

# Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers

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## I. Overall Structure of the Hedge Fund—Tax Issues

The structure of a hedge fund is generally designed to be tax and administratively efficient, and is largely dependent upon the classes of investors—for example, U.S. taxable, foreign, and U.S. tax-exempt—the asset classes, and sometimes upon the jurisdictions in which the individual investment management professionals will be located—such as structuring necessary to minimize the New York City unincorporated business tax.

A group of individual investment professionals will manage the hedge fund's portfolio and will also function as its general partner. In most cases the investment professionals will form two entities, both treated as partnerships for U.S. federal income tax purposes: one entity—the “investment manager”—to manage the portfolio and receive management fees—that is, the “2” in a 2/20 compensation structure—and a different entity—the “general partner”—to receive incentive compensation in the form of a carried interest—the “20” in a 2/20 compensation structure.

The individual investment professionals will often be limited partners in both entities but pay self-employment tax only on their interest in the entity receiving the management fees—the investment manager—and then only with respect to their general partnership interest in the investment manager. They will not typically pay self-employment tax<sup>1</sup> with respect to the income and gain allocated to them under the carried interest held by the general partner entity. In addition, individual investment professionals located in New York City will typically pay New York City unincorporated business tax<sup>2</sup> only on the earnings of the investment manager—the management fees.

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<sup>1</sup> See *infra* Part VI.D for a discussion on the self-employment tax.

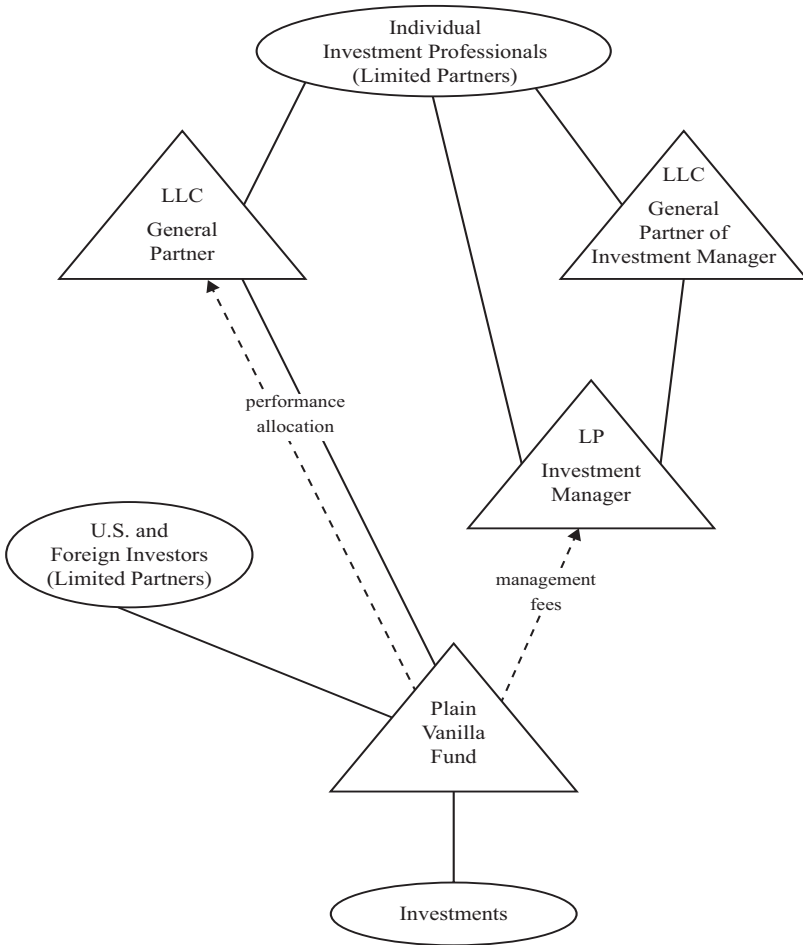
<sup>2</sup> See *infra* Part VI.E for a discussion on the New York City unincorporated business tax.

There are five common hedge fund structures. This Part describes those structures, the rationale behind each structure, and the situations for which each structure is best suited.

*A. The Plain Vanilla Domestic Structure*

If all of the investors in a hedge fund will be U.S. taxable investors, then the fund is generally structured as a single limited partnership or limited liability company that is treated as a partnership for U.S. federal income tax purposes. The investors in the fund are treated as partners in the partnership for U.S. federal income tax purposes.

**Plain Vanilla Domestic Structure**



There are several reasons to use an entity that is treated as a partnership for U.S. federal income tax purposes. First, partnerships are not subject to

an entity level tax. Instead, each partner reports its allocable share of the partnership's income, gain, loss, deduction, and credit in its income for each year.<sup>3</sup> So, if a hedge fund incurs losses during the year, a partnership structure may allow the investors to claim their share of these losses which, subject to limitations, may be used by investors to offset their other, nonfund income. Second, the character of partnership income, gain, loss, deduction, and credit passes through to its partners.<sup>4</sup> Thus, if a partnership earns long-term capital gains or qualified dividend income and allocates a portion of these gains or dividends to a partner, the partner will report long-term capital gains or qualified dividend income.

Finally, and importantly, if the individual members of the management team receive a portion of their compensation in the form of a "carried interest" or a "profits interest" in a partnership—the "20" of a "2/20" compensation structure<sup>5</sup>—allocated to the general partner, they may avoid reporting the value of the carried interest in income and avoid section 457A, which applies only to contingent fees and does not apply to carried interests.<sup>6</sup> Moreover, under current law, any allocations of long-term capital gains or qualified dividend income to the general partner as part of its carried interest would retain their character in the hands of the individual members of the general

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<sup>3</sup>I.R.C. §§ 701–702.

<sup>4</sup>I.R.C. § 702(b).

<sup>5</sup>The management team typically receives two types of compensation in return for structuring the hedge fund and managing its assets. In a "2/20" compensation structure, the "2" and the "20" refer to each of the components. First, the investment manager receives a periodic management fee normally calculated as a percentage of the fund's net asset value at the time the fee is paid. The typical fee ranges from 1% to 2% per year. This portion of the manager's compensation is the "2" of the "2/20." The fee does not depend upon the performance of the fund and is generally characterized as ordinary income and taxed at ordinary income tax rates. Second, the general partner, which is ordinarily affiliated with the investment manager, typically receives a performance payment in exchange for services provided to the fund, such as 20% of the fund's profits. This portion of the management team's compensation is the "20" of the "2/20." This portion of the compensation, referred to as the "carry" or "carried interest" is often structured as a "profits interest" in the partnership.

<sup>6</sup>I.R.C. § 457A; *see infra* Part VI.C.2.

partner and be subject to tax at reduced rates.<sup>7</sup>

However, legislation was introduced to change this last benefit of partnership treatment.<sup>8</sup> Although this legislation was not enacted, the Obama Administration has proposed ordinary income treatment for carried interests

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<sup>7</sup>The maximum rate of tax paid by an individual taxpayer on its net long-term capital gains and qualified dividends is 15%. This 15% rate is scheduled to expire for taxable years beginning after December 31, 2012. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150, *amended by* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 101(a)(1), 124 Stat. 3296, 3298. Accordingly, unless the law changes, in 2013, the maximum rate of tax on the net long-term capital gains of individuals will increase to 20% and all dividends—including qualified dividends—will be taxed at an ordinary income rate of 39.6%. The Obama Administration's Revenue Proposals for the Fiscal Year 2013 would allow the 15% tax rate applicable to net long-term capital gains to expire for high income individuals, resulting in a 20% tax rate on these gains, and would tax all dividends at ordinary income rates. See OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, *Budget of the U.S. Government Fiscal Year 2013* (Feb. 2012) [hereinafter OMB EXECUTIVE BUDGET 2013], available at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/budget.pdf>; DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals* (Feb. 2013) [hereinafter TREASURY REVENUE EXPLANATIONS 2013], available at <http://www.treasury.gov/resource-center/tax-policy/Documents/general-explanations-fy2013.pdf>. The proposal to tax qualified dividends at ordinary income rates is new. However, the Obama Administration has proposed a maximum net long-term capital gains tax rate of 20% every year in every year's budget since fiscal year 2010. See OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, *Budget of the U.S. Government Fiscal Year 2012* (Feb. 2011) [hereinafter OMB EXECUTIVE BUDGET 2012], available at <http://www.gpo.gov/fdsys/pkg/BUDGET-2012-BUD/pdf/BUDGET-2012-BUD.pdf>; DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals* (Feb. 2011) [hereinafter TREASURY REVENUE EXPLANATIONS 2012], available at <http://www.treasury.gov/resource-center/tax-policy/documents/general-explanations-fy2012.pdf>; OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, *Budget of the U.S. Government Fiscal Year 2011* (Feb. 2010) [hereinafter OMB EXECUTIVE BUDGET 2011], available at <http://www.gpo.gov/fdsys/pkg/BUDGET-2011-BUD/pdf/BUDGET-2011-BUD.pdf>; DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* (Feb. 2010) [hereinafter TREASURY REVENUE EXPLANATIONS 2011], available at <http://www.treasury.gov/resource-center/tax-policy/documents/general-explanations-fy2011.pdf>; OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, *Budget of the U.S. Government Fiscal Year 2010* (Feb. 2009) [hereinafter OMB EXECUTIVE BUDGET 2010], available at <http://www.gpo.gov/fdsys/pkg/BUDGET-2010-BUD/pdf/BUDGET-2010-BUD.pdf>; DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (Feb. 2009) [hereinafter TREASURY REVENUE EXPLANATIONS 2010], available at <http://www.treasury.gov/resource-center/tax-policy/documents/general-explanations-fy2010.pdf>. Finally, beginning in 2013, U.S. individuals will be subject to an additional 3.8% "Medicare tax" on their "net investment income" to the extent that their net investment income, when added to their other modified adjusted gross income, exceeds \$200,000 for an unmarried individual, \$250,000 for a married taxpayer filing a joint return—or a surviving spouse—or \$125,000 for a married individual filing a separate return. I.R.C. § 1411. Net investment income generally includes interest, dividends, and net capital gains. I.R.C. § 1411(c).

<sup>8</sup>See *infra* Part VI.G.2.

in the most recent budget proposals.<sup>9</sup>

Despite the benefits of a partnership structure for U.S. taxable investors, there is an increasing number of reasons why U.S. taxable investors may prefer to invest in a hedge fund through an entity that is treated as a foreign corporation for U.S. federal income tax purposes.<sup>10</sup>

### B. *The Master Feeder Structure*

If, in addition to U.S. taxable investors, a hedge fund's investors will include foreigners, or if the investors will include pension plans, foundations, or other U.S. tax-exempt organizations, and the fund will borrow to make its investments, then a "master feeder" structure may make sense.

In a typical master feeder structure, a "master fund" is formed offshore in a low-tax jurisdiction as a partnership or as a corporation that checks the box to be treated as a partnership for U.S. federal income tax purposes.<sup>11</sup> The master fund constitutes the main investing entity and holds the fund's portfolio of stocks and securities. The master fund is typically organized offshore for withholding tax reasons. If the master fund is a domestic entity treated as a partnership for tax purposes, it would be the withholding agent and would be required to withhold and make payments to the Service on any U.S.-source income with respect to which withholding is required, such as U.S.-source

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<sup>9</sup>See OMB EXECUTIVE BUDGET 2013, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2013, *supra* note 7; see also *infra* Part VI.B.2. The Obama Administration has introduced similar proposals in preceding Fiscal Years. See OMB EXECUTIVE BUDGET 2012, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2012, *supra* note 7; OMB EXECUTIVE BUDGET 2011, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2011, *supra* note 7; OMB EXECUTIVE BUDGET 2010, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2010, *supra* note 7.

<sup>10</sup>See *infra* Part V.G.

<sup>11</sup>The check-the-box regulations allow certain entities to elect their tax characterization—as a disregarded entity or partnership on the one hand, or a corporation on the other—for U.S. federal income tax purposes by filing an election with the Service. Domestic partnerships and limited liability companies are treated as disregarded entities—if they have only one member—or as partnerships—if they have two or more members—for U.S. federal income tax purposes but may elect to be treated as corporations for U.S. federal income tax purposes by filing Form 8832 with the Service. Reg. § 301.7701-3(b)(1), -3(c). A business entity organized or incorporated under federal or state law as a corporation may not elect to be treated as other than a corporation for U.S. federal tax purposes. Reg. §§ 301.7701-2(b)(1), -3(a). A foreign entity that provides all of its members with limited liability and certain foreign entities specifically identified in the check-the-box regulations as per se corporations are treated as corporations for U.S. federal income tax purposes. Reg. §§ 301.7701-2(b)(8), -3(b)(2)(i)(B). However, if at least one owner of a foreign entity has personal liability, the entity is treated as a partnership for U.S. federal income tax purposes or a disregarded entity if it has just a single owner. Reg. § 301.7701-3(b)(2)(i)(A). The check-the-box regulations allow a foreign entity that is not a per se corporation to elect out of its default classification by filing a Form 8832 with the Service. Reg. § 301.7701-3(c). Because the default characterization of foreign entities to some extent depends upon the interpretation of non-U.S. law—whether a member has limited liability—foreign hedge funds will often file a protective check-the-box election to ensure that they are characterized in accordance with their intent for U.S. federal income tax purposes.

dividends and nonportfolio interest, allocable to its foreign investors—the foreign feeder described below.<sup>12</sup> On the other hand, if the master fund is organized offshore, the broker or issuer making payments to the master fund would be the withholding agent for federal tax purposes.<sup>13</sup> In addition, if the master fund could be treated as a taxable mortgage pool, organizing the master fund offshore can avoid a U.S. federal corporate income tax.<sup>14</sup>

The master fund, in turn, has two limited partners. The first limited partner is usually an entity that is organized in a low-tax jurisdiction and is treated as a corporation for U.S. federal income tax purposes. Foreigners and tax-exempt organizations invest in this entity, which is called the “foreign feeder.” Investing through an entity that is treated as a foreign corporation for U.S. tax purposes allows tax-exempt organizations to avoid incurring unrelated business taxable income (UBTI) as a result of the fund’s borrowing, limits the risk that foreigners will be treated as engaged in a U.S. trade or business for tax purposes by reason of the master fund’s activities, and limits the possibility that the master fund’s trade or business activities will taint the foreigners’ unrelated income.<sup>15</sup>

The second limited partner of the master fund is typically a limited liability company or limited partnership that is treated as a partnership for U.S. federal income tax purposes—similar to the plain vanilla domestic fund. U.S. taxable investors invest through this entity, which is commonly called the “domestic feeder.” However, some structures permit U.S. taxable investors to

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<sup>12</sup> See Reg. § 1.1441-5(b)(1) (if a withholding agent can reliably associate a Service Form W-9 provided by a U.S. partnership, “the withholding agent may treat the payment as made to a U.S. payee and the payment is not subject to withholding under section 1441” even though the partnership may have foreign partners); Reg. § 1.1441-5(b)(2) (stating a U.S. partnership is required to withhold as a withholding agent on an amount subject to withholding that is “includible in the gross income of a partner that is a foreign person”).

<sup>13</sup> See Reg. § 1.1441-5(c) (payees of a payment to a nonwithholding foreign partnership are the partners).

<sup>14</sup> See *infra* Part II.A.3 (discussing taxable mortgage pools).

<sup>15</sup> See *infra* Parts III and IV.



invest directly in the offshore master fund.<sup>16</sup>

The master feeder structure is efficient because it permits hedge fund managers to pool the assets of investors with varied tax objectives, thereby reducing administrative expenses.

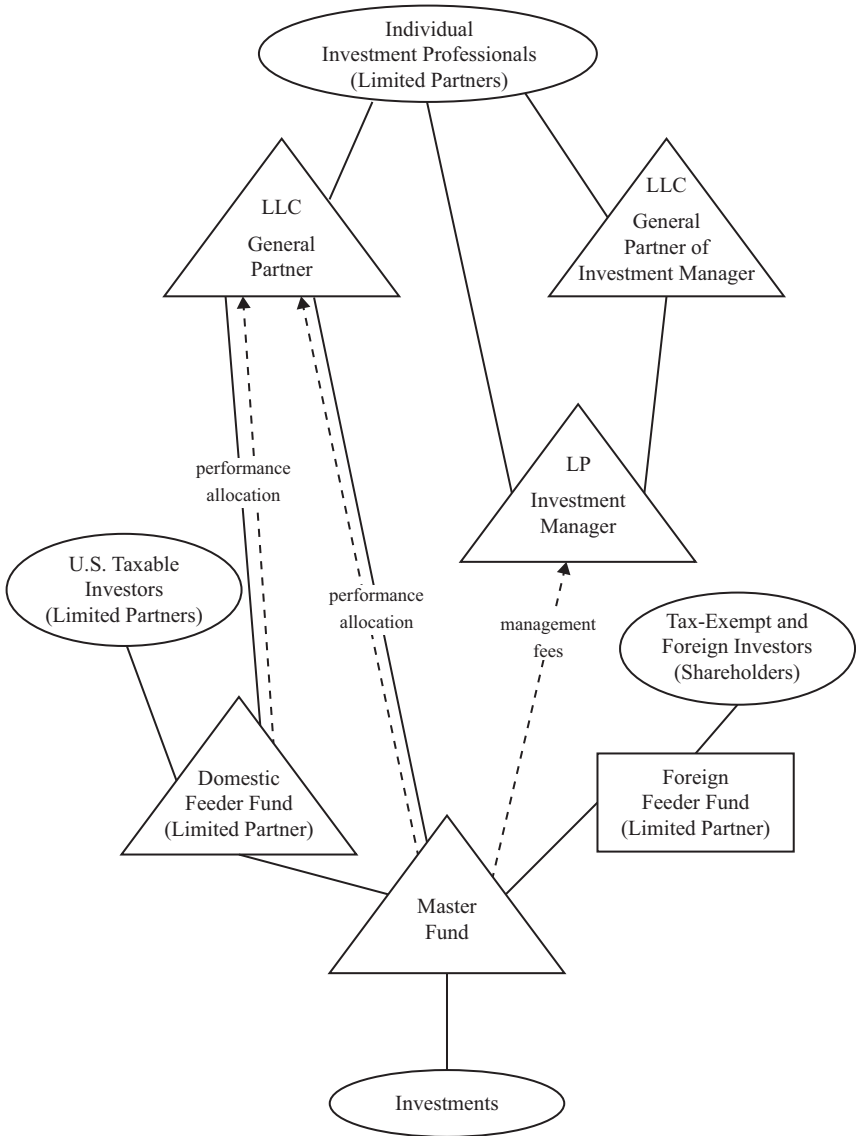
The investment manager may receive fees from the master fund or from each of the feeder funds and will typically receive its carried interest from the master fund.<sup>17</sup>

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<sup>16</sup>As an administrative matter, however, it may be simpler to have U.S. taxable investors invest through an entity that is treated as a domestic partnership for U.S. federal income tax purposes. This is because the master fund will need to provide to any person from which it will receive payments—for example, to brokers or to banks in order to open bank accounts—a Form W-8IMY with attachments of Forms W-8s and W-9s from all of its investors and a withholding statement allocating income to each investor. Accordingly, each time its investor composition changes, the master fund will have to update the Service forms and withholding statement provided to payors. Instead, if all U.S. taxable investors invest through a domestic entity that is treated as a partnership, then the domestic partnership will provide a single Form W-9 on behalf of itself to the master fund and the investor base of the master fund will consist solely of the domestic feeder and the offshore feeder funds. In addition, U.S. investors who invest directly in an offshore master fund may have additional filing requirements as a result of owning an interest in a foreign entity. See I.R.C. § 6046A (certain U.S. taxable investors with controlling interests in foreign partnerships must file Service Form 8865); I.R.C. § 6038D (individuals must report on their annual tax returns specified foreign financial assets, including interests held in a foreign hedge fund and other “foreign financial accounts” (discussed *infra* Part V.G.1.g), exceeding, in the aggregate, \$50,000 in value; the form for this reporting requirement has yet to be issued by the Service); DEPT OF THE TREASURY, *Report of Foreign Bank and Financial Accounts*, Form TD F 90-22.1 (Jan. 2012)(discussed *infra* Part V.G.1.g).

<sup>17</sup>As described above, to minimize federal self-employment tax and New York City unincorporated business tax if the investment manager is located in New York City, one entity would typically serve as the investment manager of the master fund and a second entity as the general partner of the master fund and the domestic feeder fund.

