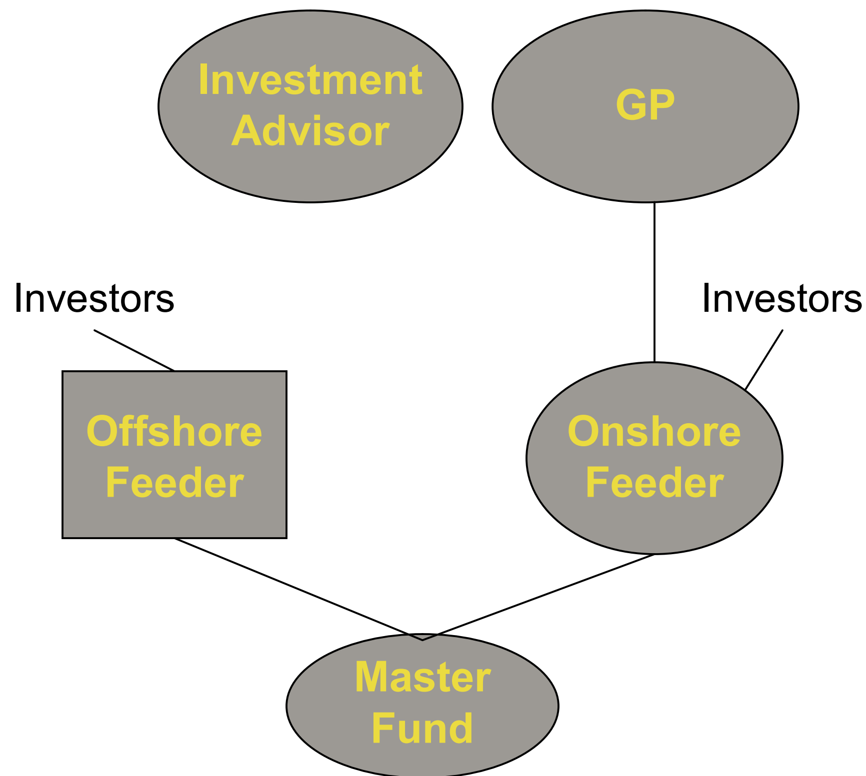
- Investment vehicle for US taxable investors
  - Avoid entity-level tax
  - Character flow-through
- Sometimes also used by state pension plans not subject to tax on UBTI
- Limited partnerships historically chosen rather than LLCs.

Basic Hedge Fund Structuring: Onshore Feeder (cont.)



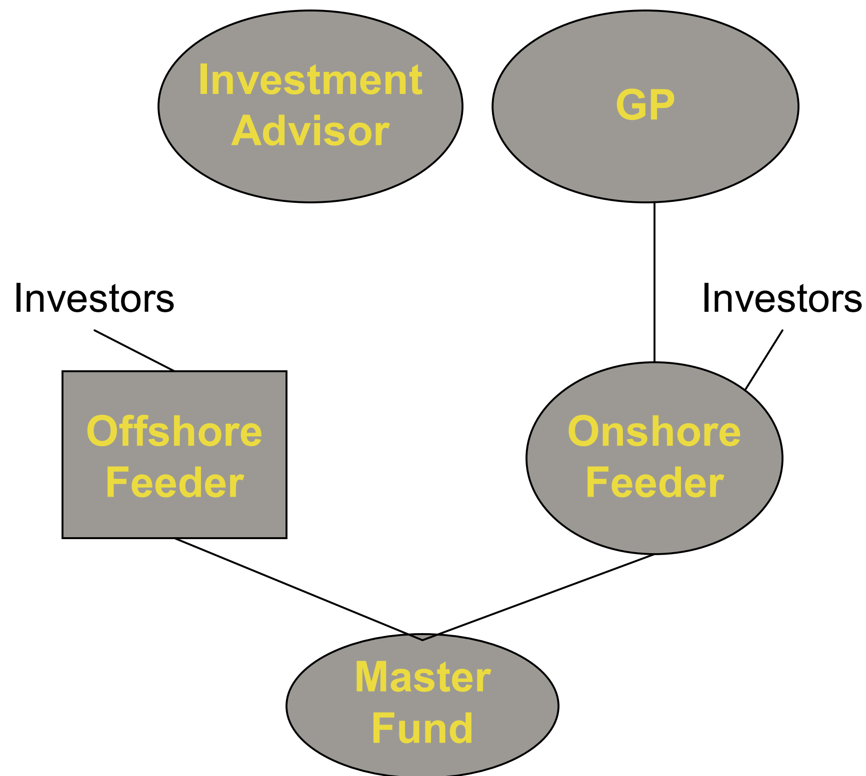
- Investors in Onshore Feeder and Offshore Feeder have periodic redemption rights
- Redemption rights create risk that Onshore Feeder could be publicly traded partnership taxed as a corporation
  - Exception if no more than 100 partners
  - Exception if 90% of gross income every year is passive income
  - Exception for certain limited redemption plans