**Master Feeder Structure**



### C. *The Parallel or Side-by-Side Fund Structure*

As an alternative to the master feeder structure, a foreign fund and a domestic fund may be organized to operate separately but to invest alongside each other using a “parallel fund” or “side-by-side” structure. The parallel fund structure achieves many of the same tax efficiencies and attracts a similar set of investors as the master feeder structure. However, a parallel fund structure allows investment managers to manage the two funds differently to take into account restrictions with respect to the foreign fund that are designed to prevent it from being treated as “engaged in a trade or business in the United States” for federal income tax purposes, which would subject the foreign fund to U.S. federal corporate income tax and possibly state and local taxes and require the filing of U.S. federal tax returns.<sup>18</sup>

Frequently, the foreign fund in a parallel fund structure will, in turn, invest in a foreign entity that checks the box to be treated as a partnership for U.S. tax purposes. This entity is commonly referred to as a “mini-master fund” or a “mini-master.” The investment manager receives its incentive compensation in the form of a carried interest in the mini-master and thereby obtains the benefits of a carried interest<sup>19</sup> and avoids section 457A.<sup>20</sup>

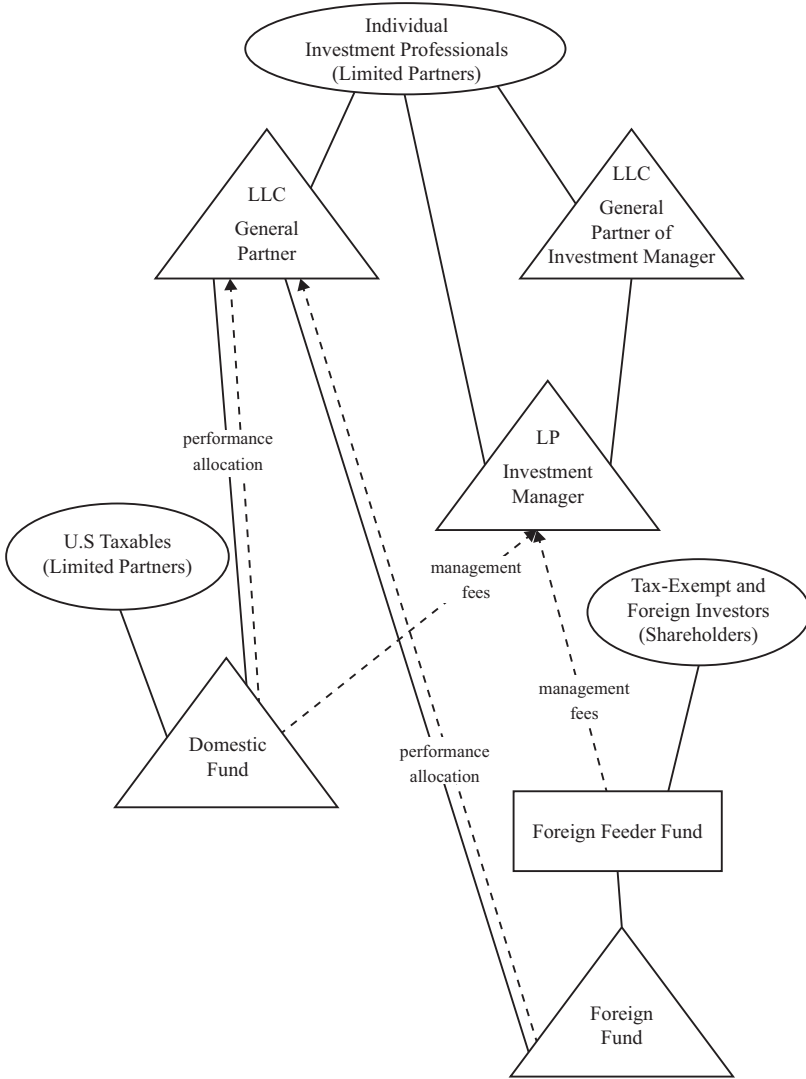
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<sup>18</sup> Reg. § 1.482.7; *see infra* Part IV.A.

<sup>19</sup> *See infra* Part VI.B.

<sup>20</sup> *See infra* Part VI.C.2.

**Side-By-Side Structure**

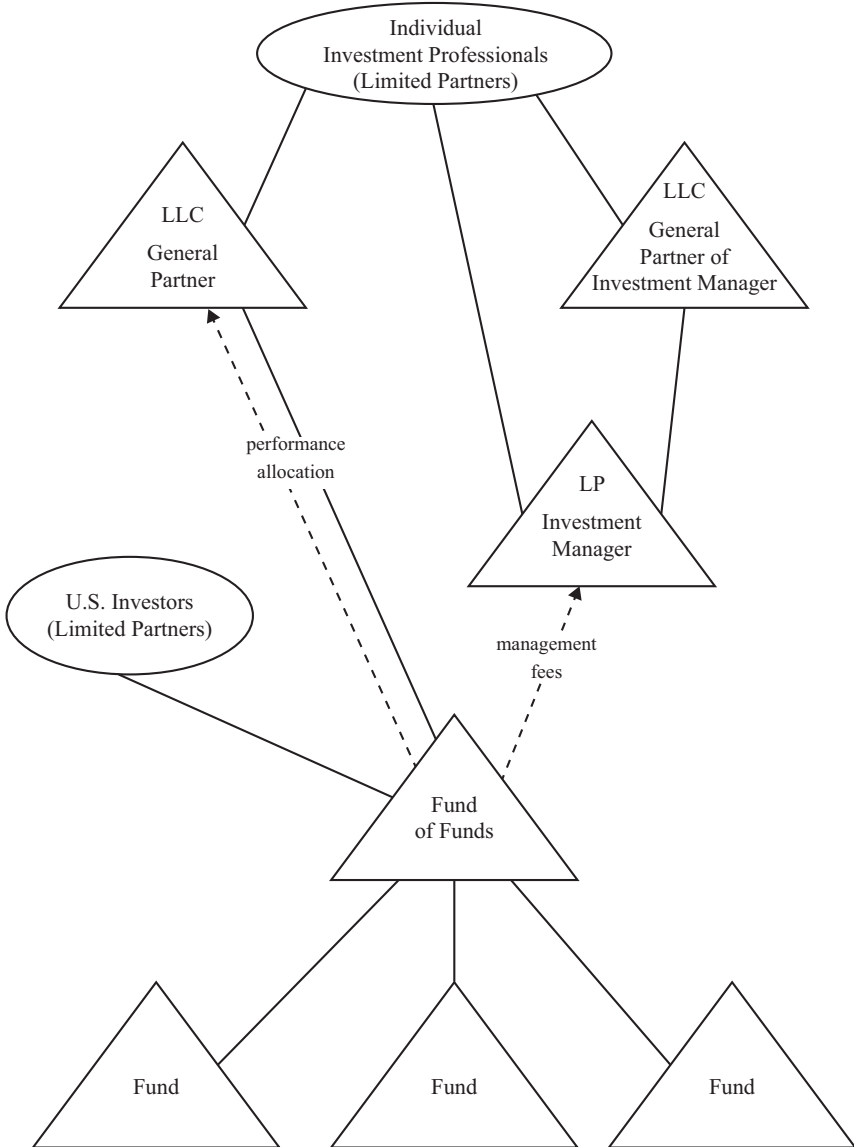


*D. The Fund of Funds Structure*

A “fund of funds” is a hedge fund that invests in a portfolio of other hedge funds. Investors seeking exposure to several hedge funds within a single investment category or across multiple categories, but that are not able to satisfy the minimum investment requirements for multiple funds or lack the resources to manage multiple investments, may choose to invest in a fund of funds to achieve greater diversity and less volatility or risk. However, the cost of investing in a fund of funds may be higher than the cost of investing in other hedge funds because the manager of the fund of funds typically charges

fees, which are in addition to the compensation being paid to the managers of the underlying hedge funds. The fund of funds strategy may be used by a plain vanilla fund, a master fund, or a parallel fund.

**Domestic Fund of Fund Structure**

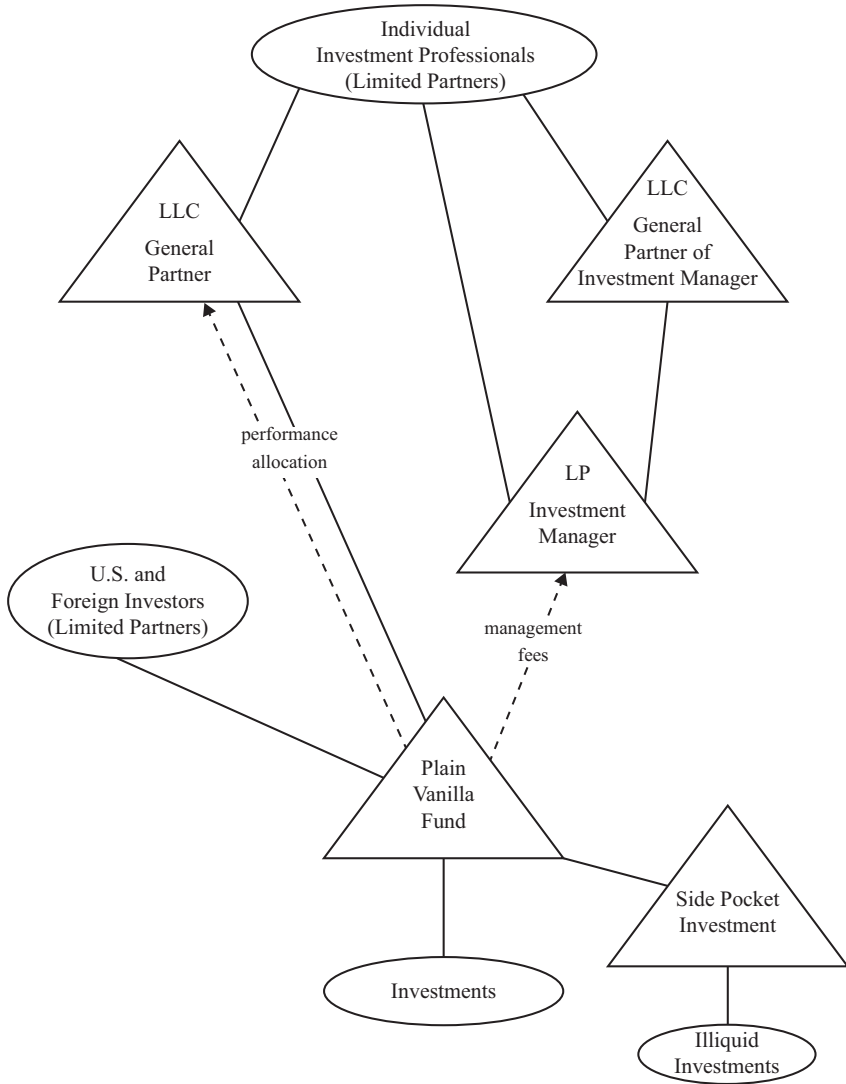


*E. The Side Pocket Structure*

Many hedge funds trade in highly liquid securities and offer their investors liquidity through the ability to withdraw from the fund during periodic pre-determined redemption periods, often following an initial lock-up period. Increasingly, however, hedge funds allocate a portion of their total capital to illiquid or difficult-to-value investments. In a feature that may be added to the plain vanilla, master feeder, or parallel fund structures, these illiquid investments may be segregated from the rest of the fund's investments into a separate compartment or entity called a "side pocket." Once an investment is put in a side pocket, income, gain, deduction, and loss from the investment are allocated only to those persons who were participants in the fund at the time the particular investment was purchased and funds associated with the investment may not be withdrawn from the partnership until the particular investment is sold, even if an investor redeems out of the hedge fund before the side pocket investment has been liquidated.

Accordingly, the side pocket arrangement gives the investment manager the flexibility to make illiquid or hard-to-value investments without the concern that the investment may need to be liquidated or valued in connection with an investor's withdrawal from the fund.

**Plain Vanilla Fund–Side Pocket Structure**



## II. Hedge Fund Choice of Entity—Overview

As described above in Part I, the overall structure of a hedge fund can take many different forms, such as master feeder, parallel, or fund of funds. However, the type of vehicle through which a particular investor participates in the hedge fund is often based on the investor's specific tax considerations. As discussed below in Parts III and IV, foreign and tax-exempt investors typically invest through a foreign feeder organized in a low-tax jurisdiction that is treated as a corporation for U.S. federal income tax purposes. Investing through a foreign feeder that is treated as a corporation for tax purposes allows tax-exempt organizations to avoid generating UBTI and limits (1) the risk that foreign investors will be treated as engaged in a U.S. trade or business for tax purposes by reason of the fund's activities and (2) the possibility that the fund's activities will taint the unrelated income of its foreign investors.

This Part focuses on the tax treatment of the domestic fund vehicle generally used by U.S. taxable investors to make their hedge fund investment.

### A. Tax Treatment of a Domestic Fund

As mentioned above, U.S. taxable investors generally prefer to invest in a vehicle that is treated as a partnership for U.S. federal income tax purposes.<sup>21</sup> Partnerships are not subject to an entity level tax; instead, each partner in its separate capacity includes its allocable share of the partnership's income, gain, loss, deduction, or credit in its income for each year—whether or not distributed.<sup>22</sup> In addition, the character of partnership income passes through to its partners,<sup>23</sup> and subject to a number of limitations, investors in partnerships can use losses and deductions allocated to them to offset other income and gain.<sup>24</sup>

#### 1. Allocations of Profits and Losses for Tax Purposes

Very generally, the items of taxable income, gain, loss, deduction, and credit of a partnership are taken into account by each partner in the manner allocated to it pursuant to the partnership agreement so long as the allocations have substantial economic effect<sup>25</sup> or, if the allocations do not have substantial economic effect—or if the partnership agreement does not provide for allocations—in accordance with the partner's interest in the partnership, taking into account all of the facts and circumstances.<sup>26</sup> The “interests in the partnership” standard is not well defined. Because investors desire certainty as to their tax consequences, most master fund and domestic fund partnership

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<sup>21</sup> However, investing through a foreign corporation is becoming increasingly attractive to U.S. taxable investors. See *infra* Part V.G.

<sup>22</sup> I.R.C. §§ 701–702(a); Reg. § 1.701-1, -1(a).

<sup>23</sup> I.R.C. § 702(b); Reg. § 1.702-1(b).

<sup>24</sup> See, e.g., I.R.C. §§ 163(d), 709(b).

<sup>25</sup> See *infra* Part II.A.1.a.

<sup>26</sup> I.R.C. § 704(b); Reg. § 1.704-1(b)(1)(i).



agreements have extensive tax allocation sections that are designed to ensure that the allocations have substantial economic effect and are respected.<sup>27</sup>

In general, the determination of whether a partnership's allocation of an item has substantial economic effect is a two-part test.<sup>28</sup> First, the allocation must have either economic effect or economic effect equivalence.<sup>29</sup> In order to have economic effect, an allocation must be consistent with the underlying economic arrangement of the partners, which means that if there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive the economic benefit or bear the economic burden.<sup>30</sup> More specifically, an allocation has economic effect if the partnership agreement throughout its term requires (1) the partners' capital accounts to be determined and maintained in accordance with Treasury Regulation section 1.704-1(b)(2)(iv), which generally provides the rules for when a partner's capital account must be increased or decreased, (2) liquidating distributions to be made in accordance with the partners' positive capital account balances upon liquidation of the partnership, and (3) any partner having a deficit in his capital account following a liquidation to be unconditionally obligated to restore the deficit to the partnership. A commonly used alternative to satisfying clause (3) is for the partnership agreement to contain a "qualified income offset."<sup>31</sup> Allocations made under a partnership agreement that does not satisfy this three-pronged test will nevertheless be deemed to have economic effect if a year-end liquidation of the partnership would produce the same economic results to the partners as if the three-pronged test were satisfied, because in that case, the allocations have "economic effect equivalence."<sup>32</sup>

Second, the economic effect of the allocation must be substantial.<sup>33</sup> In general, in order for a partnership allocation to be substantial, there must be a reasonable possibility, independent of any possible tax consequences, that the allocation will affect substantially the dollar amounts to be received by the

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<sup>27</sup> I.R.C. § 704(a)-(b).

<sup>28</sup> Reg. § 1.704-1(b)(2)(i), -1(b)(2)(ii)(i).

<sup>29</sup> Reg. § 1.704-1(b)(2)(i).

<sup>30</sup> Reg. § 1.704-1(b)(2)(ii)(a).

<sup>31</sup> See Reg. § 1.704-1(b)(2)(ii)(d). A "qualified income offset" provision generally requires any partner who unexpectedly receives an adjustment, allocation, or distribution that creates a deficit in the partner's capital account to be allocated income and gain in an amount and manner sufficient to eliminate the deficit as quickly as possible.

<sup>32</sup> Reg. § 1.704-1(b)(2)(ii)(i).

<sup>33</sup> Reg. § 1.704-1(b)(2)(i).

partners from the partnership.<sup>34</sup>

All hedge funds allocate their income, gains, losses, deductions, and credits among their partners. Some hedge funds specifically allocate income and losses, and determine and maintain capital accounts in a manner that reflects the underlying economic arrangement and is in accordance with Treasury Regulation section 1.704-1(b)(2)(iv). Thus, the drafter of a “specific allocation” provision for a fund must allocate the future items of the fund’s income, gain, loss, deduction, and credit so that, under any conceivable set of facts, the amounts allocated to the partners both reflect the underlying economics and conform to the Treasury Regulations.

Other hedge funds use “targeted allocations” to allocate income. Targeted allocations generally provide that the partnership’s income, gain, loss, deduction, and credit will be allocated to the partners so that each partner’s capital account equals the amount that the partner would receive on a hypothetical liquidation of the partnership at year end if all of the partnership’s assets were sold for their book or fair-market value and the proceeds were distributed in accordance with the cash distribution priorities—the waterfall—of the partnership agreement.<sup>35</sup> Typically, targeted allocation provisions leave a great deal of discretion with the general partner. If the targeted allocation provisions produce substantially the same economics as would result from specific allocations, they should either satisfy the “economic effect equivalence test” or be in accordance with the partners’ interest in the partnership.<sup>36</sup>

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<sup>34</sup>Reg. § 1.704-1(b)(2)(iii). The regulations provide that the economic effect of an allocation will not be considered substantial if, at the time the allocation becomes part of the partnership agreement, in present value terms (1) the after-tax economic consequences of at least one partner may be enhanced compared to such consequences if the allocation were not included in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will be substantially diminished compared to such consequences if the allocation were not included in the partnership agreement. In addition, certain shifting and transitory allocations are not considered substantial. *See* Reg. § 1.704-1(b)(2)(iii)(b), -1(b)(2)(iii)(c).

<sup>35</sup>*See* Terrence Floyd Cuff, *Several Thoughts on Drafting Target Allocation Provisions*, 87 TAXES 171 (2009) (giving a detailed discussion of the use of targeted allocations).

<sup>36</sup>However, some commentators have questioned whether the economic effect equivalence test is available for a partnership with targeted allocations. *See id.* at 188 (“One group of advisors appears positive that a well-drafted target allocation provision will satisfy the economic equivalence test. Another group of advisors is equally convinced that the typical target allocation provision cannot satisfy the economic effect equivalence test.”); *see also* N.Y. St. B.A. TAX SECTION, Rep. 1219, *Report on Partnership Target Allocations* (2010) (providing a detailed discussion of the tax issues surrounding the use of targeted allocations).

## 2. Publicly Traded Partnership Issues

As described above, a domestic hedge fund is typically structured to be taxable as a partnership for U.S. federal income tax purposes. A publicly traded partnership, described immediately below, that has more than 10% “active” income generally is treated as a corporation for U.S. federal income tax purposes and is subject to an entity level corporate tax.<sup>37</sup> Accordingly, care is taken to ensure that any fund, including a master fund or feeder fund, that is intended to be a partnership for U.S. federal income tax purposes is not treated as a publicly traded partnership that is taxable as a corporation.

In general, a publicly traded partnership is a partnership whose interests (1) are traded on an established securities market or (2) are readily tradable on a secondary market or the substantial equivalent of a secondary market.<sup>38</sup> Hedge fund interests are typically privately offered and are rarely traded on established securities markets.<sup>39</sup> Therefore, a hedge fund organized as a partnership will generally not be treated as a publicly traded partnership so long as its interests are not “readily tradable on a secondary market or the substantial equivalent of a secondary market.”<sup>40</sup>

The regulations contain a number of safe harbors on which a partnership can rely to treat its interests as not “readily tradable on the substantial equivalent of a secondary market.”<sup>41</sup> If a partnership does not qualify for one of the safe harbors, then the determination as to whether the partnership is readily tradable on the substantial equivalent of a secondary market is based on all of the facts and circumstances.<sup>42</sup>

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<sup>37</sup>I.R.C. § 7704(a), (c), (d). A publicly traded partnership will not be taxable as a corporation for any taxable year if 90% or more of its gross income during that year and all prior years consists of interest, dividends, real property rents, certain gains from the disposition of property, and certain other “qualifying income.” I.R.C. § 7704(c), (d); Reg. § 1.7704-3. For purposes of this rule, a partnership is not treated as in existence during any period before the first taxable year in which such partnership was a publicly traded partnership. I.R.C. § 7704(c)(1).

<sup>38</sup>I.R.C. § 7704(b). For purposes of the publicly traded partnership rules, an interest in a partnership includes capital or profits interests and any financial instrument or contract whose value is determined by reference to the partnership, but does not include debt instruments that are not convertible into or exchangeable for an interest in the capital or profits of the partnership and do not provide for a payment of equivalent value. Reg. § 1.7704-1(a)(2).

<sup>39</sup>See Reg. § 1.7704-1(b) (defining “established securities market”).

<sup>40</sup>Reg. § 1.7704-1(c).

<sup>41</sup>*Id.*

<sup>42</sup>*See id.*

Two safe harbors commonly used by hedge funds are the “100 partner private placement safe harbor” and the “limited liquidity trading safe harbor.”<sup>43</sup> Under the 100 partner private placement safe harbor, an interest in a partnership that does not have more than 100 partners at any time during the taxable year and all of the interests of which have been issued in a transaction that was not required to be registered under the Securities Act of 1933 is not treated as readily tradable on a secondary market or the substantial equivalent thereof.<sup>44</sup>

Under the limited liquidity safe harbor, an interest in a partnership that is only transferrable pursuant to a qualifying “redemption and repurchase agreement” is not treated as readily tradable on a secondary market or the substantial equivalent thereof.<sup>45</sup> In general, a qualifying redemption and repurchase agreement must prohibit (1) a redemption or repurchase of a partnership interest before at least 60 days following a partner’s written request, (2) the redemption or repurchase price of a partnership interest from either (A) being

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<sup>43</sup>Additional safe harbors under which a redemption or transfer will be ignored include certain “private transfers,” transfers through a “qualified matching service,” and *de minimis* transfers of 2% or less of the total partnership interests during a taxable year. Reg. § 1.7704-1(e), -1(g), -(j). Private transfers include transfers (1) in which the basis of the partnership interest in the hands of the transferee is determined, in whole or in part, by reference to its basis in the hands of the transferor or is determined under section 732; (2) at death, including transfers from an estate or testamentary trust; (3) between family members; (4) involving the issuance of interests by or on behalf of the partnership in exchange for cash, property, or services; (5) involving distributions from a retirement plan qualified under section 401(a) or an IRA; (6) in block; (7) pursuant to a right under a redemption or repurchase agreement that is exercisable only (A) upon the death, disability, or mental incompetence of the partner or (B) upon the retirement or termination of the performance of services of an individual who actively participated in the management of, or performed services on a full-time basis for, the partnership; (8) pursuant to a closed end redemption plan; (9) by one or more partners of interests representing in the aggregate 50% or more of the total interests in partnership capital and profits in one transaction or a series of related transactions; and (10) not recognized by the partnership. Reg. § 1.7704-1(e)(1). A block transfer generally includes one or more transfers by a partner and related persons during any 30-day period of partnership interests representing more than 2% of the total partnership interests. Reg. § 1.7704-1(e)(2). A redemption or repurchase agreement is a closed end redemption plan only if (1) the partnership does not issue any interest after the initial offering, and (2) no partner or person related to any partner provides contemporaneous opportunities to acquire interests in similar or related partnerships which represent substantially identical investments. Reg. § 1.7704-1(e)(4).