Basic Hedge Fund Structuring: Both Feeders



- May issue different classes of interests
  - Tracking incentive allocations for shares issued between incentive fee calculation dates
  - Different redemption rights.
  - Different management fees and/or incentive fees
  - Classes that participate or do not participate in new issues
  - Different currency denominations

Hedge Fund Structuring Issues:
Investment Advisor & General Partnership



- Typically structured as US LLCs
- Sometimes separate investment advisor and GP:
  - Facilitates different ownership
  - Avoids NYC UBT on incentive allocation to GP if Investment Advisor has an office in NYC

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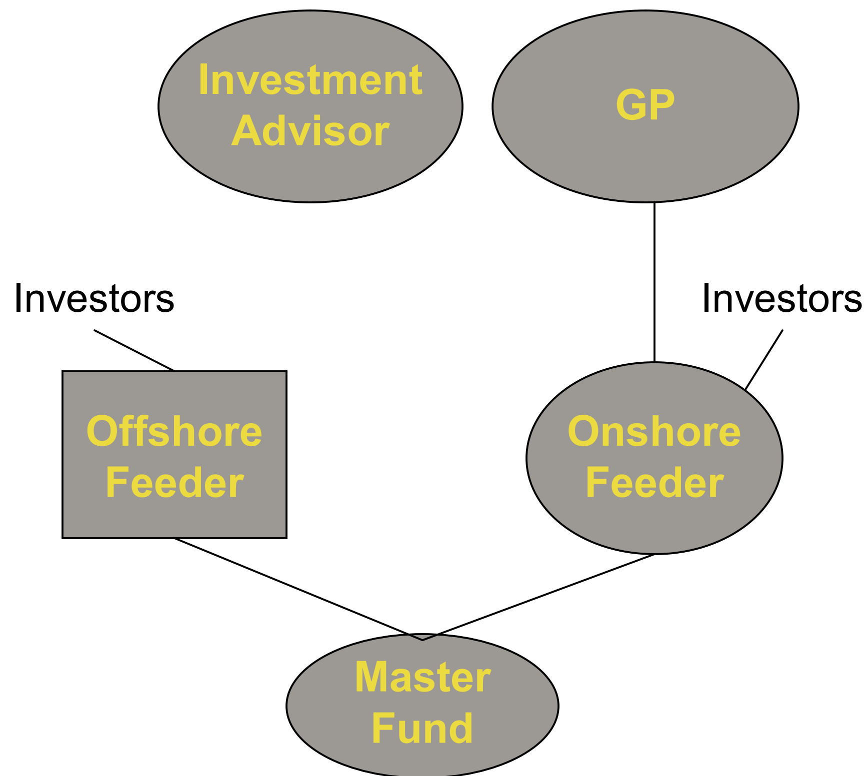
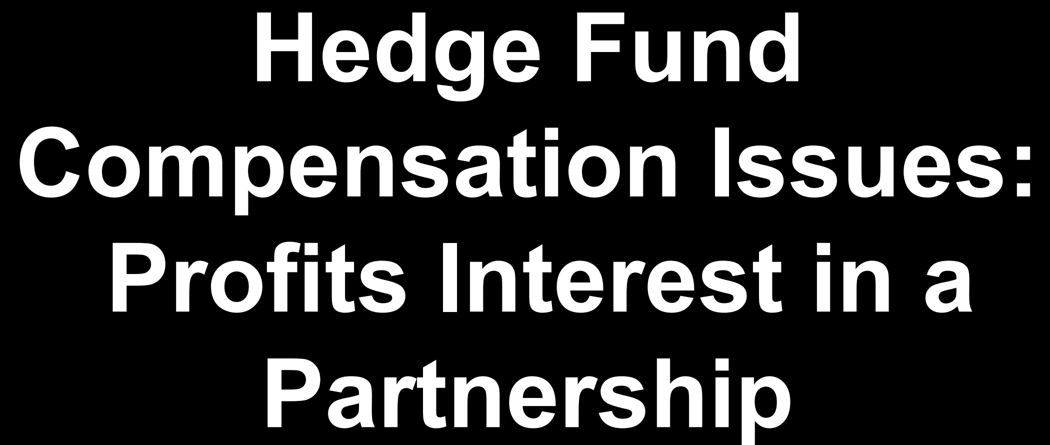
Overview of Hedge Fund Manager Compensation



- Management fees paid by Offshore Feeder and Onshore Feeder – generally 1-2% of NAV
  - Deferrable under 409A.
- Incentive compensation ("carried interest") – generally 20% of increase in NAV over high-water mark
  - Profits allocation from Onshore Feeder to GP (partnership profits interest)
  - Deferrable fee from Offshore Feeder to Investment Advisor
  - Alternatively, allocation or fee from Master Fund, based on calculations at Feeder Funds level
  - Calculated quarterly, semi-annually, or annually-accelerated with respect to redeeming investors



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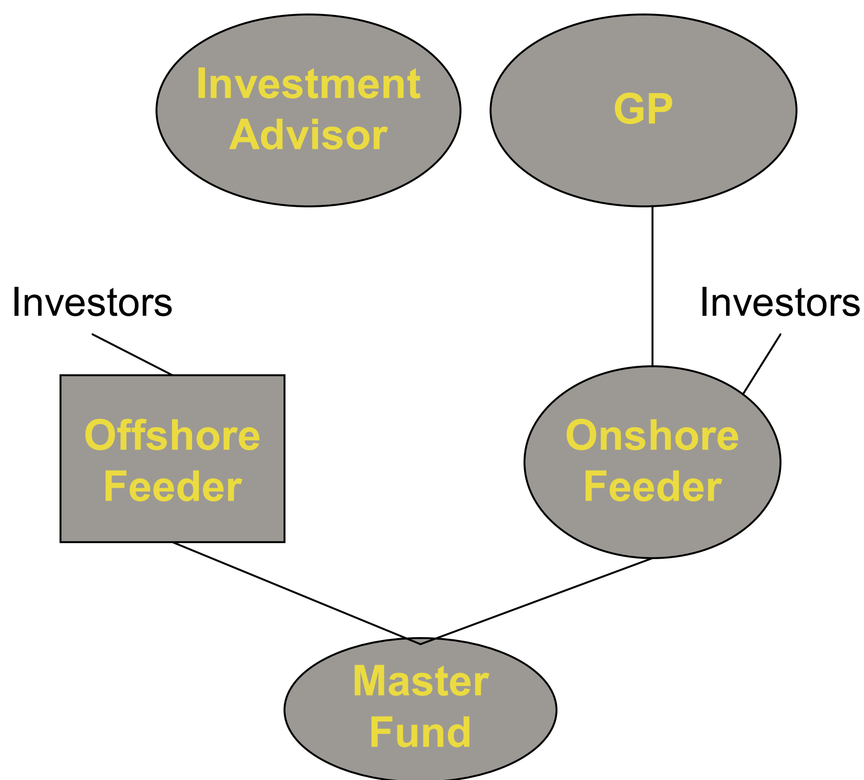
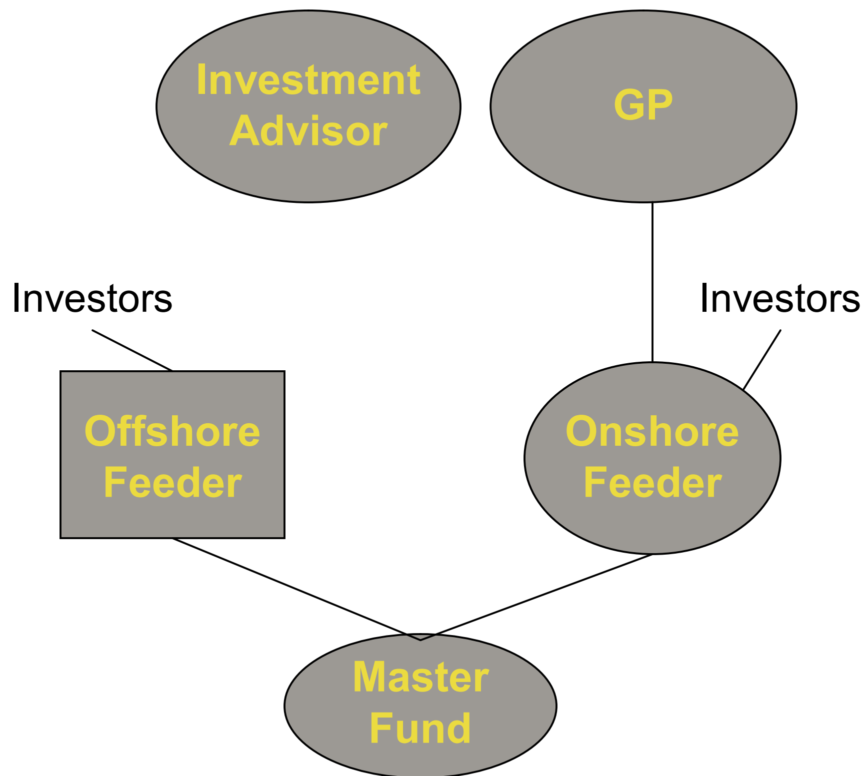
Hedge Fund Compensation Issues: Profits Interest in Partnership



- Investment Advisor, GP, and Onshore Feeder classified as partnerships for US tax purposes
- Incentive allocation from Onshore Feeder and interests in Investment Advisor and GP structured as profits interests