<sup>44</sup>Reg. § 1.7704-1(h). For purposes of calculating the number of partners under the private placement safe harbor, a person owning an interest in a flow-through entity—for example, a partnership, a grantor trust, or an S-corporation—that owns, directly or through other flow-through entities, an interest in the partnership, is treated as a partner in the partnership if “substantially all” of the value of the person’s interest in the flow-through entity is attributable to the flow-through entity’s interest and a principal purpose of the tiered arrangement is to permit satisfaction of the 100 partner limitation. See Reg. § 1.7704-1(h)(3). The 100 partner private placement safe harbor is available to Regulation S offerings if the offer and sale would not have been required to be registered under the Securities Act of 1933 had the interests been offered and sold within the United States. See Reg. § 1.7704-1(h)(2).

<sup>45</sup>Reg. § 1.7704-1(f).

established before at least 60 days following the partnership's receipt of a written request for repurchase or redemption or (B) being established more than four times a year, and (3) the sum of partnership interests transferred during the year—excluding certain exempted transfers—from constituting more than 10% of the total partnership interests.<sup>46</sup>

Some hedge funds do not rely on a safe harbor to ensure that they are not treated as a publicly traded partnership. Instead, they rely on the “facts and circumstances test” and advice of counsel to determine whether a particular transfer may be allowed, and the general partner or manager retains the right to prohibit transfers that would cause interests in the fund to be treated as readily tradable on the substantial equivalent of a secondary market.<sup>47</sup>

### 3. *Taxable Mortgage Pool Issues*

The real estate mortgage investment conduit (REMIC) rules contain safeguards to ensure that the phantom income earned by holders of residual interests is taxable in all events.<sup>48</sup> Congress created the taxable mortgage pool rules of section 7701(i) to prevent taxpayers from setting up entities that are similar to REMICs to evade these rules.<sup>49</sup> The mechanism to achieve this result is to treat any entity that looks like a REMIC—but is not a REMIC—as a corpo-

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<sup>46</sup>Reg. § 1.7704-1(f).

<sup>47</sup>The facts and circumstances test generally provides that an interest in a partnership is considered readily tradable on a secondary market or the substantial equivalent thereof if, taking into account all facts and circumstances and disregarding certain transfers, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is economically comparable to trading on an established securities market. Reg. § 1.7704-1(c)(1). However, as a threshold matter, a partnership interest will not be considered traded on an established securities market or readily tradable on a secondary market or the substantial equivalent thereof unless the partnership (1) participates in the establishment of the market or the inclusion of its interests thereof, or (2) recognizes transfers made on the market by redeeming the transferor partner—in the case of a redemption or repurchase by the partnership—or admitting the transferee as a partner or otherwise recognizing any rights of the transferee, such as a right of the transferee to receive partnership distributions, directly or indirectly, or to acquire an interest in the capital or profits of the partnership. Reg. § 1.7704-1(d). For these purposes, a transfer of a partnership interest means a transfer in any form, including redemption by the partnership or entering into a financial contract the value of which is determined by reference to the partnership. Reg. § 1.7704-1(a)(3).

<sup>48</sup>First, the REMIC rules prohibit a REMIC residual interest from being transferred to a governmental entity that is not subject to federal income tax. I.R.C. § 860E(e)(1) (imposing a tax on transfers to “disqualified organizations”); I.R.C. § 860E(e)(5) (defining disqualified organizations). Second, the portion of the income from a residual that constitutes an “excess inclusion” (1) is subject to tax in the hands of tax-exempt investors and a 30% withholding tax in the hands of foreigners, and (2) may not be offset by any unrelated losses or loss carryovers—and is not entitled to an exemption or reduction from withholding tax under a treaty. *See* I.R.C. § 860E (providing the taxable income and alternative minimum taxable income may not be less than the excess inclusion income for the year); I.R.C. § 860G(b) (foreigners subject to 30% withholding tax). In addition, excess inclusion income of an insurance company cannot be offset with an increased deduction for variable contract reserves. I.R.C. § 860E(f).

<sup>49</sup>*See* I.R.C. § 7701(i)(2)(A).

ration for federal income tax purposes regardless of its form of organization, such as a partnership, a limited liability company, or a foreign corporation.<sup>50</sup>

Very generally, an entity—or portion of an entity—is a taxable mortgage pool if it is not a REMIC and (1) substantially all of its assets are debt obligations or interests in debt obligations, (2) more than 50% of those debt obligations or interests are real estate mortgages or interests therein, (3) the entity is the obligor under debt obligations or instruments treated as debt for tax purposes, such as certain repurchase agreements,<sup>51</sup> with two or more maturities, including by reason of different acceleration rights or different expected weighted average lives, and (4) payments on those debt obligations bear a relationship to payments on the underlying debt obligations held by the entity.<sup>52</sup> Mortgage-backed securities and REMIC regular and residual interests are treated as “real estate mortgages” for purposes of the taxable mortgage pool rules.<sup>53</sup> Accordingly, a U.S. hedge fund that invests substantially all of its assets in debt obligations, more than 50% of the assets of which are mortgage-backed securities or other real estate mortgages, and that issues two or more classes of debt that have different maturity dates—the payments on which are tied to the underlying assets—will generally be a taxable mortgage pool subject to a U.S. corporate level tax.

However, the taxable mortgage pool rules contain a very significant loophole. Rather than provide that a taxable mortgage pool is taxable as a domestic corporation, the rules provide only that a taxable mortgage pool is taxable as a corporation; they do not necessarily result in a U.S. corporate tax.<sup>54</sup> Thus, a foreign hedge fund, such as a foreign master fund, that is a taxable mortgage pool and that is not engaged in a trade or business in the United States is not subject to U.S. corporate income tax and can be used to create a REMIC-like vehicle that permits the holders of its equity to avoid paying tax on its

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<sup>50</sup>Special rules exist for REITs that are taxable mortgage pools. Under Treasury Regulations that have not yet been issued, the equity holders of a REIT or registered investment company (RIC) are subject to the same rules that apply to holders of residual interests in REMICs. These rules are designed to ensure that federal income tax is paid on the excess inclusion income. *See* I.R.C. §§ 7701(i)(3), 860E(d).

<sup>51</sup>Moreover, the Service and Treasury Department have authority to treat certain equity interests as indebtedness for this purpose. I.R.C. § 7701(i)(2)(D).

<sup>52</sup>I.R.C. § 7701(i)(2); Reg. § 301.7701(i)-1.

<sup>53</sup>*See* Reg. § 301.7701(i)-1(d).

<sup>54</sup>*See* I.R.C. § 7701(i).

phantom income.<sup>55</sup>

Therefore, if there is any concern that a fund organized as a partnership for U.S. tax purposes could qualify as a taxable mortgage pool, serious consideration should be given to organizing the fund outside the United States so that it is not subject to a U.S. federal corporate tax in the event that it is treated as a taxable mortgage pool.<sup>56</sup>

## B. *Tax Elections*

### 1. *Section 754 Election*

An investor that contributes cash to a hedge fund that is treated as a partnership for U.S. federal income tax purposes in exchange for an interest in the fund will have an initial “outside” tax basis in its partnership interest equal to the amount of money contributed.<sup>57</sup> An investor that purchases an interest in a hedge fund that is treated as a partnership for U.S. federal income tax purposes from another investor will have an initial outside basis in its partnership interest equal to the purchase price paid to the other investor for the partnership interest.<sup>58</sup> Very generally, an investor’s outside basis in its partnership interest is increased by any additional contributions made by it to the fund and the amount of any income, gain, and partnership debt allocated to the investor; it is decreased by any distributions by the fund to the investor, any losses and deductions of the fund allocated to the investor, and any decrease in the investor’s share of the fund’s debt.<sup>59</sup>

A hedge fund that is treated as a partnership for tax purposes will have an “inside” tax basis in its assets. If a hedge fund purchases an asset, the fund’s inside basis in the asset will initially be the fund’s cost of the property.<sup>60</sup> Generally, a partnership is not required to adjust the inside basis of its assets when

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<sup>55</sup>See JAMES M. PEASLEE & DAVID Z. NIRENBERG, *FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS* 683 (3d ed. 2001) (“Section 7701(i) classifies a taxable mortgage pool as a corporation, but does not say whether the corporation is domestic or foreign. Accordingly, following the usual Code definitions, a taxable mortgage pool organized under U.S. domestic law would be a domestic corporation and any other taxable mortgage pool would be foreign. . . . A foreign taxable mortgage pool would be subject to U.S. tax only on certain passive income from U.S. sources and on income effectively connected with a U.S. trade or business that it conducts [and] . . . a foreign corporation whose sole business activity is investing and trading in loans and securities would not itself be subject to any U.S. tax (including withholding tax).”).

<sup>56</sup>If a foreign hedge fund is treated as a taxable mortgage pool, it would be treated as a foreign corporation and investors would be taxable under the rules applicable to passive foreign investment companies or controlled foreign corporations, but so long as the fund is not engaged in a trade or business in the United States, it would not be subject to U.S. federal income tax on a net income basis.

<sup>57</sup>I.R.C. §§ 705(a), 722.

<sup>58</sup>I.R.C. §§ 742, 1012.

<sup>59</sup>I.R.C. §§ 705(a), 752; Reg. § 1.705-1(a).

<sup>60</sup>I.R.C. § 1012.

a partner transfers its partnership interest or a partner is redeemed.<sup>61</sup> As a result, if a hedge fund partnership's assets appreciate, a member transfers its interests to a new member or is redeemed from the fund, and after the transfer or redemption the partnership sells an asset with pretransfer appreciation, then the new member or the existing members whose percentage share of the hedge fund has increased as a result of a redemption will be subject to tax on the pretransfer appreciation.<sup>62</sup> On the other hand, if a hedge fund partnership's assets depreciate, a member transfers its interest or is redeemed from the fund, and after the transfer or redemption the fund sells an asset with pretransfer depreciation, the new member or other members whose percentage share of the fund has increased as a result of the redemption will recognize a loss on the pretransfer depreciation.<sup>63</sup>

However, a partnership may make a section 754 election to adjust the inside basis of the partnership assets with respect to the new or remaining members any time there is a distribution of partnership property, such as cash, whether or not in complete liquidation of a partner's entire interest in the partnership—that is, a full or partial redemption—or a transfer of a partnership interest.<sup>64</sup> A hedge fund partnership that makes a section 754 election will adjust the basis of its assets in the event of such a redemption or transfer but only with respect to the transferee partner or the partners who do not receive the distribution.<sup>65</sup> In general, if the departing member recognizes gain on the transfer or redemption, then the fund will increase the basis of its assets with respect to the transferee partner or the remaining members by the amount of gain.<sup>66</sup> If the departing member recognizes a loss on the transfer or redemption, then the hedge fund will decrease the basis of its assets by the amount of the loss with respect to the transferee partner or the remaining members.<sup>67</sup> Section 754 elections generally benefit transferees of interests in appreciated partnerships and, by extension, the transferors.

A hedge fund that has not made a section 754 election is nevertheless

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<sup>61</sup>I.R.C. § 743(a) (stating the basis of partnership property not adjusted as the result of a transfer of an interest in a partnership unless a section 754 election is in effect or the partnership has a substantial built-in loss immediately after the transfer); I.R.C. § 734(a) (providing the basis of partnership property not adjusted as the result of a distribution to a partner unless a section 754 election is in effect or there is a substantial basis reduction with respect to the distribution).

<sup>62</sup>The allocation of taxable gain in excess of a transferee partner's economic gain will give the partner a tax basis in excess of its economic cost and, upon a sale or redemption, will result in less gain or more loss than the partner's economic gain. Thus, the partner will pay more tax when the appreciated assets are sold by the partnership and less tax when the partner sells its interest or is redeemed from the fund.

<sup>63</sup>As discussed below, this rule does not generally apply if the partnership's assets have depreciated by more than \$250,000.

<sup>64</sup>The election applies for all transfers and distributions taking place during that taxable year and all subsequent years. *See* I.R.C. § 754; Reg. § 1.754-1.

<sup>65</sup>*See* I.R.C. §§ 734(b), 743(b).

<sup>66</sup>*See* I.R.C. §§ 734(b)(1), 743(b)(1).

<sup>67</sup>*See* I.R.C. §§ 734(b)(2), 743(b)(2).



required to adjust the basis of its assets in certain limited circumstances.

First, if immediately after the distribution of property to a partner by a partnership, including in a complete or partial redemption, there is a “substantial basis reduction”—the partner recognizes a loss in excess of \$250,000 on the distribution<sup>68</sup>—the partnership is required to adjust the basis of its assets as if a section 754 election has been in place, even if the election has not been made.<sup>69</sup>

Second, if immediately after the transfer of a hedge fund interest the hedge fund has a “substantial built-in loss”—the adjusted tax basis of the fund’s assets exceeds the fair market value of such assets by more than \$250,000<sup>70</sup>—then the fund is required to adjust the basis of its assets as if a section 754 election has been in place, even if the election has not been made.<sup>71</sup>

A hedge fund that elects to be treated as an “electing investment partnership” can avoid the mandatory basis adjustments for sales of partnership interests at a time that the fund has a substantial built-in loss.<sup>72</sup> However, most hedge funds are not eligible to make the election.<sup>73</sup>

Once made, a section 754 election is irrevocable without the consent of the Service and applies to all asset distributions and transfers of fund interests during the taxable year of the election and all subsequent years.<sup>74</sup>

Because hedge funds are liquid investment vehicles with hundreds, if not thousands, of positions, making basis adjustments with respect to each such position is extraordinarily difficult as an administrative matter. Therefore, most hedge funds do not make a section 754 election.

## 2. “Stuffing Allocations” for Redeemed Partners

Some hedge funds use “stuffing” allocations—also called “fill-ups” and “fill-downs”—to allocate the taxable gain or loss that arises when assets are sold at a gain or loss in order to generate the requisite cash to redeem a member. Very generally, a hedge fund that has a stuffing allocation provision in its part-

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<sup>68</sup>I.R.C. § 734(d)(1).

<sup>69</sup>I.R.C. § 734(b).

<sup>70</sup>I.R.C. § 743(d)(1).

<sup>71</sup>I.R.C. § 743(b).

<sup>72</sup>I.R.C. § 743(e)(1), (e)(6).

<sup>73</sup>To qualify as an “electing investment partnership,” among other things, the partnership must never have been engaged in a trade or business, the partnership agreement must provide for a term not in excess of 15 years, all of the partnership interests issued by the partnership must be issued pursuant to a private offering within 24 months of the first capital contribution to the partnership, and the partnership agreement must contain substantive restrictions on redemption. See I.R.C. § 743(e)(6). Many hedge funds take the position that they are engaged in the trade or business of a trader; have a perpetual life, admit new investors, or both; and allow redemptions throughout their term, and accordingly do not qualify for the investment partnership election.

<sup>74</sup>See I.R.C. § 754; Reg. § 1.754-1(a), (c). An application to revoke a section 754 election generally will not be approved where the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or disposition. Reg. § 1.754-1(c).

nership agreement will, immediately prior to the redemption of a member, specially allocate realized taxable gain and income to a redeeming member that is receiving cash in excess of its outside basis in its hedge fund interest in an amount equal to the excess if possible, or will specially allocate realized losses and deductions to a redeeming member that is receiving cash in an amount that is less than its outside basis in its hedge fund interest in an amount equal to the deficit if possible. Stuffing allocations will not change the amount of income or loss recognized by a redeeming member; however, the character may be different. It is unclear whether stuffing allocations have “substantial economic effect” and would be respected by a court if challenged by the Service.<sup>75</sup>

### 3. Section 475(f) “Mark-to-Market” Election for Traders

Section 475(a) requires “dealers”<sup>76</sup> to mark to market their securities and take into income the gain or loss that would otherwise be recognized if the securities were sold for their fair market value on the last business day of the taxable year.<sup>77</sup> Any gain or loss with respect to a security that is marked to market is treated as ordinary income or loss.<sup>78</sup>

Hedge funds are generally not dealers and, therefore, are not required to mark their securities to market. However, section 475(f) permits “traders” in securities or commodities to elect mark-to-market treatment for their securities and commodities. The election is not available to “investors.”<sup>79</sup> Accordingly, if a hedge fund qualifies as a “trader,” it may choose to be subject to the mark-to-market regime with respect to its securities and commodities.<sup>80</sup> Securities that are identified by a hedge fund electing mark-to-market treatment as having no connection to the fund’s trading activities and clearly iden-

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<sup>75</sup> See N.Y. ST. B.A. TAX SECTION, Rep. 1220, *Aggregation Issues Facing Securities Partnerships Under Subchapter K*, 35–36 (2010) (stating that stuffing allocations are controversial and citing to commentators taking differing positions on the permissibility of stuffing allocations under current law).

<sup>76</sup> I.R.C. § 475(c)(1) (A dealer in securities “regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business or regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.”).

<sup>77</sup> I.R.C. § 475(a), (b). “Securities” for this purpose include corporate stock; interests in a widely held or publicly traded partnership; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; derivatives on any of the preceding items or any currency; and any position not listed if it is a hedge with respect to a security and is clearly identified as a hedge before the close of the day on which it was entered into. See I.R.C. § 475(c)(2); Reg. § 1.475(c)-2. Section 475(e) permits a dealer in commodities to elect to mark to market its commodities in the same manner as the rules apply to securities. I.R.C. § 475(e).

<sup>78</sup> I.R.C. § 475(d)(3).

<sup>79</sup> See I.R.C. § 475(f).

<sup>80</sup> However, trader status is not easily obtained and case law requires a high number of trades each year of securities held for short periods before a taxpayer qualifies as a trader. See *infra* Part V.A.

tified in the fund's records as being held for investment may be excluded from mark-to-market treatment.<sup>81</sup> Accordingly, depending on the facts and circumstances, it may be possible for a hedge fund that constitutes a trader and has made a mark-to-market election to exclude any illiquid investments, such as side pocket investments, from mark-to-market treatment.

A hedge fund that makes a section 475(f) election will accelerate the recognition of gain on its securities and will convert any capital gain into ordinary income. However, losses are treated as ordinary losses that are not subject to the limitations on the deductibility of capital losses.<sup>82</sup> A section 475(f) election is made by filing a statement with the Service.<sup>83</sup> Once made, the election applies to the taxable year of the election and all subsequent years and may not be revoked without the consent of the Service.<sup>84</sup>

### III. Tax Issues for Tax-Exempt Investors

#### A. *Unrelated Business Taxable Income*

A tax-exempt organization, such as a public charity, university, foundation, or pension fund, is not generally taxed on income earned from its tax-exempt activities.<sup>85</sup> However, a tax-exempt organization is subject to tax at regular corporate rates on its unrelated business taxable income (UBTI).<sup>86</sup> UBTI is generally the gross income derived by an exempt organization from any trade or business that is unrelated to its charitable activities and regularly carried on by it, less allowable deductions that are directly related to the trade or business.<sup>87</sup> An exempt organization that has \$1,000 or more of gross income from an unrelated business generally must file a Form 990-T with the Service.<sup>88</sup> A charitable remainder trust must forfeit all UBTI that it earns.<sup>89</sup>

UBTI may arise in two ways. First, if a tax-exempt organization engages directly, or indirectly through a partnership, in certain active business activi-

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<sup>81</sup>I.R.C. § 475(f)(1)(B). The security must be identified as being held for investment before the close of the day on which it was acquired, originated, or entered into.

<sup>82</sup>Capital losses of an individual taxpayer generally must first be used to offset the individual's capital gains for the taxable year. If the individual's capital losses for the taxable year exceed his capital gains for the year, the excess may be used to offset up to \$3,000 of the individual's ordinary income. Any excess capital loss is not deductible for the year but may be carried forward to subsequent years. *See* I.R.C. §§ 1211(b), 1212(b).

<sup>83</sup>*See* Rev. Proc. 99-17, 1999-7 I.R.B. 52 (providing procedures for traders in securities to make a mark-to-market election under section 475(f)).

<sup>84</sup>I.R.C. § 475(f)(3); *see also* Rev. Proc. 99-17, 1999-7 I.R.B. 52.

<sup>85</sup>*See* I.R.C. § 501.

<sup>86</sup>I.R.C. § 511(a)(1); Reg. § 1.511-1; *see also* I.R.C. § 512 (defining unrelated business taxable income); I.R.C. § 513 (defining unrelated trade or business).

<sup>87</sup>I.R.C. § 512(a)(1); Reg. § 1.513-1(a).

<sup>88</sup>Reg. § 1.6012-2(e).

<sup>89</sup>Under section 664(c)(2)(A), a charitable remainder trust that has UBTI for a taxable year is subject to an excise tax equal to the amount of the UBTI. Prior to January 1, 2007, a charitable remainder trust that incurred UBTI for the year was taxable on all of its net income for the year. I.R.C. § 664(c)(2)(A).

ties that are not related to its tax-exempt purposes, UBTI may result.<sup>90</sup> Certain income, however, is treated as sufficiently passive and does not give rise to UBTI.<sup>91</sup> This passive income generally includes capital gains, dividends, royalties, interest income from unrelated parties, certain rental income, securities lending income, annuities, income from notional principal contracts, loan commitment fees, and option premiums.<sup>92</sup>

Second, if a tax-exempt organization borrows money to make an investment or invests in a partnership that borrows money to make investments, the income or gain from the “debt-financed” investment<sup>93</sup> is UBTI—and is subject to tax—to the proportionate extent of the borrowing, notwithstanding the fact that the income or gain might otherwise be passive investment income.<sup>94</sup> The Service has privately ruled, however, that certain short-term borrowings used to facilitate redemptions do not give rise to UBTI.<sup>95</sup>

### 1. *Blocker Entities*

To avoid the UBTI that would otherwise arise if a tax-exempt organization invested directly in a hedge fund that is treated as a partnership for U.S. fed-

<sup>90</sup>I.R.C. §§ 512(a), (c), 513(a); Reg. § 1.512(c)1.

<sup>91</sup>See I.R.C. § 512(b); Reg. § 1.512(b)-1.

<sup>92</sup>See I.R.C. § 512(b); Reg. § 1.512(b)-1.

<sup>93</sup>More specifically, “debt-financed property” generally includes any income-producing property which is unrelated to the tax-exempt organization’s charitable purposes with respect to which there is “acquisition indebtedness” at any time during the year—or during the preceding 12 months, if the property is disposed of during the year. I.R.C. § 514(b). “Acquisition indebtedness” as it relates to “debt-financed property” is defined to include (1) “indebtedness incurred in acquiring or improving the property,” (2) “indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred *but for* such acquisition or improvement,” and (3) “indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred *but for* such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.” I.R.C. § 514(b)–(c) (emphasis added). However, indebtedness that is related to a tax-exempt organization’s charitable purpose is not acquisition indebtedness. I.R.C. § 514(c)(4).

<sup>94</sup>I.R.C. § 514(b)–(c); I.R.C. § 512(c) (providing the borrowing activities of a partnership are attributed to its tax-exempt partners for purposes of calculating UBTI). Gross income from the debt-financed property is generally an amount which is the same percentage—not in excess of 100%—of the total gross income derived from the property during the year as (1) the average acquisition indebtedness with respect to the property for the year is of (2) the average adjusted basis of the property for the year. I.R.C. § 514(a)(1); Reg. § 1.514-1(a). The amount of gross income generally may be reduced by allowable deductions. I.R.C. § 514(a)(2)–(3). If debt-financed property is sold or otherwise disposed of, the taxable gain on the sale or other disposition is determined based on the highest acquisition indebtedness with respect to the property during the 12-month period ending on the date of sale or disposition. Reg. § 1.514-1(a)(1)(v).

<sup>95</sup>See P.L.R. 2003-20-027 (May 26, 2003) (providing an investment fund’s borrowing to facilitate orderly redemptions of units does not give rise to unrelated debt-financed income for tax-exempt investors of the fund); P.L.R. 96-44-063 (Nov. 1, 1996) (providing a pension plan’s short-term borrowing to facilitate redemptions does not create unrelated debt-financed income).

eral income tax purposes and borrows money to make its investments, a tax-exempt organization will typically invest in a hedge fund through a foreign feeder fund that is treated as a foreign corporation for U.S. federal income tax purposes. The foreign feeder fund is typically organized in a low-tax jurisdiction so as not to be subject to material foreign taxes and is operated so as not to be subject to U.S. net income tax—that is, the fund is not engaged in U.S. trade or business. Income received by the tax-exempt organization from the foreign feeder fund generally constitutes dividends or Subpart F income, which do not give rise to UBTI.<sup>96</sup> So long as the tax-exempt organization does not borrow to make its investment in the foreign feeder fund, the organization will not report “debt-financed income” and will avoid tax on the income received from the corporation.<sup>97</sup> Because they “block” the hedge fund’s borrowings and any borrowing by the foreign corporation from being attributed to the tax-exempt organization, these foreign feeder funds are often called “blocker” corporations.

The Service has respected foreign blocker corporations in private rulings where the interposition of the foreign corporation had the following three “non-tax business purposes”: (1) the corporation provided an additional layer of limited liability protection, (2) the corporation provided greater flexibility in disposing of the investment, and (3) the corporation could manage and administer the investments more efficiently as a group, rather than have a number of investors each invest individually.<sup>98</sup> Tax-exempt investors that invest through foreign blockers to avoid UBTI should ensure that these or other nontax business purposes for using the foreign blocker are present.<sup>99</sup>

Although a foreign blocker corporation may enable tax-exempt investors to avoid UBTI, any dividends received by the foreign blocker from U.S. corporations are subject to a 30% U.S. withholding tax, and if the blocker is engaged in a trade or business in the United States, the blocker will be subject to a 35% federal corporate net income tax and possibly state, local, and a

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<sup>96</sup>P.L.R. 883-60-37 (June 14, 1988); *see also* P.L.R. 940-70-07 (Nov. 12, 1993). *But see* P.L.R. 904-30-39 (July 30, 1990). Congress cited the private letter rulings that treat Subpart F inclusions as dividends favorably in the Conference Report to the Small Business Job Protection Act of 1996, H.R. REP. NO. 104-737, at 294 n.50 (1996) (Conf. Rep.).

<sup>97</sup>*See* P.L.R. 1999-52-086 (Sept. 30, 1999).

<sup>98</sup>*See* P.L.R. 2003-15-028 (Jan. 14, 2003); P.L.R. 2002-51-016 (Sept. 23, 2002).

<sup>99</sup>Avoiding the UBTI that would otherwise be incurred by investing through a foreign blocker corporation is possible only if certain hurdles—namely section 269 and the economic substance doctrine of new section 7701(o)—are cleared. For a detailed discussion of why neither section 269 or the economic substance doctrine should deny tax-exempt organizations the benefits of investing through a foreign blocker corporation, *see generally* David S. Miller, *How U.S. Tax Law Encourages Investment Through Tax Havens*, 63 TAX NOTES INT’L (TA) 459 (Aug. 8, 2011).

30% branch profits tax.<sup>100</sup>

On July 31, 2009, Congressman Sander M. Levin introduced a bill that would generally permit tax-exempt investors to invest in leveraged hedge funds without incurring UBTI, alleviating the need for tax-exempt investors to invest in hedge fund partnerships that borrow money to make their investments through blocker corporations.<sup>101</sup>

#### IV. Tax Issues for Foreign Investors

##### A. U.S. Trade or Business

Foreign corporations that are “engaged in a trade or business” in the United States are generally subject to U.S. federal net income tax on income that is “effectively connected” with that trade or business.<sup>102</sup> “Effectively connected income” generally is taxed in the same manner and at the same graduated tax rates as the income of a U.S. corporation.<sup>103</sup> Mere investors generally are not

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<sup>100</sup>These rules are described in Part IV. See I.R.C. § 881(a)(1) (providing that foreign corporations are subject to 30% gross-basis withholding tax on U.S.-source dividends); I.R.C. § 882(a)(1) (providing that a foreign corporation engaged in a U.S. trade or business is taxable on its effectively connected income at regular U.S. corporate tax rates); I.R.C. § 884(a) (providing that foreign corporations engaged in a U.S. trade or business are subject to a 30% “branch profits” tax on their after-tax income that is not reinvested in the trade or business). If the foreign blocker corporation qualifies for the benefits of an income tax treaty, U.S.-source dividends received by the foreign blocker may be eligible for a reduced rate of withholding tax. For example, if the foreign blocker were organized in the Republic of Ireland as a section 110 company that qualifies for the benefits of the U.S.–Ireland income tax treaty, U.S.-source dividends received by the fund would be eligible for a 15% rate of withholding. See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, U.S.–Ir., art. 10, July 28, 1997, S. TREATY DOC. NO. 105-31 [hereinafter U.S.–Ir. Tax Treaty].

<sup>101</sup>The bill would amend section 514(c) to provide that debt incurred or continued by a partnership “in acquiring or carrying securities or commodities is not treated as acquisition indebtedness for purposes of determining the UBTI of limited partners.” H.R. 3497, 111th Cong. § 1(a) (2009). Notably, the bill would go beyond merely maintaining the status quo and eliminating the inconvenience for tax-exempt organizations of investing through a foreign blocker. Instead, the bill would reduce tax liability for such organizations. Under current law, a tax-exempt organization can avoid tax on debt-financed investments through a foreign blocker only to the extent that the blocker is not subject to tax. Thus, if a tax-exempt organization invests today in a foreign blocker that borrows to purchase U.S. dividend-paying equity securities, the organization will be indirectly subject to a 30% U.S. withholding tax on its share of dividend income. Under the bill, a tax-exempt organization could avoid this tax by investing directly in a hedge fund partnership. On the other hand, by exempting a tax-exempt organization from UBTI only if it invests through a partnership—but not if it borrows and buys securities directly—the bill creates perverse incentives and invites criticism that it acts to subsidize the hedge fund industry.

<sup>102</sup>I.R.C. § 882(a)(1).

<sup>103</sup>I.R.C. § 882.

treated as engaged in a trade or business.<sup>104</sup>

Foreign corporations engaged in a U.S. trade or business are also subject to a 30%—or lower treaty rate—“branch profits tax” on their “dividend equivalent amounts,” which generally are a measure of the foreign corporations’ effectively connected earnings and profits that are not reinvested in the U.S. business and are deemed repatriated offshore in any year.<sup>105</sup> The effective tax rate on effectively connected income that is repatriated—or deemed to be repatriated—offshore, if a lower treaty rate does not apply, is 54.5%.<sup>106</sup> State taxes may also apply to a foreign corporation that is engaged in a trade or business in a state.<sup>107</sup>

Section 864(b)(2)(A)(ii) provides a safe harbor under which a foreign corporation that trades in stocks, securities, and derivatives for its own account is not treated as engaged in a U.S. trade or business, even if the foreign corporation has U.S. employees or a U.S. dependent agent. Many states also apply this safe harbor.<sup>108</sup> Most hedge funds with foreign investors, including master funds that have a foreign feeder, generally limit their activities to those that qualify for the section 864(b)(2)(A)(ii) safe harbor. The safe harbor is described below.

### 1. Section 864(b)(2)(A)(ii) Safe Harbor—General

Section 864(b)(2)(A)(ii) and its current and proposed regulations provide a safe harbor under which a foreign corporation, such as a foreign feeder, is not treated as engaged in a trade or business in the United States as a result of

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<sup>104</sup> See *Wilson v. United States*, 376 F.2d 280, 293 (Ct. Cl. 1967) (“[M]anaging one’s own investment in securities is not the carrying on of a trade or business.”); *Estate of Yaeger v. Commissioner*, 889 F.2d 29, 34 (2d Cir. 1989) (“[T]he management of securities investments is not the trade or business of a trader.”); *Continental Trading, Inc. v. Commissioner*, 16 T.C.M. 1957-164, *aff’d* 265 F.2d 40 (9th Cir. 1959) (“[M]erely [the] servicing of . . . investments in this country” does not constitute a U.S. trade or business.). See generally Linda Beale et al., *An Overview of the U.S. Federal Income Tax Treatment of Collateral Debt Obligation Transactions*, 14 J. TAX’N FIN. INST. 27 (2001).

<sup>105</sup> I.R.C. § 884(a).

<sup>106</sup> This is equal to a 35% corporate tax rate plus a 30% dividend withholding tax—on branch profits tax—on the after-tax income.

<sup>107</sup> See, e.g., CAL. REV. & TAX CODE §§ 23186, 23501 (West 2011) (providing a corporate income tax imposed on foreign corporations doing business in the state); 805 ILL. COMP. STAT. 5/15.65 (2011) (providing a franchise tax imposed on foreign corporations doing business in the state); N.Y. TAX LAW § 209(1) (McKinney 2011) (providing a franchise tax imposed on foreign corporations doing business in the state); TEX. TAX CODE ANN. § 171.001(a), (c) (West 2011) (providing a franchise tax imposed on foreign corporations doing business in the state and an exemption for passive entities).

<sup>108</sup> New York State, for example, applies the section 864(b)(2)(A)(ii) safe harbor. See N.Y. TAX LAW § 209(2)(a)–(b) (McKinney 2011); N.Y. COMP. CODES R. & REG. tit. 20, § 1-3.3(b) (2011).

“trading in stocks and securities”<sup>109</sup> or derivatives<sup>110</sup> for its own account even if the trading is effected within the United States directly by the taxpayer or its employees or through a resident broker, commission agent, custodian, or other independent or dependent agent, such as an investment manager, and irrespective of whether the employee or agent has discretionary authority to make decisions in effecting the transactions, or the foreign corporation has a U.S. office.<sup>111</sup>

The section 864(b)(2)(A)(ii) safe harbor is not available to dealers.<sup>112</sup> Thus, so long as an offshore hedge fund or a master fund with a foreign feeder limits its activities to trading in stocks, securities, or derivatives, the offshore fund or the foreign feeder will not be subject to U.S. federal corporate income tax. Secondary market purchases and sales of publicly offered securities, purchases of publicly offered bonds at original issuance, securities lending, and entering into interest rate swaps and credit default swaps are all generally considered to be activities that come within the section 864(b)(2)(A)(ii) safe harbor.<sup>113</sup> Many hedge funds adhere to investment guidelines provided by tax counsel to ensure that their activities fall within the trading safe harbor. An example of tax guidelines is attached as an Exhibit to this Article. However, as the next section explains, there are several unanswered interpretational questions about the safe harbor.

a. *Origination and Workouts.* There are two key categories of uncertainty regarding the section 864(b)(2)(A)(ii) safe harbor: loan origination and workouts.

The Service asserts that the safe harbor is not available to a foreign corporation that originates loans, either directly or through an agent or partnership.<sup>114</sup> The policy behind the prohibition is to prevent an offshore corporation with

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<sup>109</sup>The term “securities” includes “any note, bond, debenture or other evidence of indebtedness, or any evidence in or right to subscribe to or purchase any of the foregoing.” Reg. § 1.864-2(c)(2); *see also* P.L.R. 88-07-004 (Nov. 10, 1987) (reasoning Treasury bond futures are securities); P.L.R. 87-04-006 (Oct. 15, 1986) (explaining that bankruptcy trade claims are securities).

<sup>110</sup>Reg. § 1.864(b)-1(b)(2). The preamble to the proposed regulations allows foreign hedge funds to currently apply the section 864(b)(2)(A)(ii) safe harbor to derivatives, even before the proposed refractors are finalized. *See* T.D. 8735, 1997-2 C.B. 72.

<sup>111</sup>Reg. § 1.864-2(c)(2) (Trading in stocks and securities includes “effecting transactions in stocks or securities, including buying, selling (whether or not by entering into short sales) or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer, and any other activity closely related thereto (such as obtaining credit for the purpose of effecting such buying, selling or trading).”).

<sup>112</sup>I.R.C. § 864(b)(2)(A)(ii).

<sup>113</sup>*See* Beale et al., *supra* note 104, at 27.

<sup>114</sup>*See* G.C.M. 119,800 (Sept. 22, 2009). Interest income received by a foreign corporation on loans originated to U.S. borrowers constitutes income effectively connected with such foreign corporation’s banking, financing, or similar business when an agent—whether dependent or independent—regularly and continuously originates loans in the United States on the foreign corporation’s behalf.



a U.S.-based investment manager from unfairly competing with U.S. commercial banks and other U.S. financial institutions. The technical basis for a prohibition on origination activity is far less clear.<sup>115</sup> Nevertheless, most offshore hedge funds do their best to try to determine what constitutes origination activity, as opposed to secondary market investing, and avoid origination activity scrupulously. Thus, offshore hedge funds and master funds with foreign feeders do not generally make loans directly to borrowers, do not negotiate loan terms with borrowers, and do not participate as the original members of a loan syndicate. Instead, these funds wait a period of time—generally 24 to 48 hours—after a loan syndication closes and is fully funded before purchasing an interest in the loan. In addition, many offshore hedge funds will refrain from entering into a commitment to buy a loan unless the commitment contains a “material adverse effect” clause (MAE clause or MAC) that allows the fund to decline to purchase the loan if the borrower’s condition or market conditions change materially between the time the commitment is entered into and the date the loan would otherwise be required to be purchased. Some investment managers that wish to participate in origination or workout activities without causing their foreign fund to be subject to U.S. corporate tax organize parallel funds to engage in a “season and sell” strategy. In a season and sell strategy, a domestic fund—a limited partnership or limited liability company with only domestic investors—originates loans, holds them for a specified period of time, typically 60–90 days—the “seasoning period”—and then offers to sell the loans to a parallel foreign fund administered by the investment manager. In these structures, the parallel foreign fund is often prohibited from committing to purchase a loan before the seasoning period ends. The risk in all of these strategies is that the Service will argue that the purported originator—the unrelated nominal lender or syndicate member, or the domestic parallel fund in a season and sell structure—is acting as an agent for the foreign fund and, therefore, the foreign fund does not qualify for the trading safe harbor.<sup>116</sup> A 48-hour “waiting period,” a prohibition against entering into loan commitments without MAE clauses, and, in a season and sell structure, an independent review process before the foreign fund purchases loans, along with a mechanism to help ensure that the foreign fund pays fair market value for the loans it purchases from the domestic fund, are all designed to demonstrate that the originator of the loan is not an agent of the foreign fund.

A second but related issue arises for offshore funds, including master funds with foreign feeders, that renegotiate the loans they hold—that is, workouts. For tax purposes, a significant modification of a loan is treated as the redemp-

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<sup>115</sup> See Beale et al., *supra* note 104, at 27.

<sup>116</sup> See OFFICE OF CHIEF COUNSEL, INTERNAL REVENUE SERVICE, GENERAL LEGAL ADVICE MEMORANDUM 2009–2010 (Oct. 2, 2009) (providing that a foreign corporation is treated as engaged in a trade or business in the United States by reason of origination activities performed in the United States by an independent agent on behalf of the foreign corporation).

tion of the unmodified loan and the origination of a new loan with the modified terms.<sup>117</sup> Thus, an offshore fund that engages in loan restructurings that significantly modify the underlying loans may be treated as engaged in origination activity for tax purposes. Most advisors do not believe that an offshore fund that purchases a loan in the secondary market with every expectation that the loan will perform according to its terms will be treated as engaged in a U.S. trade or business for federal income tax purposes if the debtor subsequently becomes troubled and the investment manager on behalf of the fund consents to a modification that is designed to preserve the offshore fund's investment.<sup>118</sup> On the other hand, there is concern that an offshore fund with a U.S. investment manager that purchases nonperforming loans of troubled borrowers in order to renegotiate the loans and then sell the performing loans at a profit could be engaged in a trade or business for U.S. federal income tax purposes.<sup>119</sup>

b. *Four Strategies to Deal with Origination and Workout Issues.* Four strategies—in addition to the season and sell strategy—exist for foreign funds, including the foreign feeder fund in a master feeder structure, that wish to participate in origination or workout activity in the United States without being subject to U.S. corporate tax. First, the foreign fund may limit—but not entirely avoid—origination or restructuring activity. Case law generally provides that a foreigner is not engaged in a trade or business in the United States unless the U.S. activities are “considerable, continuous and regular.”<sup>120</sup> Thus, a foreign fund that engages in a limited number of loan originations or workouts may engage in insufficient activity to be treated as engaged in a trade or business.<sup>121</sup> Second, if all of the investment professionals who engage in the loan origination and restructuring activity reside permanently outside the United States and perform all of their activities on behalf of the fund

<sup>117</sup> See Reg. § 1.1001-3(b).

<sup>118</sup> See, e.g., *Guidance on Economic Downturn Issues*, N.Y. St. B.A. TAX SECTION, Rep. 1163, Pt. V (2008).

<sup>119</sup> *Id.*

<sup>120</sup> See *De Amodio v. Commissioner*, 34 T.C. 894 (1960) (concluding that the taxpayer was not engaged in a trade or business in the United States because the taxpayer's activities were sporadic, irregular, and minimal rather than continuous, regular, and considerable), *aff'd on other grounds*, 299 F.2d 623 (3d Cir. 1962); *cf.* *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940) (noting taxpayer's continuous, regular, and considerable activities suggested that taxpayer was engaged in a trade or business); *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953) (citing continuous, regular, and considerable activities as evidence that taxpayer engaged in a U.S. trade or business), *aff'd*, 221 F.2d 227 (9th Cir. 1995).

<sup>121</sup> See *Pasquel v. Commissioner*, 12 T.C.M. (CCH) 1431, T.C.M. (P-H) ¶ 54,002 (1954) (finding a single, isolated loan insufficient to constitute a U.S. trade or business); *cf.* *Inverworld v. Commissioner*, 71 T.C.M. (CCH) 3231, 1996 T.C.M. (RIA) ¶ 96,301 (finding that continuous and regular activities, including lending, constituted engaging in a trade or business); see also David D. Stewart, *IRS Examining Foreign Hedge Fund Debt Investment Issues*, 122 TAX NOTES (TA) 1330 (Mar. 16, 2009) (noting that Jeffrey Dorfman, Service Office of Associate Chief Counsel (International), recognizes that “the case law on determining when a foreign entity engaged in lending activity is engaged in a U.S. trade or business is ambiguous”).

only while physically located outside the United States, a foreign fund may freely originate and work out loans without incurring a U.S. corporate tax. In practice, this strategy tends to work better for corporate and commercial loan restructurings and workouts than it does for residential loan transactions, which typically require a physical presence in the United States. Third, if all of a fund's income will be foreign source income and capital gain and the fund does not have an office or fixed place of business in the United States, the fund should not recognize any income or gain that is effectively connected with a trade or business in the United States for U.S. federal income tax purposes.<sup>122</sup> The office of an independent agent is not attributed to the fund for these purposes.<sup>123</sup> Thus, if all of the activities of the fund in the United States are conducted through the office or other fixed place of business of an independent agent, which may include a U.S. investment manager, then the independent agent's office will not be attributed to the fund, and if the fund does

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<sup>122</sup> See Reg. § 1.864-5(a) (providing that foreign source income of a foreign person that is engaged in a trade or business in the United States is not treated as effectively connected income unless it is described in sections -5(b) or -5(c)); Reg. § 1.864-5(b) (describing dividends, interest, and gains and losses from the sale of securities); Reg. § 1.864-6(a) (providing that foreign-source income, gain, or loss that is described in Regulation section 1.864-5(b) and received by a foreign person is treated as effectively connected income only if the income, gain, or loss is attributable under sections -6(b) or -6(c) to an office or other fixed place of business—as defined in Regulation section 1.864-7—which the foreign person has in the United States at some time during the taxable year).