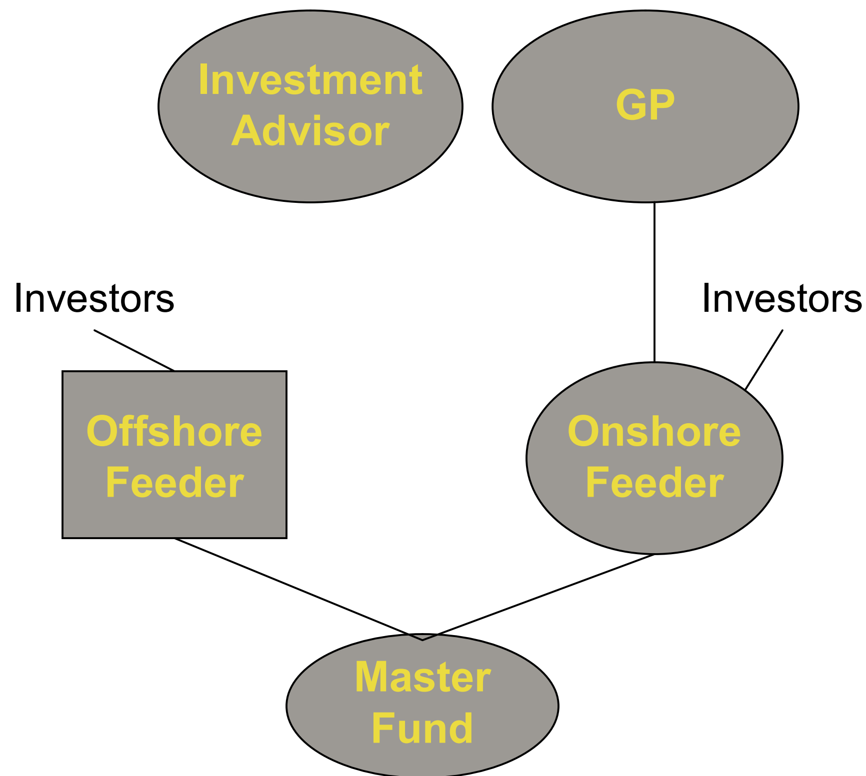
Hedge Fund Compensation Issues: Profits Interest in Partnership (cont.)



Benefits of Using Profits Interests

- Tax-free receipt of profits interests
- Character flow-through
- Capital gain on sale of interest
- Deferral until gain recognized by Master Fund
  - Less significant for hedge funds with frequent trading or mark-to-market for tax purposes, e.g., section 1256 contracts
- No self-employment taxes on distributions
- Section 409A inapplicable
- May avoid investment expense limitations for investors

Profits Interest in Partnership: Current Tax Rules



- Capital interest v. profits interest:
  - Capital interest = some liquidation value
  - Profits interest = anything other than capital interest (including "carried interest")
- Receiving a partnership interest for services:
  - Capital interest for services is taxable
  - Currently: IRS generally won't attempt to tax the receipt of a profits interest for services Rev. Proc. 93-27
  - Currently: Generally no need for section 83(b) election on unvested profits interest for services

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Profits Interest in Partnership:
Proposed Changes to Current IRS Rules

- Proposed regulations issued in May 2005 would apply section 83 to receipt of a profits interest for services
- However, the proposed rules generally would allow tax-free receipt of a profits interest, if the right elections are made:
  - "Safe harbor" liquidation value election.
  - Section 83(b) election (for unvested interests)

- "Safe Harbor" liquidation election:
  - Value of partnership interest equals "liquidation value"
  - Pure profits interest has no liquidation value
  - Requirements for making an effective election:
    - Partnership agreement must contain provisions, legally binding on all of the partners, that all partners agree to comply with the safe harbor
    - Alternatively, each partner in the partnership must execute a legally binding document agreeing to the safe harbor
    - Forfeiture allocations
  - Effective date of election cannot be prior to execution date

Profits Interest in Partnership:
Proposed Changes to Current IRS Rules (cont.)

- If proper elections not made:
  - Upon grant of vested partnership interest, service partner taxable on the fair market value of the partnership interest
  - Value of partnership interest is the amount a willing buyer would pay a willing seller
  - Even a pure profits interest has some value

Profits Interest in Partnership:
Proposed Legislative Changes (cont.)

- Chairman Rangel's Tax Reform Bill (H.R. 3970) and the "Temporary Tax Relief Act of 2007" (H.R. 3996) as passed by the House
- Would characterize all income allocated to an "investment services partnership interest" as ordinary income from services, regardless of the nature of the income earned by the partnership
- SECA would also apply to such income

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Profits Interest in Partnership:
Proposed Legislative Changes (cont.)

- Exception for capital interests, i.e., the portion of a service providers interest that is acquired for invested capital
  - Only a “reasonable allocation” to the service provider’s capital interest is permitted
  - An allocation is not reasonable if the service provider is allocated more than a partner with equivalent invested capital who does not provide services

Profits Interest in Partnership:
Proposed Legislative Changes (cont.)

- Theory of the proposal is that the distributions are payments for personal services and should be taxed as such
- Estimated Revenue Gain (over 10 Years)--$25 Billion

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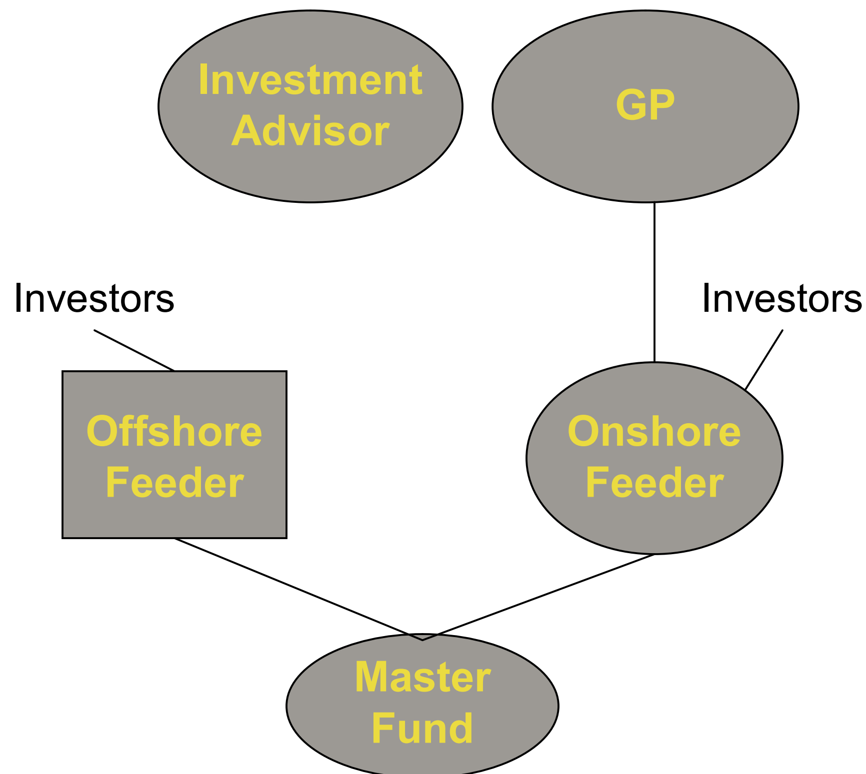
Hedge Fund Compensation Issues: Deferral of Fee Income



Incentive Fee From Offshore Feeder

- Investment Advisor may have right to defer receipt of incentive fees from Offshore Feeder
- Deferral of taxation if:
  - Offshore Feeder uses cash, rather than accrual, method for tax purposes (Investment Advisor may not use cash method if any corporate members)
  - Avoid constructive receipt
- Section 409A requirements are satisfied

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Deferral of Fee Income: Impact of Section 409A

- Significant penalties if section 409A requirements not met
  - Deferral is lost - amounts includible in income when vested
  - Additional 20% tax on ALL deferred amounts (not just those with respect to which a violation occurred);
  - Plus interest on ALL deferred amounts;
  - The service provider liable for the additional tax and interest

Deferral of Fee Income:
Requirements of Section 409A

- Provided section 409A rules are satisfied, the Investment Advisor may choose:
  - How much fee income to defer
  - When the deferred amounts are to be paid.
  - The form of payment of deferred amounts (e.g., installment payments or a lump sum)

Deferral of Fee Income:
Requirements of Section 409A (cont.)

- Strict timing rules on when elections to defer must be made
  - Generally, election must be made in the taxable year before the year in which the services are performed
- Elections to select the time and form of payment must be made at the time of the deferral election

Deferral of Fee Income:
Requirements of Section 409A (cont.)

- Limited opportunities to change the time and form of payment after the initial deferral election
  - Subsequent elections generally cannot be effective until one year after the election is made
  - Acceleration of distributions not permitted
  - New election must defer payment for at least 5 additional years
- Prohibition on offshore funding of deferred compensation

Deferral of Fee Income:
Deferral of Compensation by Employees of Investment Advisor

- Investment Advisor may desire to share management fee with employees; employee deferrals also subject to section 409A rules
- Typical structure
  - Employees elect time and form of payment in accordance with section 409A
  - Payments are made by the fund to Investment Advisor based on employee elections; Investment Advisor then makes payments to employees

Deferral of Fee Income:
Deferral of Compensation by Employees of Investment Advisor (cont.)