<sup>123</sup> Reg. § 1.864-7(d)(2). This Treasury Regulation provides that the office or other fixed place of business of an independent agent is not treated as the office or other fixed place of business of a principal that is a foreign person, even if the agent has authority to negotiate and conclude contracts in the name of the principal and regularly exercises that authority. Regulation section 1.864-7(d)(3)(i) defines an independent agent as an agent of independent status acting in the ordinary course of its business in that capacity. Under Regulation section 1.864-7(d)(3)(ii), the determination of whether an agent is an independent agent is made without regard to whether the agent is related to the principal. Also, under Regulation section 1.864-7(d)(3)(iii), if an agent is an exclusive agent, the facts and circumstances are taken into account to determine whether the agent is an independent agent. In *Taisei Fire & Marine Ins. Co. v. Commissioner*, 104 T.C. 535 (1995), the Tax Court defined an independent agent—for purposes of the U.S.–Japan Tax Treaty—as an agent that is “legally independent”—that is, has discretion over the details of its work—and “economically independent”—or, bears the entrepreneurial risk of its operations. There is no suggestion in the Treasury Regulations that would prohibit a limited partner from being an independent agent with respect to a partnership. In fact, by expressly permitting related parties to be independent agents, the Treasury Regulations suggest that a limited partner could indeed be an independent agent. Nevertheless, in *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962), and *Unger v. Commissioner*, 936 F.2d 1316 (D.C. Cir. 1991), the courts held that the U.S. office of a partnership should be attributed to the foreign partner for purposes of the U.S.–Canada tax treaty. In *Donroy*, the court suggested that a general partner might fail to qualify as an independent agent. See also Rev. Rul. 90-80, 1990-2 C.B. 170. However, if the fund does not have any office in the United States and the investment manager qualifies as an independent agent and is not a general partner, *Donroy* and *Unger* would be distinguishable and, under Regulation section 1.864-7(d), the U.S. office of the investment manager should not be attributed to the fund, regardless of whether the investment manager receives its compensation as a profits interest.

not otherwise have any office or other fixed place of business in the United States, none of the fund's income or gain will be attributed to an office or other fixed place of business in the United States and, therefore, none of the fund's income and gain, which will all be foreign-source, will be effectively connected income. Finally, special regimes in countries that have entered into tax treaties with the United States—principally Ireland and Luxembourg—effectively permit hedge fund investment managers that qualify as “independent agents” to engage in loan origination and workout activities from within the United States without any material foreign tax or, under the treaties, any U.S. federal income tax being imposed on the fund.<sup>124</sup> However, the hedge fund may still be subject to state taxes. Ireland and Luxembourg each have enacted taxing regimes for certain companies that permit the companies to avoid all or substantially all home jurisdiction tax.<sup>125</sup> In Ireland, one of these entities is known as a “section 110 company.”<sup>126</sup> Section 110 companies are generally subject to Irish tax at a rate of 25% on their net income.<sup>127</sup> However, section 110 companies are permitted to issue variable payment notes that provide for interest payments to holders equal to the companies' profits.<sup>128</sup> Thus, the companies' profits are offset by an equal amount of interest deductions and there is no amount of net income subject to tax. In order to qualify for taxation as a section 110 company, a company must (1) be resident in Ireland, (2) only acquire, hold, or manage “qualifying assets”—generally, stocks, bonds, other securities, futures, options, swaps, derivatives, and other similar instruments, and (3) acquire or hold at least €10 million of qualifying assets on the first day it acquires qualifying assets.<sup>129</sup> A company that intends to rely on section 110 is required to notify the Irish Revenue of its intent to be taxed as a section 110 company.<sup>130</sup> In Luxembourg, a special tax regime exists for securitization companies.<sup>131</sup> Although Luxembourgish

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<sup>124</sup> See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.–Lux., art. 5, Apr. 3, 1996, S. TREATY DOC. NO. 104-33 [hereinafter U.S.–Lux. Tax Treaty]; U.S.–Ir. Tax Treaty, *supra* note 100, art. 5.

<sup>125</sup> See Taxes Consolidation Act 1997, § 110 (Act No. 39/1997) (Ir.), available at <http://www.irishstatutebook.ie/1997/en/act/pub/0039/index.html>; Income Tax Law of December 4, 1997, art. 46, (Lux.), amended by Securitization Law of March 22, 2004, art. 8(c), (Lux.).

<sup>126</sup> See generally Taxes Consolidation Act 1997 (Act No. 39/1997) (Ir.), available at <http://www.irishstatutebook.ie/1997/em/act/pub/0039/index.html>.

<sup>127</sup> See *id.* (providing that profits from a qualifying company will be treated as annual profits or gains, taxable under Case III of Schedule D, which is currently a rate of 25%).

<sup>128</sup> See, e.g., ARTHUR COX, ESTABLISHING SPECIAL PURPOSE VEHICLES IN IRELAND (2011), [http://www.arthurcox.com/uploadedFiles/Publications/Publication\\_List/Arthur%20Cox%20-%20Establishing%20Special%20Purpose%20Vehicles%20in%20Ireland,%20May%202011.pdf](http://www.arthurcox.com/uploadedFiles/Publications/Publication_List/Arthur%20Cox%20-%20Establishing%20Special%20Purpose%20Vehicles%20in%20Ireland,%20May%202011.pdf) (last visited Mar. 14, 2012).

<sup>129</sup> Taxes Consolidation Act 1997 (Act No. 39/1997) (Ir.), available at <http://www.irishstatutebook.ie/1997/em/act/pub/0039/index.html>.

<sup>130</sup> *Id.*

<sup>131</sup> Income Tax Law of December 4, 1997, art. 46, (Lux.), amended by Securitization Law of March 22, 2004, art. 89(c) (Lux.).

securitization companies are subject to the corporate income tax and municipal business tax at a maximum aggregate rate of 28.59%, any obligation of a securitization company to investors or creditors—for example, interest or dividends—is a tax-deductible expense.<sup>132</sup> Thus, the gross income of a Luxembourgish securitization company may be offset by an equal deduction and, effectively, Luxembourgish securitization companies are exempt from Luxembourg corporate income tax and the municipal business tax. In addition, Luxembourgish securitization companies are exempt from the Luxembourg net worth tax<sup>133</sup> and, unless the securitization companies have real estate in Luxembourg, are not subject to registration taxes.<sup>134</sup> Finally, distributions from securitization companies are exempt from Luxembourg withholding tax.<sup>135</sup> In addition, both Ireland and Luxembourg have tax treaties with the United States that exempt an Irish or Luxembourgish company that qualifies for the benefits of the treaty from U.S. federal income tax so long as the company does not have a “permanent establishment” in the United States.<sup>136</sup> Moreover, under the treaty, the activities of an “independent agent” are disregarded for purposes of determining whether the Irish or Luxembourgish company has a permanent establishment in the United States.<sup>137</sup> Thus, if a hedge fund (1) is organized in Ireland or Luxembourg under one of the special regimes—for example, the fund is a Luxembourg securitization vehicle or an Irish section 110 company, (2) qualifies for the benefits of the relevant tax treaty, and (3) has an investment manager that qualifies as an “independent agent,” then the investment manager can originate and work out loans on behalf of the fund from within the United States without any U.S. federal income tax or any material foreign tax being imposed on the fund. The rules for qualifying for benefits under each treaty are complex. However, generally speaking, if 50% of the owners of beneficial interest in a company are residents of the United States or the relevant treaty jurisdiction and no more than 50% of the payments that are deductible for purposes of Irish—or, under the Luxembourg treaty, Luxembourgish—law are paid to persons that are not residents of the United States or Ireland—or, under the Luxembourg treaty, Luxembourg—then the Irish—or, under the Luxembourg treaty,

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<sup>132</sup> *Id.*

<sup>133</sup> Wealth Tax Law of October 16, 1934, ¶ 4 (Lux.), amended by Securitization Law of March 22, 2004, art. 90 (Lux.).

<sup>134</sup> Securitization Law of March 22, 2004, art. 52(1) (Lux.).

<sup>135</sup> Income Tax Law of December 4, 1997, art. 97 (Lux.), amended by Securitization Law of March 22, 2004, art. 89(d) (Lux.).

<sup>136</sup> See U.S.–Lux. Tax Treaty, *supra* note 128, art. 5; U.S.–Ir. Tax Treaty, *supra* note 100, art. 5 (identifying a “permanent residence” as a “fixed place of business through which the business of an enterprise is wholly or partly carried on,” especially a place of management, a branch, or an office). *But see* U.S.–Lux. Tax Treaty, *supra* note 124, art. 24(10) (excluding “holding companies” from the benefits of art. 5).

<sup>137</sup> See U.S.–Lux. Tax Treaty, *supra* note 124, art. 5; U.S.–Ir. Tax Treaty, *supra* note 100, art. 5.

Luxembourgish—company should qualify for the benefits of the treaty.<sup>138</sup> To qualify as an independent agent, the hedge fund investment manager must be “legally” and “economically” independent of the fund.<sup>139</sup> Legal independence means that the manager has freedom in the manner by which it performs its specific duties for the fund.<sup>140</sup> Investment managers generally satisfy this standard. Economic independence means that the manager bears risk of loss for its business—that is, the manager is not guaranteed revenue and is not protected from loss if it is unable to generate sufficient revenue.<sup>141</sup> Investment managers that manage a number of similar funds and managed accounts may indeed qualify as economically independent under this test. It is also helpful if the investment manager is not the general partner in the fund.<sup>142</sup>

### B. U.S. Withholding Tax

Although a foreign hedge fund that is not engaged in a U.S. trade or business may avoid net income taxation in the United States, the fund will nevertheless be subject to a 30% withholding tax on certain of its U.S.-source income, unless an exemption applies. More specifically, the United States imposes a 30% withholding tax on U.S.-source “fixed or determinable annual or periodical” income (FDAP) that is not effectively connected with the conduct of a trade or business within the United States received by foreign funds and foreign feeder funds.<sup>143</sup> FDAP generally includes all items of gross income, except gains on sales of property.<sup>144</sup> Common types of FDAP include divi-

<sup>138</sup> See U.S.–Lux. Tax Treaty, *supra* note 124, art. 23; U.S.–Ir. Tax Treaty, *supra* note 100, art. 24.

<sup>139</sup> See *Taisei Fire & Marine Ins. Co., Ltd. v. Commissioner*, 104 T.C. 535, 549–50 (1995). The Organisation for Economic Co-operation and Development (OECD) commentaries contain the same definition of an independent agent, and the Tax Court in *Taisei* relied on the commentaries as authority to interpret the treaty. See F.S.A. 973A (Jan. 17 1992) (providing an 11-factor test for determining whether an agent is independent); U.S.–Ir. Tax Treaty, *supra* note 100, art. 5(6) (providing technical explanation).

<sup>140</sup> See *Taisei*, 104 T.C. at 552; F.S.A. 973A (Jan. 17, 1992); OECD MODEL TAX CONVENTION ON INCOME AND CAPITAL art. 5, cmt. 37 (2008) (providing that an independent agent is typically not subject to significant control with respect to the manner in which the work is carried out; the agent exercises freedom in the conduct of the business within the scope of its authority).

<sup>141</sup> See *Taisei*, 104 T.C. at 555; F.S.A. 973A (Jan. 17, 1992); OECD MODEL TAX CONVENTION ON INCOME AND CAPITAL art. 5, cmt. 38.6 (2008) (providing that an independent agent’s activities should constitute an autonomous business in which the agent bears risk and receives reward through the use of its entrepreneurial skills and knowledge).

<sup>142</sup> See *Unger v. Commissioner*, 936 F.2d 1316, 1320 (D.C. Cir. 1991) (holding that a Canadian limited partner had a permanent establishment in the United States by reason of the partnership’s office in the United States, and expressly declining to attribute the general partner’s U.S. office to the Canadian limited partner); *Donroy, Ltd. v. United States*, 301 F.2d 200, 208 (9th Cir. 1962) (holding that a Canadian limited partner had a permanent establishment in the United States by reason of the partnership’s office in the United States and the U.S. general partner’s U.S. office).

<sup>143</sup> I.R.C. §§ 871(a), 881(a).

<sup>144</sup> I.R.C. §§ 871(a), 881(a).

dends, interest, certain rents, royalties, salaries, and wages.<sup>145</sup> Although U.S.-source dividends are generally subject to a 30% withholding tax unless reduced under a tax treaty,<sup>146</sup> exemptions from the U.S. withholding tax fortunately exist for other common types of hedge fund income. First, a broad exemption from withholding exists for interest that qualifies as “portfolio interest.”<sup>147</sup> Second, capital gains that are not attributable to U.S. real estate generally are not subject to U.S. withholding tax.<sup>148</sup> Third, income from nonequity notional principal contracts and certain equity notional principal contracts is generally sourced by reference to the residence of the payee and is not subject to U.S. withholding tax.<sup>149</sup> However, payments on “specified notional principal contracts” that are directly or indirectly contingent upon, or determined by reference to, the payment of a U.S.-source dividend are treated as U.S.-source payments that are subject to a 30% withholding tax.<sup>150</sup> A notional principal contract is “specified” if the contract is identified by the Secretary as a specified notional principal contract or the underlying security<sup>151</sup> referenced in the contract is (1) sold by the long party<sup>152</sup> to the short party<sup>153</sup> at the time the transaction is entered into—“crosses in,” (2) sold by the short party to the

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<sup>145</sup>I.R.C. §§ 871(a)(1)(A), 881(a)(1); Reg. §§ 1.871-7(b)(1), 1.881-2(b)(1).

<sup>146</sup>Notably, the United States does not have an income tax treaty with the Cayman Islands, the jurisdiction of many hedge funds.

<sup>147</sup>I.R.C. §§ 871(h), 881(c). Portfolio interest generally includes interest paid to a foreign person on an obligation that is in registered or book-entry form—or satisfies certain special bearer bond rules—and for which the foreign person furnishes the payor with the appropriate withholding certificate to establish its foreign status—the Service Form W-8BEN. Interest will not qualify for portfolio interest if (1) the interest is contingent interest, (2) the foreign person is a “10% shareholder”—as specially defined for tax purposes—of the payor, (3) the foreign person is a “controlled foreign corporation” with respect to which the payor is a “related person”—each as specially defined, or (4) the interest is received by a foreign bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its business. *See* I.R.C. §§ 871(h)(2), 881(c) (portfolio interest exemption from withholding); Reg. § 1.1441-1(e)(1)(ii) (providing that a withholding agent may treat a payment as made to a foreign person so long as the agent can reliably associate the payment with a beneficial owner withholding certificate); I.R.C. § 1441(c)(9) (no deduction or withholding on portfolio interest).

<sup>148</sup>I.R.C. §§ 871(a), 881(a); *see also* I.R.C. § 897 (providing that foreign investors in U.S. real property interests are subject to tax on any gain realized on the disposition of their interests); I.R.C. § 1445 (providing that transferee of any U.S. real property interest from a foreign person is required to withhold 10% of the amount realized by the foreign person on the disposition of the U.S. real property interest).

<sup>149</sup>Reg. § 1.863-7(b)(1).

<sup>150</sup>I.R.C. § 871(m).

<sup>151</sup>The “underlying security” is the security with respect to which the dividend equivalent payment is paid. An index or fixed basket of securities is treated as a single security. I.R.C. § 871(m)(4)(C).

<sup>152</sup>A “long party” is any party to the contract which is entitled to receive any payment that is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States with respect to such underlying security. I.R.C. § 871(m)(4)(A).

<sup>153</sup>A “short party” is any party to the contract which is not a long party with respect to such underlying security. I.R.C. § 871(m)(4)(B).

long party at the termination of the contract—“crosses out,” (3) not readily tradable on an established securities market, or (4) posted as collateral by the short party to the long party at the time the transaction is entered into.<sup>154</sup> Further, under section 871(m), after March 18, 2012, a 30% U.S. withholding tax will be imposed on any payment on any notional principal contract that directly or indirectly is contingent upon, or determined by reference to, the payment of a U.S.-source dividend except to the extent that the Secretary determines that the notional principal contract is of a type which does not have the potential for tax avoidance.<sup>155</sup> Finally, the Service has authority to treat payments that are substantially similar to payments on specified notional principal contracts as also subject to withholding tax.<sup>156</sup>

On January 23, 2012, the U.S. Treasury Department and the Service issued proposed and temporary regulations under section 871(m). Under Temporary Regulation section 1.871-16T, the March 18, 2012, date in the statute on which withholding on payments made on specified notional principal contracts was scheduled to begin was extended to December 31, 2012.<sup>157</sup>

The proposed regulations provide that withholding will apply beginning in 2013 to a payment that is contingent upon, or determined by reference to, the payment of a U.S.-source dividend on a derivative contract—whether it is a notional principal contract or some other equity-traded instrument<sup>158</sup>—if (1) the long party is “in the market” on the pricing or termination date,<sup>159</sup>

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<sup>154</sup>I.R.C. § 871(m)(3)(A)(i)–(iv). For purposes of section 871(m), the term “payment” includes any gross amount used to compute any net payment amount transferred to or by the taxpayer. I.R.C. § 871(m)(5).

<sup>155</sup>I.R.C. § 871(m)(3)(B). The statute does not indicate the characteristics of a notional principal contract that does not have the potential for tax abuse. However, prior legislative proposals and the Obama Administration’s Revenue Proposals for the Fiscal Year 2010 suggested that the following factors may be relevant: (1) whether the terms of the equity swap require the foreign person to post more than 20% of the value of the underlying stock as collateral, (2) whether the terms of the equity swap include provisions addressing the hedge position of the counterparty to the transaction, (3) whether the underlying stock is publicly traded and the notional amount of the swap represents less than 5% of the total public float of that class of stock and less than 20% of the 30-day average daily trading volume, (4) whether the foreign person crosses in or crosses out, (5) whether the prices of the equity that are used to measure the parties’ entitlements or obligations are based on objectively observable prices, and (6) whether the swap has a term of at least 90 days.

<sup>156</sup>I.R.C. § 871(m)(2)(C).

<sup>157</sup>Temp. Reg. § 1.871-16T(b).

<sup>158</sup>An “equity linked instrument” is a financial instrument or combination of financial instruments that references one or more underlying securities to determine its value, including a futures contract, forward contract, option, or other contractual arrangement. Prop. Reg. § 1.871-15(d)(2)(i), 77 Fed. Reg. 3202 (2012).

<sup>159</sup>A long party is “in the market” if it buys or sells the underlying security, but only if the amount purchased or sold is 10% or more of the notional amount of the derivative. Prop. Reg. § 1.871-16(c)(1), 77 Fed. Reg. 3202 (2012).



(2) the underlying security is not regularly traded,<sup>160</sup> (3) the underlying security is posted as collateral by the short party and the amount of that security exceeds 10% of the fair market value of the collateral posted by the short party on any date the derivatives contract is outstanding, (4) the contract remains outstanding for less than 90 days, excluding the date it was entered into,<sup>161</sup> (5) the long party controls, by contract or otherwise, the short party's hedge, (6) the aggregate notional principal amounts of all derivatives referencing the same security and entered into by the long party exceed 5% of the total public float of that class of security or 20% of the 30-day average daily trading volume, determined as of the close of the business day immediately preceding the first day in the term of the swap,<sup>162</sup> or (7) the derivative is entered into after the announcement of a special dividend but before the ex-dividend date.<sup>163</sup> The proposed regulations further note that dividend equivalent payments on transactions entered into with a principal purpose of avoiding the Treasury Regulations may be subject to withholding.<sup>164</sup>

If a domestic hedge fund or domestic master fund that is treated as a partnership for U.S. tax purposes has a foreign feeder or other foreign investor, the domestic fund will be a withholding agent and obligated to withhold tax on distributions to the foreign feeder or other investors that are subject to withholding under section 871(m).<sup>165</sup>

## V. Tax Issues for U.S. Investors

### A. *Investor vs. Trader and the Deductibility of Hedge Fund Expenses, Including the Management Fee*

If a hedge fund that is treated as a partnership for U.S. federal income tax purposes carries on a trade or business for federal income tax purposes—is a “trader”—under section 162(a), investors will be permitted to deduct all ordinary and necessary expenses paid or incurred by the fund in carrying on the trade or business during the taxable year. Expenses deducted under section 162 are not generally subject to limitation. A hedge fund's expenses

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<sup>160</sup> A security is “regularly traded” if it is listed on an SEC-registered national securities exchange or a section 11A national market system and it meets minimum trading and volume requirements. Prop. Reg. § 1.871-16(c)(2)(i), 77 Fed. Reg. 3202 (2012).

<sup>161</sup> Both offsetting positions and early terminations of a contract whose initial term exceed 90 days would implicate this rule. Prop. Reg. § 1.871-16(c)(4)(ii), 77 Fed. Reg. 3202 (2012).

<sup>162</sup> Prop. Reg. § 1.871-16(c)(6)(i), 77 Fed. Reg. 3202 (2012).