- Section 409A has special rules permitting such "back to back" arrangements
  - Unclear under Section 409A whether payments to employees may be made based on events at the Investment Advisor level ("reverse back to back" arrangements)
  - Example: Arrangement provides that all deferred amounts (by Investment Advisor and employees of the Investment Advisor) are paid if the contract between the Investment Advisor and fund terminates

Deferral of Fee Income: Legislative Proposals

- Headlines contribute to perception by policymakers that fund managers earn substantial amounts that are not adequately taxed
- “1 Man, 1Year $3.7 Billion Payout” Washington Post, April 17, 2008
- “Wall Street Winners Get Billion Dollar Pay Days” The New York Times, April 16, 2008
- “Managers Use Hedge Funds as Big I.R.A.’s” New York Times, April 17, 2007

Proposed Current Taxation of Offshore Deferred Compensation

- Most recent version: H.R. 6049, the “Energy and Tax Extenders Act of 2008”
- Compensation received from a “nonqualified entity” is includible in income when vested
  - If the amount of compensation is not readily ascertainable when vested, then income inclusion occurs when the amount is ascertainable, BUT an additional 20% tax and interest applies

Proposed Current Taxation of Offshore Deferred Compensation (cont.)

- Nonqualified entities:
  - Foreign corporations unless substantially all the income is effectively connected with a US trade or business or subject to a comprehensive foreign income tax
  - A partnership unless substantially all of its income is allocated to persons OTHER than foreign persons whose income is not subject to a comprehensive foreign tax and tax-exempt organizations
- Applies to compensation for services performed after 2008

- With respect to pre-2009 compensation that has already been deferred, applies to amounts otherwise includible in 2018 or later. Such amounts includible income in 2017 or, if later, when vested
- Projected to raise approximately $25 billion over 10 years

$1 Million Cap on Nonqualified Deferred Compensation

- Senate proposal from 2007; introduced in April 2008 by Senator Clinton (S. 2866)
- Would impose an annual cap of $1 million on deferred compensation
- Deferred compensation in excess of the cap would be taxable when vested
- Not targeted at hedge funds; would apply to all nonqualified deferred compensation
- Initial estimate was approximately $900 million over 10 years

Allocations of Gains
and Losses

Hedge Fund Allocations: Overview

- Onshore Feeder limited partnership agreement periodically allocates to partners’ capital accounts increases in NAV based on beginning capital account balances, with reallocations to General Partner of incentive allocations
- Capital account allocations are not based on tax realization principles

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Hedge Fund Allocations: Overview (cont.)

- Tax items generally to be allocated consistent with capital account allocations – subject to stuffing allocations with respect to redeeming partners
- Separate allocations (and management fees and incentive allocations) for side pocket investments that are illiquid and/or difficult to value

Stuffing Allocations: The Problem

- Investor X owns 10% of Fund and asks to be redeemed
  - X's capital account (amount to be received on redemption) is $100
  - X's tax basis in the Fund is $80
- To redeem X, Fund sells securities worth $100, and recognizes $20 gain (taxable). Normally, if Fund has $20 gain:
  - X is allocated (pays tax on) $2
  - Remaining investors are allocated (pay tax on) $18

Stuffing Allocations: The Problem (cont.)

- Remaining investors complain that X gets all the cash, but they get stuck with 90% of the taxable income
- What to do?

Stuffing Allocations: A Solution?

- Remaining investors say: allocate all $20 to X
  - They argue that X comes out the same either way
- If Fund allocates $2 of gain to X, X has $20 total gain:
  - $2 gain allocated from the partnership
  - $18 additional gain on receiving the $100 cash in redemption:
    - $100 cash – ($80 prior basis + $2 newly allocated gain) = $18

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Stuffing Allocations: A Solution? (cont.)

- If Fund allocates all $20 of gain to X, X still has $20 total gain:
  - – $20 gain allocated from the partnership
  - – $ 0 additional gain on receiving the $100 cash in redemption:
    - $100 cash – ($80 prior basis + $20 newly allocated gain) = $0

Stuffing Allocations: A Solution?

- Assume for simplicity all the gain is long-term capital gain
  - So X doesn't care whether he is allocated $2 or $20
  - However, the other investors have avoided an allocation of $18 gain
  - Generally, all gain is not long-term capital gain; redeemed investor may be allocated short-term capital gain, displacing long-term capital gain on redemption payments

Stuffing Allocations: A Solution? (cont.)

- Allocating that extra $18 to X is a “stuffing” or “fill-up” allocation
  - It fills X’s tax basis up to the amount of X’s capital account, so X has no additional gain on the redemption distribution

Stuffing Allocations: A Solution?

- Fill-up allocations seem intuitively fair; the taxable gain is allocated to the investor who gets the cash
- However, fill-up allocations are controversial
  - Allocations generally are supposed to affect the dollar amounts an investor receives; otherwise the allocations lack "economic effect"
  - X receives the same $100 distribution with or without the fill-up allocation

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Derivative Interests in Hedge Funds: Who Might Be Interested?

- Non-U.S. Investors – Conversion of dividend income into foreign source (and therefore exempt) capital gain or swap payments
- U.S. Individuals – Potential conversion of short-term capital gain and ordinary income into long-term capital gain, as well as deferral

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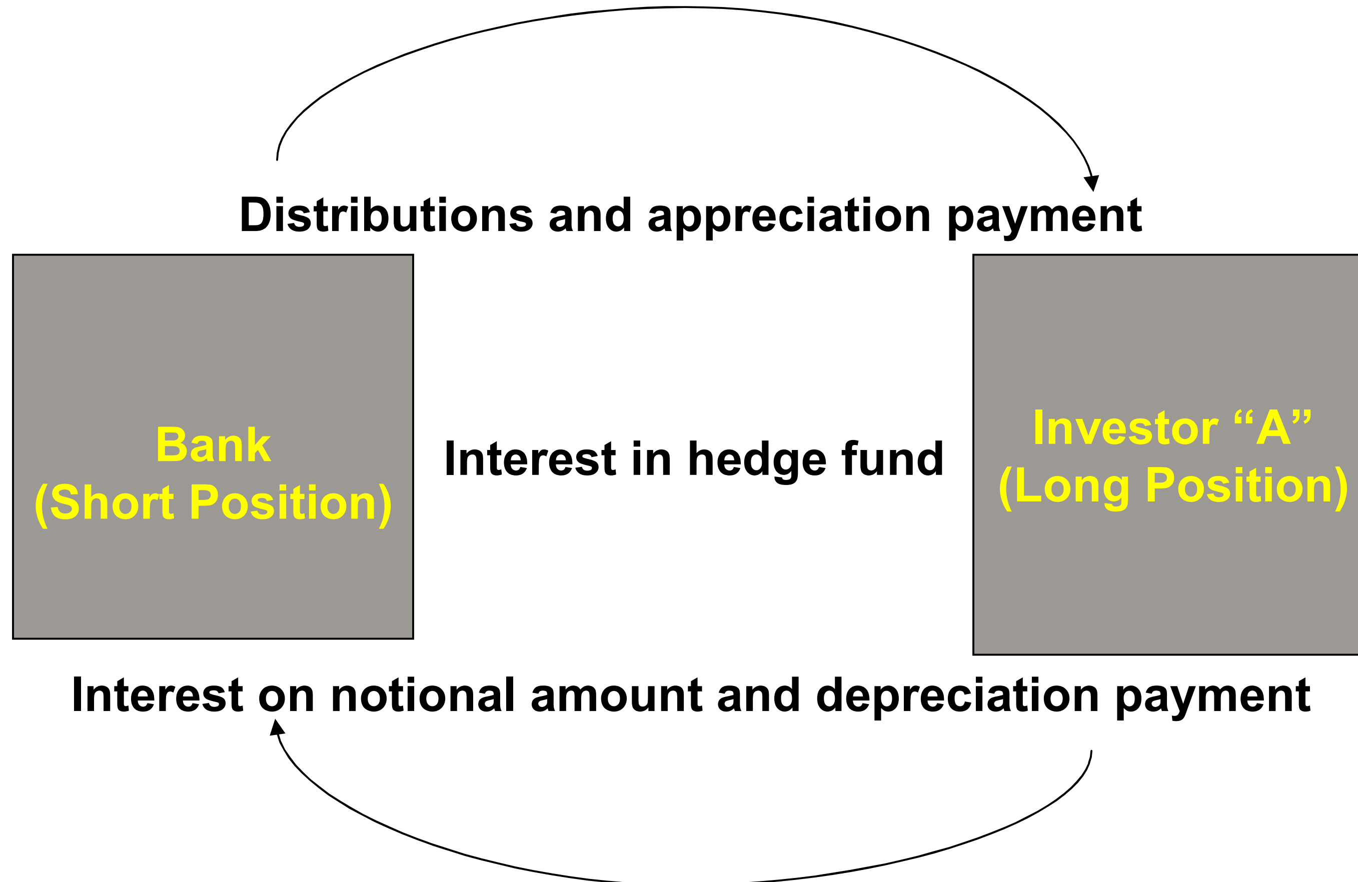
Derivative Interests in Hedge Funds: Non-U.S Investors

- Tax stakes: Avoiding common law ownership
- Technique: Total Return Swap over hedge fund value

Derivative Interests in Hedge Funds:
Total Return Swap on Hedge Fund Value

- Dealer pays appreciation in hedge fund's value periodically or at end of term
- Dealer pays distribution-equivalent amount currently
- Customer pays depreciation in hedge fund's value periodically or at end of term
- Customer pays LIBOR plus a credit spread periodically

Derivative Interests in Hedge Funds: Total Return Swap (cont.)



- US withholding tax treatment of payments of FDAP
  - Foreign investors generally subject to 30% withholding tax on U.S. – source payments of FDAP
  - Income from equity swaps (i.e., NPCs) sourced according to residence of recipient. Reg. § 1.863-7(b)
  - Thus, payments received by a foreign investor under an equity swap will be foreign-source income and not subject to withholding tax. Reg. § 1.1441-4(a)(3)(i)

Derivative Interests in Hedge Funds: Total Return Swap (cont.)