<sup>163</sup> Prop. Reg. § 1.871-16(c), 77 Fed. Reg. 3202 (2012).

<sup>164</sup> Prop. Reg. § 1.871-15(e), 77 Fed. Reg. 3202 (2012).

<sup>165</sup> See Reg. § 1.1441-5(b)(1) (providing that if a withholding agent can reliably associate a Service Form W-9 provided by a U.S. partnership, the withholding agent may treat the payment as made to a U.S. payee and the payment is not subject to withholding under section 1441 even though the partnership may have foreign partners); Reg. § 1.1441-5(b)(2) (providing that a U.S. partnership is required to withhold as a withholding agent on an amount subject to withholding that is includible in the gross income of a partner that is a foreign person).

generally include management fees, investment expenses—such as brokerage fees—periodic payments under notional principal contracts, and legal, accounting, and other professional fees. Interest expense is subject to a separate set of deductibility rules under section 163. These rules are described in Part V.B, below.

On the other hand, if a hedge fund is merely an “investor” for U.S. federal income tax purposes, an individual member of the fund will not be entitled to deduct his or her share of the hedge fund’s expenses under section 162 but will instead deduct his or her share of the hedge fund’s expenses under section 212.<sup>166</sup> Section 212 deductions are subject to considerable limitation. First, they are treated as “miscellaneous itemized deductions” and are generally deductible by an individual—as well as by trusts and estates—only to the extent that the aggregate amount of the deductions exceeds 2% of the individual’s adjusted gross income.<sup>167</sup> Second, an individual whose adjusted gross income exceeds a specified threshold amount will be required to further reduce the amount of his or her otherwise allowable itemized deductions.<sup>168</sup> So, an individual with adjusted gross income of \$5 million who pays \$20,000 in management fees on a \$10 million portfolio will be denied a deduction entirely for the \$20,000 payment unless the individual has more than \$80,000 of other miscellaneous itemized deductions. Third, miscellaneous itemized deductions are not allowed in computing the alternative minimum tax (AMT).<sup>169</sup>

Fourth, some states, including New York, limit or prohibit the deduction of itemized deductions for certain taxpayers.<sup>170</sup>

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<sup>166</sup>I.R.C. § 212 would generally permit an individual investor to deduct his or her portion of the fund’s ordinary and necessary expenses incurred to earn and collect income and to manage the fund’s investments, subject to the limitations described in the text.

<sup>167</sup>I.R.C. § 67(a); I.R.C. § 641(b).

<sup>168</sup>I.R.C. § 68(a). Prior to 2006, otherwise allowable itemized deductions, other than medical expenses, investment interest, theft and casualty losses, and gambling losses, were reduced by the lesser of (1) 3% of the excess of adjusted gross income (AGI) over the specified threshold amount, and (2) 80% of the amount of the itemized deductions otherwise allowable for such taxable year. However, in 2001, Congress enacted legislation that phases out the 3/80% limitation—1/3 each year—over the period from 2006 to 2009. For taxable years 2006 and 2007, itemized deductions were reduced by the lesser of 2% of AGI over the threshold and 53 1/3%—2/3 of 80%—of the itemized deductions. For taxable years 2008 and 2009, itemized deductions were reduced by the lesser of 1% of AGI over the threshold and 26 2/3%—1/3 of 80%—of the itemized deductions. For the 2010, 2011 and 2012 taxable years the limitation does not apply. However, in 2013, the full 3/80% limitation will be reinstated. *See* The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150, *amended by* Public Law No. 111-312, § 101(a)(1), 124 Stat. 3296, 3298; The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 601(a)(1), 124 Stat. 3296, 3309.

<sup>169</sup>I.R.C. § 56(b)(1)(A)(i).

<sup>170</sup>*See, e.g.*, N.Y. TAX LAW § 615 (McKinney 2011) (providing, among other restrictions, that taxpayers with New York adjusted gross income over \$1 million may not claim the New York itemized deduction, except for the portion of the deduction attributable to any charitable contribution allowed under section 170, multiplied by 50%).

Finally, the Obama Administration has proposed that high-income individuals be permitted to benefit from itemized deductions only to the extent of 28% of the expenditure, rather than at their higher marginal rates.<sup>171</sup>

Accordingly, the ability of high income investors to deduct their distributive shares of a hedge fund's expenses will be severely restricted, if not eliminated, if the hedge fund is an investor and not a trader.

The determination of whether a hedge fund's activities constitute a trade or business is a question of fact.<sup>172</sup> Conceptually, a trader is someone who aims for rapid portfolio turnover, whereas an investor is someone who tends to hold securities for a longer duration.<sup>173</sup> Courts generally agree that the following three factors are to be considered in determining whether a taxpayer is an investor or a trader: (1) the taxpayer's investment intent, (2) the nature of the income generated by the taxpayer's activities, and (3) the frequency, extent, and regularity of the taxpayer's transactions.<sup>174</sup> In addition, for trader status the courts

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<sup>171</sup> See OMB EXECUTIVE BUDGET 2013, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2013, *supra* note 7. The Obama Administration has proposed limiting the value of itemized deductions to 28% in every budget since Fiscal Year 2010. See OMB EXECUTIVE BUDGET 2012, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2012, *supra* note 7; OMB EXECUTIVE BUDGET 2011, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2011, *supra* note 7; OMB EXECUTIVE BUDGET 2010, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2010, *supra* note 7.

<sup>172</sup> See *Commissioner v. Groetzinger*, 480 U.S. 23 (1987); *Higgins v. Commissioner*, 312 U.S. 212 (1941); *Estate of Yaeger v. Commissioner*, 889 F.2d 29 (2d Cir. 1989); *Holsinger v. Commissioner*, 96 T.C.M. (CCH) 85, 2008 T.C.M. (RIA) ¶ 08,191; *Mayer v. Commissioner*, 67 T.C.M. (CCH) 2949, 1994 T.C.M. (RIA) ¶ 94,209; *Paoli v. Commissioner*, 62 T.C.M. (CCH) 275, 1991 T.C.M. (RIA) ¶ 91,351.

<sup>173</sup> See *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983) (holding that a taxpayer whose holding periods for investments sold averaged 3 1/2 and 8 years, respectively, was not a trader); *Levin v. United States*, 597 F.2d 760, 765 (Ct. Cl. 1979) (“[A] ‘trader’ is an *active* investor in that he does not passively accumulate earnings.”); *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955) (holding that investors purchase “for capital appreciation and income, usually without regard to short-term developments,” while traders buy and sell “with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis”).

<sup>174</sup> See *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976) (assessing the frequency, extent, and regularity of transaction and investment intent to determine trader status); *Moller*, 721 F.2d at 812 (stating that considerations relevant to trader status include “investment intent, the nature of the income to be derived from the activity, and the frequency, extent, and regularity of the taxpayer's securities transactions”); *Hart v. Commissioner*, 73 T.C.M. (CCH) 1684, 1997 T.C.M. (RIA) ¶ 97,011 (stating that for a taxpayer to be a trader, “the trading activity must be substantial, which means ‘frequent, regular, and continuous’”); *Holsinger*, 96 T.C.M. (CCH) at 86, 2008 T.C.M. (RIA) ¶ 08,191 at 1017 (holding such factors for the court to consider are: “(1) [t]he taxpayer's intent, (2) the nature of the income to be derived from the activity, and (3) the frequency, extent, and regularity of the taxpayer's securities transactions”).

require the taxpayer's trading activity to be substantial, not sporadic.<sup>175</sup> Significant long-term capital gains—and dividends and interest income—are indications of investor status, whereas short-term gains from daily market swings and frequent investment turnover are signs of trader status.<sup>176</sup> Nevertheless, even hundreds of trades a year may be insufficient to qualify for trader status.<sup>177</sup> Many hedge funds take the position that they qualify as traders.<sup>178</sup>

### B. *Deductibility of Interest Expense*

Section 163(d) permits an individual to deduct “investment interest” expense to the extent of his or her “net investment income” for the taxable year. Investment interest expense is generally the amount of interest paid or accrued

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<sup>175</sup> See *Hart v. Commissioner*, 73 T.C.M. (CCH) 1684, 1997 T.C.M. (RIA) ¶ 97,011 (For a taxpayer to be a trader, “the trading activity must be substantial, which means ‘frequent, regular, and continuous enough to constitute a trade or business’ as opposed to sporadic trading.”); see also *Holsinger*, 96 T.C.M. (CCH) at 87, 2008 T.C.M. (RIA) ¶ 08,191 at 1018 (holding that trading was insubstantial where taxpayer executed trades on less than 40% of the trading days in one year and less than 45% of the trading days in the second year); *Cameron v. Commissioner*, 94 T.C.M. (CCH) 245, 247, 2007 T.C.M. (RIA) ¶ 07,260, at 1510 (holding that trading on more than ten days in a given month only twice over several years was insubstantial); *Mayer*, 67 T.C.M. (CCH) at 2949–50, 1994 T.C.M. (RIA) ¶ 94,209 at 1150–51 (holding over 1,100 transactions in each of three years at issue as substantial); *Moller*, 721 F.2d at 811–12 (holding that trading was insubstantial when a taxpayer executed at most 83 purchases and 41 sales in one year and 76 purchases and 30 sales in the second year).

<sup>176</sup> See *Yaeger*, 889 F.2d at 33 (stating that the length of holding period and source of profit distinguish traders from investors); *Mayer*, 67 T.C.M. (CCH) at 2949–50, 1994 T.C.M. (RIA) ¶ 94,209 at 1149–50 (holding that trader status requires taxpayer to “catch the swings in the daily market movements, and to profit from these short-term changes, . . . rather than to profit from the long-term holding of investments”); see also *Cameron*, 94 T.C.M. (CCH) at 247, 2007 T.C.M. (RIA) ¶ 07,260 at 1509; *Liang*, 23 T.C. at 1044 (1955) (stating that absence of frequent short-term turnover indicative of investment activity); *Holsinger*, 96 T.C.M. (CCH) at 87, 2008 T.C.M. (RIA) ¶ 08,191 at 1019 (finding that taxpayers were not traders because they did not seek to profit from “daily swings in the market”).

<sup>177</sup> See, e.g., *Yaeger*, 889 F.2d at 31–32 (2d Cir. 1989) (holding that a taxpayer that consummated over 2,000 transactions over a two-year period—over 1,000 in each year—was not a trader); *Moller*, 721 F.2d at 814 (holding that a taxpayer who executed at most 83 purchases and 41 sales in one year and 76 purchases and 30 sales in the second year was not a trader); *Mayer*, 67 T.C.M. (CCH) at 2950, 1994 T.C.M. (RIA) ¶ 94,209 at 1150 (holding that a taxpayer that conducted over 1,100 transactions in each of three years at issue was not a trader); *Cameron*, 94 T.C.M. (CCH) at 247, 2007 T.C.M. (RIA) ¶ 07,260, at 1510 (holding that 46 purchases and 14 sales in one year and 109 purchases and 103 sales in second year was not sufficient for trader status); *Holsinger*, 96 T.C.M. (CCH) at 85, 2008 T.C.M. (RIA) ¶ 08,191, at 1018 (holding that approximately 372 trades the year at issue was not sufficient for trader status).

<sup>178</sup> See N.Y. ST. B.A. TAX SECTION, Rep. 1166, *Report on Proposed Carried Interest and Fee Deferral Legislation* (2008). However, a domestic partnership that simply holds an interest in a lower-tier partnership, such as the domestic fund in a master feeder structure, may not be a trader. See Rev. Rul. 2008-39, 2008-31 I.R.B. 252 (stating that annual management fees paid by upper-tier partnership holding lower-tier partnership interests for investment was a section 212 expense even though lower-tier partnership was a trader).

on debt incurred to purchase investment property.<sup>179</sup> Investment income is income from investment property that produces portfolio income—for example, interest, dividends, annuities, royalties—or from a trade or business that is not a passive activity and in which the taxpayer does not participate.<sup>180</sup> Investment income generally does not include long-term capital gain and qualified dividend income, unless the taxpayer elects to treat these items as investment income taxable at ordinary rates.<sup>181</sup> Accordingly, a hedge fund investor who borrows to make his or her investment in a hedge fund or who is allocated interest expense from the hedge fund will be able to deduct the interest expense on the debt to the extent of his or her gross income from the hedge fund and other investments that are taxed at ordinary income tax rates.<sup>182</sup> To the extent any investment interest expense exceeds investment income, the excess is carried forward indefinitely.<sup>183</sup>

### C. *Deductibility of Organization and Syndication Expenses*

The costs associated with organizing a hedge fund and selling interests in the fund to investors are typically paid by the fund. The fund may immediately deduct up to \$5,000 of its organization expenditures, reduced by the amount by which these costs exceed \$50,000.<sup>184</sup> Therefore, a hedge fund that has start-up costs in excess of \$55,000 will not be entitled to immediately deduct any of those costs.<sup>185</sup> However, any organizational expenses that are not immediately deductible may be amortized over 180 months—15 years.<sup>186</sup> If the fund liquidates before the end of the 180-month period, any unamortized organizational expenses may be deducted as a loss under sec-

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<sup>179</sup>I.R.C. § 163(d)(1), (3).

<sup>180</sup>I.R.C. § 163(d)(4).

<sup>181</sup>I.R.C. § 163(d)(4)(B).

<sup>182</sup>Rev. Rul. 2008-12, 2008-10 I.R.B. 520 (stating that a nonmaterially participating individual partner's distributive share of the interest expense of a partnership engaged in the trade or business of trading securities is subject to the investment interest limitation in section 163(d)(1)). Interest expense deductions are itemized deductions that are not classified as miscellaneous itemized deductions and thus are not subject to the 2% floor limitation. I.R.C. § 67(b)(1). However, the Obama Administration has proposed to limit the value of itemized deductions for high income individuals to 28% beginning in 2013. See OMB EXECUTIVE BUDGET 2013, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2013, *supra* note 7. The Administration has introduced this proposal each fiscal year since 2010. See *supra* note 171.

<sup>183</sup>I.R.C. § 163(d)(1), (2).

<sup>184</sup>See I.R.C. § 709(b)(1)(A).

<sup>185</sup>I.R.C. § 709; Reg. §§ 1.709-1(a), -1T(b). Amortizable organizational expenses include legal and accounting fees for services incident to the organization of the partnership, such as the negotiation and preparation of a partnership agreement, and filing fees. The following are not considered organizational expenses: expenses connected with acquiring or transferring assets to the partnership, expenses connected with the admission or removal of partners other than at the time the partnership is first organized, expenses connected with a contract relating to the operation of the partnership trade or business—even where the contract is between the partnership and one of its members—and syndication expenses. Reg. § 1.709-2(a).

<sup>186</sup>I.R.C. § 709(b)(1)(B).

tion 165.<sup>187</sup> Organizational expenses are generally considered miscellaneous itemized deductions to individual fund investors unless the fund is engaged in a trade or business—that is, is a “trader.”<sup>188</sup> As discussed above in Part V.A, miscellaneous itemized deductions are generally subject to significant limitation and a high income individual may not be able to deduct organizational expenses at all.<sup>189</sup> The costs associated with marketing and selling hedge fund interests—as opposed to organizing the fund—are not deductible or amortizable but, instead, must be capitalized.<sup>190</sup> Therefore, they will be added to the investor’s basis and generally reduce capital gains or increase capital loss. Thus, capitalized syndication costs may be more beneficial to individual investors since they can be fully utilized to offset future capital gain or reduce capital loss, whereas organizational expenses may be nondeductible to the investor as a result of the itemized deduction limitations.

#### D. *Passive Activity Losses*

Although section 469 generally limits the ability of individual taxpayers to offset losses that arise from passive investments in active businesses, such as a passive investment in a real estate business, against income that arises from active involvement, such as salary or income from a trade or business in which the taxpayers materially participate, and portfolio income, such as interest, dividends, royalties, and gain from the sale of property held for investment, hedge funds are generally not subject to the passive activity loss limitations.<sup>191</sup> Therefore, section 469 will not generally prevent individual hedge fund invest-

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<sup>187</sup> See I.R.C. § 165(c) (permitting individuals to deduct losses incurred in a trade or business or losses incurred in a transaction entered into for profit).

<sup>188</sup> See I.R.C. § 63(d) (providing that all deductions allowed in chapter 1 of the Code, which includes section 709, are itemized deductions); I.R.C. § 67(b) (providing that all itemized deductions that are not listed in section 67(b) are miscellaneous itemized deductions—the deductions allowed by section 709 are not among those listed in section 67(b)).

<sup>189</sup> I.R.C. § 67(a). If the fund is engaged in a trade or business, the organizational expenses would not be miscellaneous itemized deductions, but instead would be deductible trade or business expenses under section 162. The Obama Administration has also proposed to limit the value of itemized deductions for high income individuals to 28% beginning in 2013. See OMB EXECUTIVE BUDGET 2013, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2013, *supra* note 7. The Administration has introduced this proposal each fiscal year since 2010. See *supra* note 171.

<sup>190</sup> I.R.C. § 709(a). These so-called syndication expenses are costs related to issuing and marketing interests in the fund, including: brokerage fees; registration fees; legal fees of the underwriter or placement agent and the issuer—the general partner or the fund—for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes; accounting fees for preparation of representations to be included in the offering materials; and printing costs of the prospectus, placement memorandum, and other selling and promotional material. These expenses are not subject to the election under section 709(b) and must be capitalized. Reg. § 1.709-2(b).

<sup>191</sup> See Temp. Reg. § 1.469-1T(e)(6)(i) (stating that an activity of trading personal property for the account of owners in the activity is not a passive activity).

tors from using their share of the hedge fund's ordinary losses to offset unrelated active ordinary income, such as salary, and capital losses from the fund may generally be used by investors to offset unrelated capital gains—except that individuals may use up to \$3,000 a year of capital losses each year to offset ordinary income.

#### E. *At-Risk Limitations*

The “at-risk” rules of section 465 generally limit a taxpayer's loss with respect to an activity to the amount that the taxpayer has at risk and could actually lose from the activity. The at-risk rules are designed to prevent taxpayers from deducting losses in excess of their economic investment in certain activities, including an investment in a hedge fund.<sup>192</sup> Any losses in excess of a taxpayer's amount at risk that are disallowed in any year may be carried forward indefinitely.<sup>193</sup>

For purposes of applying the limitations of section 465, an individual hedge fund investor's amount at risk generally consists of the amount of cash contributed to the hedge fund and amounts borrowed to purchase the hedge fund shares, to the extent that the taxpayer is personally liable—or has pledged property as security—for the borrowed amounts.<sup>194</sup>

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<sup>192</sup>See H.R. REP. NO. 94-658, at 3002 (1976) (“To prevent a situation where the taxpayer may deduct a loss in excess of his economic investment in certain types of activities, the . . . amendment provides that the amount of any loss (otherwise allowable for the year under present law) which may be deducted in connection with one of these activities, cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year.”).

<sup>193</sup>I.R.C. § 465(a)(2).

<sup>194</sup>I.R.C. § 465(b)(1), (2). In addition, a partner in a partnership is generally considered at risk to the extent that his or her basis in the partnership is increased by his or her share of the partnership's net income and decreased by his or her share of the partnership's deductible losses. Prop. Reg. § 1.465-22(c)(1), -22(c)(2); see also H.R. REP. NO. 94-658, at 2921 (1976).

*F. Other Limitations and Special Rules: Section 1256, the Straddle Rules, the Short Sale Rules, the Constructive Sale Rules, the Constructive Ownership Rules, and the Wash Sale Rules*

Hedge funds employ various types of investment strategies, often involving rapid investment turnover and entering into investment positions that bear a relationship to one another. The following is a brief overview of some of the special tax rules that affect investors in hedge funds.

1. *Section 1256 Contracts*

Section 1256 contracts include certain regulated futures contracts,<sup>195</sup> foreign currency contracts,<sup>196</sup> and nonequity options.<sup>197</sup> Section 1256 contracts held by a hedge fund at the end of each taxable year are treated for U.S. federal income tax purposes as if they were sold by the fund for their fair market value on the last business day of such taxable year and any gain or loss from the deemed sale—and any gain or loss on an actual sale—is treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss.<sup>198</sup> If a section 1256 contract held by a fund at the end of a taxable year is sold in the following year, the amount of any gain or loss realized on such sale is adjusted to reflect the gain or loss previously taken into account.<sup>199</sup>

If any portion of the net capital loss of an individual taxpayer for a year consists of a net loss on section 1256 contracts, the taxpayer may elect to carry the loss back three years and deduct the loss against net capital gain to the extent of gain on section 1256 contracts.<sup>200</sup>

2. *Straddle Rules*

A hedge fund that enters into derivative arrangements that substantially diminish the fund's risk of loss with respect to publicly traded stock or securi-

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<sup>195</sup>A regulated futures contract is a contract with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market and which is traded on or subject to the rules of a qualified board or exchange. I.R.C. § 1256(g)(1).

<sup>196</sup>A foreign currency contract is a contract that requires delivery of—or the settlement of which depends on the value of—a foreign currency that is a currency in which positions are also traded through regulated futures contracts, which is traded in the interbank market, and which is entered into at arm's length at a price determined by reference to the price in the interbank market. I.R.C. § 1256(g)(2)(A).

<sup>197</sup>I.R.C. § 1256(b). A nonequity option is any listed option that is not an equity option. I.R.C. § 1256(g)(3). The term "equity option" means any option to buy or sell stock, or the value of which is determined directly or indirectly by reference to any stock or any "narrow-based security index"—as defined in section 3(a)(55) of the Securities Exchange Act of 1934, as in effect on the date of enactment of section 1256(g). The term equity option includes an option on a group of stocks only if the group satisfies the requirements for a narrow-based security index, as so defined. I.R.C. § 1256(g)(6).

<sup>198</sup>I.R.C. § 1256(a)(1), (3).