- Long counterparty should not be treated as tax owner under common law
  - Factors favoring transfer of ownership
    - Benefit from appreciation
    - Bear risk of loss for depreciation
  - Factors against transfer of ownership
    - No right to receive or sell fund shares
    - No right to vote fund shares
    - Have no creditor interest in the hedge fund
    - Short limited duration of ownership in swap

- Tax stakes:
  - Must avoid common law ownership – see analysis above
  - Must also avoid Section 1260
    - Section 1260 is intended to prevent taxpayers from entering into derivative contracts for the purpose of converting ordinary income into long-term capital gain and deferring recognition of income until maturity of contract
    - Section 1260 re-characterizes long-term capital gain into ordinary income and imposes interest charge on any deferral

Derivative Interests in Hedge Funds: Section 1260

- Applies to (i) long-position under equity swaps; (ii) forward to acquire an asset; (iii) same strike collars and (iv) transactions having "substantially same effect"
- Section 1260 does not affect tax ownership for any other purpose of the Code
- Section 1260 does not apply to foreign persons

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Derivative Interests in Hedge Funds: Avoiding Section 1260

- Two basic types of options:
  - Black-Scholes Option – Hard for dealer to hedge, so likely expensive. Very robust from tax perspective
  - Structured Options – More aggressive from tax perspective
    - CPPI option – Underlying consists of a debt or debts plus hedge fund interests
    - Accreting strike price option – Leveraged option where strike price increases at LIBOR plus credit spread

- Contingent payment debt rules may apply
  - U.S. holders would be subject to tax under the OID regulations based on the “comparable yield” of the issuer
  - Would be treated as interest income
  - All gains on sale ordinary
- Non-U.S. holders arguably exempt from tax under the portfolio interest rules

ERISA Implications

ERISA Implications: Overview

- Private pension plans, IRAs, and Governmental pension plans are likely investors
- Private pension plans are subject to ERISA
  - ERISA imposes strict fiduciary rules on persons who invest "plan assets"
  - ERISA prohibits certain transactions between a plan and parties in interest to a plan (including fiduciaries and service providers)
  - ERISA imposes personal liability on plan fiduciaries for losses; civil penalties and excise taxes apply to prohibited transactions

ERISA Implications: Overview (cont.)

- IRAs are not subject to ERISA's fiduciary rules, but are subject to prohibited transaction rules under the Internal Revenue Code
- Governmental plans are not subject to ERISA, but are subject to regulation under State law

ERISA Implications: Plan Asset Rules

- If a plan acquires an equity interest in another entity, the plan's assets include both the equity interest and an undivided interest in each of the entity's underlying assets unless:
  - the investment is a *publicly offered security*
  - the entity is an *operating company*; or
  - equity participation in the entity by benefit plan investors is *not significant*
- There is also a statutory exemption for investments in mutual funds

ERISA Implications: Significant Investment Test

- Investment by Benefit Plan Investors is not significant if less than 25% of the value of any class of the fund's equity interests is held by benefit plan investors
- Benefit plan investors include only those investors subject to ERISA or the Code prohibited transaction rules
  - Governmental plans are not considered benefit plan investors
- The interest of the investment manager is disregarded in applying the test

- Test is a ratio test determined by the ratio of Benefit Plan Investors to total investments in the fund
- Example: Fund has a single class of equity interests
  - $15,000 held by ERISA Plans
  - $5,000 held by IRAs
  - $20,000 held by the Fund manager (disregarded)
  - $40,000 by governmental plans
  - $20,000 held by non tax-exempt investors
  - Investment by BPI is significant ($15,000 + $5,000)/($15,000 + $5,000 + $40,000 + $20,000) = 25%

ERISA Implications: Significant Investment Test

- If a plan asset entity makes an investment in another entity (i.e., an investment fund) only the percentage of the equity interest held by the Benefit Plan Investors is taken into account
- Example: Investment Fund A makes an investment in Fund B. 30% of the equity of Fund A is held by Benefit Plan Investors. Fund A buys 40% of the equity of Fund B. In applying the test to Fund B, only 12% (30% x 40%) of Fund A's investment is considered to be investment by Benefit Plan Investors

ERISA Implications: Publicly-Offered Securities

- A security is deemed to be publicly-offered it if satisfies all three requirements:
  - Part of a class of securities registered under section 12(b) or 12(g) of the ’34 Act or part of a public offering under ’33 Act registration statement and class of securities is registered under the ’34 Act when purchased;
  - *Widely-held* (if it is owned by 100 or more investors that are independent of the issuer and each other); and
  - *Freely-transferable*.
    - Factual question.
    - If the minimum investment is less than $10,000, presumption is that the security is freely transferable.