<sup>199</sup>I.R.C. § 1256(a)(2).

<sup>200</sup>I.R.C. § 1212(c).



ties or other “actively traded personal property”<sup>201</sup> is generally treated as having entered into a “straddle” subject to the “straddle rules” of section 1092.<sup>202</sup> Moreover, certain positions held by a hedge fund may constitute a straddle with certain positions held by investors in the fund.<sup>203</sup>

Section 1092, in combination with section 263(g), generally provides for four adverse tax consequences to a taxpayer that enters into a straddle. First, if the taxpayer disposes of a position in a straddle at a loss, the loss is deferred to the extent of any unrecognized gain in any offsetting positions that make up the straddle.<sup>204</sup> Second, the holding period of any position in a straddle that has not been held for more than a year prior to becoming a position in the straddle is eliminated and a new holding period does not begin to accrue again until the straddle has been closed out.<sup>205</sup> Third, any loss with respect to a straddle position is generally treated as a long-term capital loss if any other position in the straddle had been held for more than a year prior to becoming a position in the straddle.<sup>206</sup> Finally, under section 263(g), net interest and carrying charges that are properly allocable to personal property which is part of the straddle must be capitalized and realized only when the personal property is sold.<sup>207</sup>

A hedge fund may make a “mixed straddle” account election.<sup>208</sup> A “mixed straddle” generally is any straddle in which one or more, but not all, positions are section 1256 contracts.<sup>209</sup> The mixed straddle account rules require a daily “marking to market” of all open positions in the account and a daily netting

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<sup>201</sup> Actively traded personal property generally means any personal property of a type that is actively traded. I.R.C. § 1092(d)(1).

<sup>202</sup> More specifically, the straddle rules apply to “offsetting positions” with respect to “actively traded personal property.” I.R.C. § 1092(c)(1), (d)(1).

<sup>203</sup> See I.R.C. § 1092(d)(4)(C).

<sup>204</sup> I.R.C. § 1092(a)(1). A taxpayer that “identifies” all of its positions in a straddle is not subject to the normal straddle loss deferral rules. Instead, if the taxpayer has a loss with respect to an identified position, the taxpayer’s basis in each of the offsetting positions of the straddle is increased. Section 1092(a)(2)(B) permits taxpayers to “identify” a straddle if (1) the straddle is clearly identified in its records before the earlier of the close of the day on which the straddle is acquired, or such time as the Service provides by regulations, (2) to the extent provided by regulations, the value of each position of the straddle—in the hands of the taxpayer immediately before the creation of the straddle—is not less than the basis of such position in the hands of the taxpayer at the time the straddle is created, and (3) the straddle is not part of a larger straddle. By identifying the positions that make up a straddle, a taxpayer can limit the possibility that the positions that comprise the identified straddle will be treated as part of a straddle with other potentially offsetting positions held by the taxpayer—or a hedge fund in which the taxpayer is a partner. I.R.C. § 1092(a)(1).

<sup>205</sup> I.R.C. § 1092(b)(1); Temp. Reg. § 1.1092-2T(a).

<sup>206</sup> I.R.C. § 1092(b)(1); Temp. Reg. § 1.1092-2T(b).

<sup>207</sup> I.R.C. § 263(g).

<sup>208</sup> I.R.C. § 1092(b)(2)(A)(i)(II).

<sup>209</sup> Temp. Reg. § 1.1092-5T (“The term ‘mixed straddle’ means a straddle (i) all of the positions of which are held as capital assets, (ii) at least one (but not all) of the positions of which is a section 1256 contract, (iii) for which an election under section 1256(d) has not been made, and (iv) which is not part of a larger straddle.”).

of gains and losses from positions in the account.<sup>210</sup> At the end of a taxable year, the annual net gains or losses from the mixed straddle account are recognized for tax purposes.<sup>211</sup> The mixed straddle account rules are not entirely clear, and there is no assurance that the Service will accept a mixed straddle account election by a hedge fund.

### 3. *Short Sale Rules*

Gain or loss from a short sale of property by a fund is generally treated as capital gain or loss to the extent the property used by the fund to close the short sale constitutes a capital asset in the fund's hands.<sup>212</sup> Generally, if the property used by the fund to close a short sale had a long-term holding period on the date the short sale is entered into, any gain on the short sale will be long-term capital gain; otherwise, any gain on a short sale is generally short-term capital gain.<sup>213</sup> A loss on a short sale is treated as a long-term capital loss if, on the date of the short sale, "substantially identical property" has been held by the fund for more than one year.<sup>214</sup> In addition, the holding period of "substantially identical property" held by the fund on the date it enters into a short sale is generally terminated.<sup>215</sup> Gain or loss on a short sale is generally not realized until the short sale is closed.<sup>216</sup>

### 4. *Constructive Sale Rules*

The constructive sale rules are generally designed to prevent taxpayers from effectively eliminating their economic exposure to property without paying the tax that would be due had they sold the property.<sup>217</sup> Under section 1259, if a taxpayer is treated as having made a "constructive sale" with respect to appreciated stock, certain debt obligations, or partnership interests—each an appreciated "financial position"—the taxpayer is required to recognize gain as if the financial position had been sold at its fair market value on the date it enters into the transaction.<sup>218</sup> A taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer (1) enters into a short sale of the financial position or substantially identical property, (2) enters into an "offsetting notional principal contract" with respect to

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<sup>210</sup>Temp. Reg. § 1.1092-4T(c)(1).

<sup>211</sup>Temp. Reg. § 1.1092-4T(c)(2).

<sup>212</sup>I.R.C. § 1233(a).

<sup>213</sup>I.R.C. § 1233(b).

<sup>214</sup>I.R.C. § 1233(d).

<sup>215</sup>I.R.C. § 1233(b)(2).

<sup>216</sup>Reg. § 1.1233-1(a).

<sup>217</sup>See H.R. REP. NO. 105-48, at 439 (1997) ("In recent years . . . several financial transactions have been developed or popularized which allow taxpayers to substantially reduce or eliminate their risk of loss (and opportunity for gain) without a taxable disposition. Like most taxable dispositions, many of these transactions also provide the taxpayer with cash or other property in return for the interest that the taxpayer has given up.").

<sup>218</sup>I.R.C. § 1259(a).

the financial position or substantially identical property,<sup>219</sup> (3) enters into a futures or forward contract to deliver a substantially fixed amount of the financial position or substantially identical property, or its cash value, for a substantially fixed price,<sup>220</sup> or (4) to the extent provided in future regulations, enters into one or more other transactions—or acquires one or more positions—that have substantially the same effect as a transaction described in clauses (1)–(3).<sup>221</sup>

The subsequent holding period for any appreciated financial position that is subject to these constructive sale rules will be determined as if such position were acquired on the date of the constructive sale.<sup>222</sup>

### 5. *Constructive Ownership Rules*

The constructive ownership rules are generally designed to prevent taxpayers from achieving long-term capital gains treatment and deferral by entering into derivatives with respect to partnerships, mutual funds, and similar flow-through entities that provide the taxpayer with substantially all of the economic benefits and burdens of ownership, where long-term capital gains treatment would not be available had the taxpayer owned the underlying flow-through entity directly.<sup>223</sup> More specifically, under the constructive ownership rules of section 1260, if a fund (1) holds a long position under a notional principal contract on a pass-through entity—including a partnership, mutual fund or real estate investment trust, or certain foreign corporations, (2) enters into a forward or futures contract to acquire a pass-through entity, or (3) is the holder of a call option and the grantor of a put option with substantially equal strike prices and substantially contemporaneous maturity dates on a pass-through entity, then any gain that would otherwise be long-term capital gain on the contract is treated as ordinary income, and the U.S. investors in the fund are subject to an interest charge on their deferral.<sup>224</sup> The construc-

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<sup>219</sup>An “offsetting notional principal contract” means, with respect to a financial position, an agreement which includes (1) a requirement to pay or provide credit for all or substantially all of the investment yield, including appreciation, on the financial position for a specified period, and (2) a right to be reimbursed for or receive credit for all or substantially all of any decline in the value of the financial position. I.R.C. § 1259(d)(2).

<sup>220</sup>I.R.C. § 1259(c)(1)(C); *see also* I.R.C. § 1259(d)(1) (defining forward contract).

<sup>221</sup>I.R.C. § 1259(c)(1)(E).

<sup>222</sup>I.R.C. § 1259(a)(2)(B).

<sup>223</sup>*See* H.R. REP. NO. 106-238, at 384 (1999) (“The Committee is concerned with the use of derivative contracts by taxpayers in arrangements that are primarily designed to convert what otherwise would be ordinary income and short-term capital gain into long-term capital gain. Of particular concern are derivative contracts with respect to partnerships and other pass-thru entities. The use of such derivative contracts results in the taxpayer being taxed in a more favorable manner than had the taxpayer actually acquired an ownership interest in the entity.”).

<sup>224</sup>I.R.C. § 1260(d).

tive ownership rules do not apply to positions that are marked to market by a hedge fund that has made a section 475(f) election.<sup>225</sup>

### 6. *Wash Sale Rules*

The wash sale rules attempt to prevent taxpayers from (1) selling securities, (2) within a short period of time before or after the sale purchasing substantially identical securities, and (3) recognizing a loss for tax purposes. If this were permitted, taxpayers would be able to recognize losses on their securities investments without materially changing their economic exposure to the securities. Under the wash sale rules of section 1091, if a hedge fund sells shares of stock or securities at a loss and within the period beginning thirty days before the sale and ending 30 days after the sale acquires—or enters into a contract or an option to acquire—substantially identical stock or securities, the loss is disallowed.<sup>226</sup> Instead, the basis of the newly acquired stock or securities is adjusted upward to reflect the amount of the disallowed loss.<sup>227</sup>

### G. *The Disadvantages and Advantages for U.S. Taxable Investors of Investing in a Foreign Blocker—as Opposed to a U.S. Feeder*

As mentioned above, most U.S. taxable investors in hedge funds invest in the U.S. feeder, which is treated as a partnership for U.S. tax purposes. An investment in the U.S. feeder allows flow-through of long-term capital gains, qualified dividends, losses, and expenses. However, the ability of investors to use the losses and other expenses of a partnership are limited, and additional limitations have been proposed.<sup>228</sup> These limitations may make it more attractive for U.S. taxable investors to invest through a foreign feeder treated as a foreign corporation for U.S. tax purposes, rather than in the domestic feeder. This section explores the pros and cons to a U.S. taxable investor of investing in a foreign feeder that is treated as a foreign corporation for U.S. federal income tax purposes, as opposed to a domestic feeder.

#### 1. *The Disadvantages of Investing Through a Foreign Corporation*

Investing through a foreign corporation does present some costs. First, losses of a foreign corporation do not offset the shareholder's income and gain from other sources. Second, any dividends received by the foreign corporation from

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<sup>225</sup>I.R.C. § 1260(d)(2) (providing that section 1260 does not apply if all of the positions that are part of the transaction are marked to market under any provision).

<sup>226</sup>I.R.C. § 1091(a).

<sup>227</sup>I.R.C. § 1091(d).

<sup>228</sup>See *infra* Part V.G.2.a, b, e–i.

a U.S. corporation are subject to a 30% U.S. withholding tax.<sup>229</sup> Third, if the foreign corporation is engaged in a trade or business in the United States, it is subject to a 35% federal corporate net income tax, possibly state and local taxes, and potentially a 30% branch profits tax.<sup>230</sup> Finally, long-term capital gains and qualified dividends do not pass through a CFC.<sup>231</sup>

a. *No Pass-Through of Losses.* The most significant disadvantage for a U.S. taxable investor investing in a foreign feeder is the inability to claim losses prior to a disposition or complete redemption of its interest in the foreign feeder. This inability arises because the foreign feeder is treated as a corporation for U.S. federal income tax purposes.

b. *No Pass-Through of Capital Gains—Controlled Foreign Corporations and Passive Foreign Investment Companies.* A foreign feeder may be a “controlled foreign corporation” (CFC) for U.S. federal income tax purposes. If it is, then U.S. taxable investors that own more than 10% of the total voting power of the foreign feeder’s voting stock will generally be required to report their pro rata share of all of the income and gain of the feeder as ordinary income.<sup>232</sup> Very generally, a CFC is a foreign corporation more than 50% of the equity interests of which, measured by vote or value, are owned directly, indirectly, or constructively by U.S. persons who each possess directly, indirectly, or constructively 10% or more of the combined voting power of all classes of voting equity in the corporation on any day during the taxable year of the corporation.<sup>233</sup> These U.S. persons are referred to as “United States shareholders.”<sup>234</sup>

To avoid the adverse consequences of holding stock in a CFC, U.S. taxable investors should avoid holding directly, indirectly, or by attribution more than 9.9% of the voting interests of the foreign feeder, or else care should be taken to ensure that U.S. persons with 10% or more of the voting power do not collectively own more than 50% of the vote or value of the foreign

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<sup>229</sup> See I.R.C. § 881(a)(1) (providing that foreign corporations are subject to 30% gross-basis withholding tax on U.S.-source dividends). If the foreign corporation fund qualifies for the benefits of an income tax treaty, U.S.-source dividends received by the foreign corporation fund may be eligible for a reduced rate of withholding tax. For example, if the foreign corporation were organized in Ireland as a “section 110 company” or collective investment unit trust that qualifies for the benefits of the income tax treaty with Ireland, U.S.-source dividends received by the fund would be eligible for a 15% rate of withholding. See U.S.–Ir. Tax Treaty, *supra* note 100, art. 10.

<sup>230</sup> See I.R.C. § 882(a)(1) (providing that a foreign corporation engaged in a U.S. trade or business is taxable on its effectively connected income at regular U.S. corporate tax rates); I.R.C. § 884(a) (providing that foreign corporations engaged in a U.S. trade or business are subject to a 30% “branch profits” tax on their after-tax income that is not reinvested in the trade or business).

<sup>231</sup> See I.R.C. § 951(a).

<sup>232</sup> See I.R.C. § 951(a).

<sup>233</sup> See I.R.C. § 957(a).

<sup>234</sup> I.R.C. § 951(b).

feeder.<sup>235</sup>

So long as a U.S. investor is not subject to the CFC rules with respect to the foreign feeder—that is, the foreign feeder is not a CFC or, if it is, the U.S. investor does not own, and is not treated as owning, 10% of the voting power—the investor will be subject to the passive foreign investment company (PFIC) rules with respect to the foreign feeder.<sup>236</sup>

Generally, under the PFIC rules, a U.S. investor that makes a timely “qualified electing fund” (QEF) election<sup>237</sup> is required to include in gross income in each taxable year (1) as ordinary income, the U.S. investor’s pro rata share of the PFIC’s ordinary earnings and (2) as long-term capital gain, the U.S. investor’s pro rata share of the PFIC’s net capital gain, whether or not such amounts are distributed to the investor.<sup>238</sup> A U.S. investor in a PFIC that does not make a timely QEF election is required to report any gain on the disposition of its interests in the PFIC as ordinary income, rather than capital gain.<sup>239</sup> In addition, the investor is required to compute the tax liability on this gain and any “excess distributions”<sup>240</sup> as if the items had been earned ratably over each day in the U.S. investor’s holding period—or a certain portion thereof—for the equity interests.<sup>241</sup> The tax on the items is imposed at the highest ordinary income tax rate for each taxable year prior to the current year to which the items are allocated, regardless of the rate otherwise applicable to the investor.<sup>242</sup> Further, the U.S. investor is subject to a nondeductible interest charge, at the rate for underpayments of tax, as if his or her income tax

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<sup>235</sup> Thus, a U.S. person could own up to 50% of the vote and value of a foreign feeder without the foreign feeder being treated as a CFC so long as there is not another U.S. person that owns or is treated as owning 10% or more of the voting power of the foreign feeder.

<sup>236</sup> I.R.C. § 1297(d). In general, a PFIC is any foreign corporation if (1) 75% or more of the gross income of the corporation for the taxable year is passive income, which includes dividends, interest, rents and royalties, or (2) the average percentage of assets held by the corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50%. I.R.C. §§ 1297(a)–(b), 954(c).

<sup>237</sup> A taxpayer may make a QEF election by attaching a PFIC Annual Information Statement, an Annual Intermediary Statement—if applicable—and a completed Form 8621 to the taxpayer’s federal income tax return for the year filed on or before the return’s due date for such taxable year—determined with regard to extensions. *See* I.R.C. § 1295(b)(2); Reg. § 1.1295-1(f).

<sup>238</sup> I.R.C. § 1293(a). In certain cases in which a QEF does not distribute all of its earnings in a taxable year, the electing U.S. investor may also be permitted to elect to defer payment of some or all of the taxes on the QEF’s income, subject to a nondeductible interest charge on the deferred amount. I.R.C. § 1294.

<sup>239</sup> *See* I.R.C. § 1291(a)(1), (2).

<sup>240</sup> An “excess distribution” is the amount by which distributions during a taxable year with respect to the equity interests exceed 125% of the average amount of distributions in respect thereof during the three preceding taxable years—or, if shorter, the U.S. investor’s holding period for the interests. I.R.C. § 1291(b).

<sup>241</sup> I.R.C. § 1291(a)(1). For purposes of these rules, gifts, exchanges pursuant to corporate reorganizations, and use of the equity interests as security for a loan may be treated as a taxable disposition of the interests. *See* I.R.C. § 1298(b)(6); Prop. Reg. § 1.1291-3(b)(1), -3(d)(1).

<sup>242</sup> *See* I.R.C. § 1291(c)(1)–(2).

liabilities had been due with respect to each such prior year.<sup>243</sup> This regime denies individual investors long-term capital gains rates, and the underpayment rate significantly exceeds the borrowing cost for most investors, unless the PFIC distributes all or substantially all of its income each year and no meaningful appreciation in the value of its stock is expected.

Therefore, U.S. taxable investors in a foreign feeder would generally make a QEF election with respect to the foreign feeder to allow a pass-through of long-term capital gains and to avoid the tax on excess distributions. It should be noted, however, that in order for an investor to make a QEF election, the hedge fund must agree to make certain information available to the investor,<sup>244</sup> which not all hedge funds are willing to do.

c. *The PFIC on a PFIC Rules.* An offshore feeder that is a PFIC may acquire interests in other entities that are treated as PFICs for U.S. tax purposes. In this event, the U.S. investor will have to make a timely QEF election with respect to each PFIC to avoid the denial of capital gains rule and the “penalty” interest charge.<sup>245</sup> However, the offshore feeder is not permitted to make a QEF election on behalf of the investor.<sup>246</sup> For purposes of the PFIC rules, the U.S. investor will be treated as owning stock in the PFIC held by the offshore feeder by reason of its ownership of the offshore feeder.<sup>247</sup> It may be difficult for the U.S. investor to obtain the information necessary to compute its tax liability. Moreover, even if a QEF election is made with respect to each PFIC, if one PFIC is sold by the foreign feeder at a loss and another at a gain, the investor will be required to report the gross gain on the first, and will not be able to offset the loss on the second against the gain. Instead, the investor’s basis in the foreign feeder will increase by its share of the foreign feeder’s net income and gain that is reported.<sup>248</sup> Only upon a sale or redemption of the investor’s interest in the foreign feeder will the prior income or gain inclusion give rise to reduced capital gain or increased loss.<sup>249</sup>

d. *Dividend—and Other—Withholding Tax.* Foreign corporations are subject to U.S. withholding tax on dividends, which has been a meaningful disincentive for U.S. taxpayers to invest in a hedge fund that will earn a material amount of dividends on U.S. equities through a foreign feeder.<sup>250</sup>

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<sup>243</sup> I.R.C. § 1291(c)(3).

<sup>244</sup> I.R.C. § 1295(a); Reg. § 1.1295-1(g) (requiring PFIC Annual Information Statement).

<sup>245</sup> See Reg. § 1.1295-1(d)(3) (“An election under section 1295 shall apply only to the foreign corporation for which an election is made. Therefore, if a shareholder makes an election under section 1295 to treat a PFIC as a QEF, that election applies only to stock in that foreign corporation and not to the stock in any other corporation which the shareholder is treated as owning by virtue of its ownership of stock in the QEF.”).

<sup>246</sup> See I.R.C. § 1295; Reg. § 1.1295-1(d).

<sup>247</sup> See I.R.C. § 1298(a)(2)(B).

<sup>248</sup> Reg. § 1.1293-1(c)(2)(i).

<sup>249</sup> *Id.*

<sup>250</sup> See I.R.C. § 881(a)(1) (providing that foreign corporations are subject to 30% gross-basis withholding tax on U.S.-source dividends).

However, equity swaps can be used to avoid the withholding tax and, if regulations under new section 871(m)<sup>251</sup> provide a safe harbor under which equity swaps will continue to be exempt from withholding, then U.S. taxpayers will be able to hold equity portfolios in swap form through foreign corporations without U.S. withholding tax.

e. *U.S. Trade or Business Risk.* A U.S. taxpayer that invests in a hedge fund through a foreign corporation instead of a U.S. partnership exposes itself to the risk that the foreign corporation is treated as engaged in a trade or business in the United States. The consequences of that treatment would be disastrous. In this case, the foreign corporation would be subject to a U.S. federal corporation tax on its effectively connected income, potentially subject to state and local taxes, and could be subject to the branch profits tax.<sup>252</sup>

f. *No U.S. Foreign Tax Credits for Individuals or for Corporations with Less than 10% of the Voting Power.* U.S. individuals that invest in a foreign corporation—and U.S. corporations with less than 10% of the voting power of a foreign corporation—are not entitled to U.S. foreign tax credits for the foreign taxes paid by the foreign corporation.<sup>253</sup>

g. *Additional Filings—FATCA Reporting Requirements for “Foreign Financial Institutions.”* In general, under the FATCA provisions of the Hiring Incentives to Restore Employment Act (HIRE Act),<sup>254</sup> beginning on January 1, 2014, a 30% withholding tax will be imposed on U.S.-source interest, dividends, rents and other “fixed or determinable, annual or periodical” income, and, beginning on January 1, 2015, on the gross proceeds from the sale or other disposition of any property that produces U.S.-source interest or dividends, such as stock or debt of a U.S. corporation, that are paid to a foreign hedge

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<sup>251</sup> See *supra* Part IV.B.

<sup>252</sup> See I.R.C. § 881(a)(1) (providing that foreign corporations are subject to 30% gross-basis withholding tax on U.S.-source dividends); I.R.C. § 882(a)(1) (providing that a foreign corporation engaged in a U.S. trade or business is taxable on its effectively connected income at regular U.S. corporate tax rates); I.R.C. § 884(a) (providing that foreign corporations engaged in a U.S. trade or business are subject to a 30% “branch profits” tax on their after-tax income that is not reinvested in the trade or business).

<sup>253</sup> See I.R.C. § 902(b)(2)(B)(i) (providing that deemed paid foreign tax credit are available only for domestic corporation which owns 10% or more of the voting stock of a foreign corporation).

<sup>254</sup> FATCA stands for Foreign Account Tax Compliance Act of 2009, H.R. 3933, 111th Cong. (2009). The provisions discussed in this section were originally introduced in FATCA but were enacted as part of the HIRE Act. See Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147, 124 Stat. 72. FATCA was never enacted.



fund, foreign blocker corporation, or other “foreign financial institution,”<sup>255</sup> unless the foreign financial institution enters into an agreement (a “FATCA agreement”) with the U.S. Treasury Department to provide certain information with respect to United States persons and certain foreign persons that hold equity or debt of the foreign financial institution and, starting in 2017, to withhold on payments to holders that do not provide the information. In addition, starting in 2017, foreign hedge funds, foreign blocker corporations, and other financial institutions will be subject to a 30% withholding tax on certain foreign-source “passthru payments” made to them unless these foreign financial institutions also enter into a FATCA agreement.<sup>256</sup> However, the withholding tax does not apply to payments on or the proceeds from “obligations” that are outstanding on December 31, 2012.<sup>257</sup> As discussed below,

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<sup>255</sup>I.R.C. § 1472(d) broadly defines a “foreign financial institution” to include any foreign entity that (1) accepts deposits in the ordinary course of a banking or similar business, (2) holds financial assets for the account of others as a substantial portion of its business, or (3) is engaged or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in financial assets, including securities, partnership interests, commodities, or any interest in such securities, partnership interests or commodities. The proposed regulations indicate that a “business” for FATCA purposes is much broader than for federal income tax purposes. Therefore, in addition to foreign investment and commercial banks, most foreign hedge funds, foreign “blocker corporations,” foreign collateral debt obligation issuers, foreign private equity funds, and other foreign securitization vehicles that are mere “investors” in securities or commodities are likely to be treated as engaged in a business for purposes of FATCA and may be treated as “foreign financial institutions” that must enter into an agreement with the U.S. Treasury Department or be subject to the withholding provisions. *See* Prop. Reg. § 1.1471-5(d)-(e), 77 Fed. Reg. 9022 (2012). Any foreign financial institution that is more than 50% owned by a foreign financial institution or is more than 50% commonly owned with the financial institution is considered part of the same “expanded affiliated group” as the foreign financial institution and generally is subject to the same reporting and withholding requirements. Thus, if a foreign financial institution enters into an agreement with the U.S. Treasury, all other foreign financial institutions that are also members of the expanded affiliated group generally are required to comply with the agreement. Special rules, applicable through December 31, 2015, exempt members located in counties where information reporting is prohibited by law. Prop. Reg. § 1.1471-4(e), 77 Fed. Reg. 9022 (2012).

<sup>256</sup>I.R.C. Section 1471(a).

<sup>257</sup>The proposed regulations issued on February 8, 2012, extended the “grandfather date” from March 18, 2012, the date in the statute, to December 31, 2012. Prop. Reg. § 1.1471-2(b), 77 Fed. Reg. 9022 (2012).

The term “obligation” is not defined in the HIRE Act. However, the Proposed Regulation section 1.1471-2(b)(2)(ii) defines the term “obligation” to include any legal agreement that (1) produces or could produce withholdable payments or foreign passthru payments, (2) is not treated as equity for U.S. tax purposes, and (3) has a definitive expiration date or term. If an obligation is outstanding on or before December 31, 2012, it will be grandfathered and future payments on the obligation will not be subject to FATCA withholding. However, equity, savings deposits, demand deposits and brokerage, custodial, and similar agreements to hold financial assets for the account of others will not be grandfathered. Prop. Reg. § 1.1471-2(b)(1)-(2), 77 Fed. Reg. 9022 (2012). Moreover, any “material modification”—as determined under Reg. § 1.1001-3 for debt obligations and under a facts and circumstances test for all other obligations—to an obligation outstanding on December 31, 2012, will cause the obligation to lose its grandfathered status.

these provisions will effectively require most foreign hedge funds to enter into agreements with the U.S. Treasury Department.<sup>258</sup> The remainder of this subsection discusses these rules as they apply to foreign hedge funds, but the rules apply equally to foreign blocker corporations.

Foreign hedge funds will need to enter into a FATCA agreement with the U.S. Treasury Department prior to June 30, 2013.<sup>259</sup> Although the Service has not yet revealed a template for the FATCA agreement, the proposed regulations indicate that the FATCA agreement will require a foreign hedge fund to identify each equity interest in the hedge fund held by:

1. a United States person,<sup>260</sup> which includes:
  - a. a United States person;<sup>261</sup>
  - b. a foreign entity that is treated as a corporation or partnership for U.S. tax purposes in which a United States person owns more than 10% of the stock by vote or value or the profits or capital interest, in the case of a partnership;<sup>262</sup>
  - c. a foreign entity that is treated as a grantor trust for U.S. tax purposes if a United States person is treated as an owner;<sup>263</sup>

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<sup>258</sup>The proposed regulations provide for an exemption from FATCA for any entity that certifies to the Service that: (1) it is organized in a jurisdiction has not been identified by the Financial Action Task Force as being “at-risk” with respect to its anti-money laundering and measures to combat the financing of terrorism—currently, there are no European Union members on this at-risk list, *see* FINANCIAL ACTION TASK FORCE, [www.fatf-gafi.org](http://www.fatf-gafi.org) (last visited Mar. 15, 2012)—and Bermuda, the British Virgin Islands, and the Cayman Islands are also not on the risk list; (2) it is regulated as an investment fund; (3) its underwriter and any other distributor of its interests have entered into a FATCA agreement or are otherwise exempt from FATCA; and (4) its interests can be held only by non-U.S. individuals, foreign financial institutions that have entered into a FATCA agreement or are otherwise exempt from FATCA, publicly traded nonfinancial foreign entities, nonpublicly traded foreign financial entities with no significant U.S. holders, governmental instrumentalities such as sovereign wealth funds, and certain retirement funds. Prop. Reg. § 1.1471-5(f)(1)(i)(D), 77 Fed. Reg. 9022 (2012).

<sup>259</sup>Notice 2011-53, 32 I.R.B. 124. The Proposed Regulations did not change this date.

<sup>260</sup>I.R.C. § 1471(d)(1) (defining “United States account”); Prop. Reg. §§ 1.471-4(a)(2), 77 Fed. Reg. 9022 (2012) (FATCA agreement will require identifying “U.S. accounts”), -5(a)(2), 77 Fed. Reg. 9022 (2012) (“U.S. accounts” are financial accounts held by “specified U.S. persons” or “U.S. owned foreign entities”).

<sup>261</sup>I.R.C. § 1473(3) (defining “specified U.S. person”); Prop. Reg. § 1.1747-1(c), 77 Fed. Reg. 9022 (2012) (same).

<sup>262</sup>I.R.C. § 1471(d)(3) (“United States owned foreign entity” as any foreign entity with “substantial United States owners”); Prop. Reg. § 1.1471-5, 77 Fed. Reg. 9022 (2012) (same); *see also* I.R.C. § 1473(2)(A)(i)–(ii) (defining “substantial United States owner” in corporation and partnership contexts); 1.473-1(b)(1)(i)–(ii), 77 Fed. Reg. 9022 (2012) (same).

<sup>263</sup>I.R.C. § 1473(2)(A)(iii)(I) (defining “substantial United States owner” in the grantor-trust context); Prop. Reg. § 1.1473-1(b)(1)(iii)(A), 77 Fed. Reg. 9022 (2012) (same).

- d. a foreign entity that is treated as a foreign trust for U.S. federal income tax purposes, if a United States person is the beneficial owner of more than 10% of any portion of its assets;<sup>264</sup>
  - e. a foreign entity that is engaged, or holds itself out as being engaged, primarily in the business of investing, reinvesting, or trading in securities, interests in partnerships, or commodities and in which any United States person owns any interest;<sup>265</sup>
2. persons and entities that do not comply with reasonable requests for information to identify whether the holder is a U.S. person;<sup>266</sup> and
  3. accounts held by foreign financial institutions that do not enter into a FATCA agreement with the U.S. Treasury Department.<sup>267</sup>

Furthermore, the FATCA agreement will require a foreign hedge fund to report annually to the Service on its U.S. accounts and accounts held by “recalcitrant account holders” that did not respond to information requests.<sup>268</sup>

Starting in 2014, a foreign hedge fund that enters into a FATCA agreement will be required to report certain information to the Service regarding its equity holders.<sup>269</sup> Additional information will be required to be reported starting in 2016.<sup>270</sup>

Foreign hedge funds that enter into FATCA agreements will be required to withhold on certain payments made to recalcitrant account holders and foreign financial institutions that have not entered into a similar agreement with the U.S. Treasury Department.<sup>271</sup> Under the proposed regulations, beginning January 1, 2014, withholding would apply to payments of U.S.-source FDAP income.<sup>272</sup> Beginning on January 1, 2015, withholding would extend to gross

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<sup>264</sup>I.R.C. § 1473(2)(A)(iii)(II) (defining “substantial United States owner” in the foreign-trust context); Prop. Reg. § 1.1473-1(b)(1)(iii)(B), 77 Fed. Reg. 9022 (2012) (same).

<sup>265</sup>I.R.C. § 1473(2)(B) (describing special rule applicable to investment vehicles); Prop. Reg. § 1.1473-1(b)(5), 77 Fed. Reg. 9022 (2012) (same).

<sup>266</sup>I.R.C. § 1471(d)(6) (defining “recalcitrant account holders”); Prop. Reg. §§ 1.1471-4(a)(2), 77 Fed. Reg. 9022 (2012) (providing that a FATCA agreement will require identifying “recalcitrant account holders”); -5(g)(2), 77 Fed. Reg. 9022 (2012) (also defining “recalcitrant account holders”).

<sup>267</sup>Prop. Reg. § 1.1471-4(a)(2), 77 Fed. Reg. 9022 (2012) (providing that a FATCA agreement will require identifying accounts held by nonparticipating foreign financial institutions).

<sup>268</sup>Prop. Reg. § 1.1471-4(a)(3), 77 Fed. Reg. 9022 (2012).

<sup>269</sup>Prop. Reg. § 1.1471-4(a)(3), -4(d)(7)(ii)(A), 77 Fed. Reg. 9022 (2012).

<sup>270</sup>Prop. Reg. § 1.1471-4(a)(3), -4(d)(7)(ii)(B), 77 Fed. Reg. 9022 (2012).

<sup>271</sup>Prop. Reg. § 1.1471-4(b), 77 Fed. Reg. 9022 (2012).

<sup>272</sup>Prop. Reg. §§ 1.1471-2(a)(1), 77 Fed. Reg. 9022 (2012) (withholding applies to withholdable payments); -4(b)(1), 77 Fed. Reg. 9022 (2012) (FATCA agreement will require withholding); 1.1473-1(a)(1)(i), 77 Fed. Reg. 9022 (2012) (payments of U.S.-source FDAP income are withholdable payments).

proceeds from the sale of assets that produce U.S.-source FDAP income.<sup>273</sup>

Starting in 2017, a foreign hedge fund will be required to (1) deduct and withhold 30% from any payment to any recalcitrant account holder that fails to provide the requested information or any holder that is a foreign financial institution and has not entered into a similar agreement with the U.S. Treasury Department, to the extent the payment is “attributable to” a withholdable payment—a foreign source “passthru payment”—or (2) elect to receive its U.S.-source payments, including gross proceeds from sales of U.S. stock and debt, subject to 30% withholding on the portion that is allocable to the recalcitrant investor or noncompliant foreign financial institution.<sup>274</sup>

It is likely that by 2014, substantially all foreign hedge funds that directly receive a material amount of U.S.-source income on assets that are not grandfathered will enter into FATCA agreements and require all of their investors to certify whether they are United States persons or United States owned foreign entities and to provide the required information if they are. By 2017, substantially all foreign hedge funds that receive foreign-source passthru payments will likely enter into similar FATCA agreements.

To illustrate how these rules will work, assume that an offshore “fund-of-funds” hedge fund owns only interests in other offshore hedge funds that are treated as foreign corporations for U.S. tax purposes. This offshore fund-of-funds will not directly receive U.S.-source payments or proceeds from the sale of U.S. stock or securities. However, if one of the underlying offshore hedge funds it owns receives U.S.-source payments on an obligation that is not grandfathered, then by June 30, 2013, the underlying hedge fund will be required to enter into a FATCA agreement with the U.S. Treasury Department or otherwise be subject to 30% withholding on the payments, and beginning in 2017, this underlying hedge fund will withhold on payments to the offshore fund-of-funds unless the fund-of-funds has entered into its own FATCA agreement.

If a foreign hedge fund is the beneficial owner of a payment that is subject to withholding, which may arise because a payment to the foreign hedge fund is subject to withholding or because the foreign hedge fund withholds from a recalcitrant investor in the hedge fund, then a refund is available only if the foreign hedge fund or recalcitrant investor, as the case may be, is entitled to a reduced rate of tax under a tax treaty, and then only to the extent the

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<sup>273</sup> Prop. Reg. §§ 1.1471-4(b)(1), 77 Fed. Reg. 9022 (2012) (FATCA agreement will require withholding); 1.1473-1(a)(1)(ii), 77 Fed. Reg. 9022 (2012) (providing that withholdable payments include gross proceeds of sales that produce U.S.-source FDAP income beginning in 2015).

<sup>274</sup> I.R.C. § 1471(b)(1)(D), (b)(3). The proposed regulations reserve on the definition of foreign source passthru payments and request comment. Prop. Reg. § 1.1471-5(h)(2), 77 Fed. Reg. 9022 (2012); *see also* Preamble to Proposed Regulations, 77 Fed. Reg. 9022, 9026 (requesting comments on the scope and ultimate implementation of withholding on foreign passthru payments).

refund is attributable to that reduced rate.<sup>275</sup> Thus, if a foreign hedge fund that is treated as a corporation and is not entitled to treaty benefits fails to enter into a FATCA agreement by 2014 and consequently is subject to a 30% withholding tax on all of its U.S.-source dividends, interest, and, starting in 2015, the proceeds from sales of U.S. stock and debt, neither the hedge fund nor its investors will be able to receive a refund under any circumstances. Likewise, if a foreign investor that is not entitled to treaty benefits invests in a foreign hedge fund that has entered into a FATCA agreement, and by 2017 the foreign investor fails to certify its status, and if relevant, the status of its investors, to the hedge fund, then it will be subject to withholding on passthru payments to it and may not be able to receive a refund. The effect of this withholding tax may amount to a double tax in certain circumstances.

h. *Additional Filings—Service Form 926.* A U.S. investor that purchases an interest in an offshore hedge fund—that is treated as a corporation—for cash is generally required to file Service Form 926—*Return by a U.S. Transferor of Property to a Foreign Corporation*—or a similar form with the Service, if (1) immediately after the purchase the investor owns directly, indirectly, or by attribution 10% or more of the total voting power or total value of the corporation, or (2) the investor or any related person transfers more than \$100,000 to the corporation during the 12 month period ending on the date of such transfer.<sup>276</sup> Failure to file Service Form 926 subjects the taxpayer to a penalty equal to 10% of the fair market value of the property at the time of the exchange, up to a maximum of \$100,000, unless the failure was due to intentional disregard—in which case, there is no maximum.<sup>277</sup> However, the penalties do not apply if the failure to disclose is due to reasonable cause and not willful neglect.<sup>278</sup>

i. *Additional Filings—Service Form 5471.* A U.S. investor that owns or is treated as owning at least 10% by vote or value of the equity of an offshore corporation—for example, an offshore hedge fund—may be required to file an information return on Service Form 5471—*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*—and provide additional information regarding the corporation annually on Service Form 5471 if the investor is treated as actually or constructively owning more than 50% by vote or value of the equity of the corporation.<sup>279</sup> The penalty for failure to file Service Form 5471 is \$10,000 per year and increases up to \$50,000 if the

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<sup>275</sup> I.R.C. § 1474(b).

<sup>276</sup> See I.R.C. § 6038B; see also Reg. § 1.6038B-1(b)(3).

<sup>277</sup> I.R.C. § 6038B(c)(1)–(2).

<sup>278</sup> I.R.C. § 6038B(c)(2).

<sup>279</sup> See I.R.C. § 6038(a), (e); I.R.C. § 6046(a)(1)(B); Reg. § 1.6038-2(a).

failure is not corrected within 90 days following notification from the Service.<sup>280</sup> The penalty does not apply if the failure is due to reasonable cause.<sup>281</sup>

j. *Additional Filings—Service Form 8621.* Any U.S. investor that is a direct or indirect shareholder of a PFIC must file Service Form 8621—*Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*—for each year in which the investor (1) recognizes gain on a direct or indirect disposition of PFIC stock, (2) receives certain direct or indirect distributions from a PFIC, or (3) makes certain PFIC-related elections.<sup>282</sup> There is currently no specific penalty for failure to file Service Form 8621.

Moreover, in taxable years beginning on or after March 18, 2010, any U.S. investor that is a shareholder in a PFIC must file an annual information return containing such information as the Service may require.<sup>283</sup> It appears that this information will be reported on a subsequent version of Form 8621.<sup>284</sup>

k. *Additional Filings—Specified Foreign Financial Asset Reporting.* U.S. individuals are required to file an annual information report on Service Form 8938 disclosing their ownership of and certain other information about any interest they hold in a foreign hedge fund if the aggregate value of the hedge fund interest, any interest they hold in a “foreign financial account,”<sup>285</sup> any stock or security issued by a foreign person, any interest in a foreign

<sup>280</sup>I.R.C. § 6679(a).

<sup>281</sup>I.R.C. § 6679(a)(1).

<sup>282</sup>See DEP’T OF THE TREASURY, INTERNAL REVENUE SERV., INSTRUCTIONS FOR FORM 8621 (2011).

<sup>283</sup>I.R.C. § 1298(f). See Notice 2010-34, 2010-17 I.R.B. 612 (“[S]hareholders of a PFIC that were not otherwise required to file Form 8621 annually prior to March 18, 2010, will not be required to file an annual report as a result of the addition of section 1298(f) for taxable years beginning before March 18, 2010.”). Until the Service releases a revised Service Form 8621, PFIC shareholders that otherwise are not required to file a Service Form 8621 under the current instructions to the form will not be required to file the form for taxable years beginning on or after March 18, 2010. However, these taxpayers will be required to file the form with respect to those “suspended taxable years” once the revised form is released. Notice 2011-55, 2011-29 I.R.B. 53.

<sup>284</sup>See DEP’T OF THE TREASURY, INTERNAL REVENUE SERV., INSTRUCTIONS FOR FORM 8621 (2011) (“A subsequent revision of Form 8621 [will be] modified to meet the requirements of section 1298 (f), as set forth in guidance to be included in future regulations.”).

<sup>285</sup>A “foreign financial account” is a depository or custodial account at, and any nonpublicly traded equity and debt issued by, a foreign financial institution. I.R.C. § 1471(d)(2). A “foreign financial institution” is a foreign entity that (1) accepts deposits in the ordinary course of a banking or similar business, (2) holds financial assets for the account of others as a substantial portion of its business, or (3) is engaged or holds itself out as engaged primarily in the business of investing, reinvesting, or trading in financial assets, including securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities. I.R.C. § 1471(d)(4), (5). For individuals and married couples living abroad, the thresholds are \$200,000/\$300,000—individual—and \$400,000/\$600,000—married couples. Temp. Reg. § 1.6038D-2T(a)(3), (4). Certain “specified domestic entities” will also have to file the Form. See Temp. Reg. §§ 1.6038D-1T(a)(1), -2T(a); Prop. Reg. § 1.6038D-6(a), 76 Fed. Reg. 78,594-01 (2011).

entity, or any financial instrument or contract issued by a foreign person and held for investment, outside of a financial account—such assets, collectively, “specified foreign financial assets”—exceeds \$50,000 at any of a taxable year or \$75,000 at any time during the taxable year.<sup>286</sup> The value of an asset is presumed to exceed \$50,000 unless the individual provides the Service with enough information to determine its value.<sup>287</sup> Although these specified foreign financial asset reporting requirements overlap somewhat with the FBAR reporting requirements discussed below, these requirements do not replace the existing FBAR filing requirements imposed on United States persons. The reporting requirement for specified foreign financial assets applies with respect to taxable years beginning after March 18, 2010.<sup>288</sup>

The penalty for failure to disclose the required information is \$10,000 and increases up to \$50,000 if the failure is not corrected within 90 days following notification from the Service.<sup>289</sup> However, the penalties do not apply if the failure to disclose is due to reasonable cause and not willful neglect.<sup>290</sup>

A 40% accuracy-related penalty is imposed—in place of the 20% accuracy-related penalty imposed under current law—on any understatement of tax liability attributable to any foreign financial asset that was required to be disclosed to the Service, but was not.<sup>291</sup> Accordingly, if a U.S. investor in a foreign hedge fund fails to file Service Forms 926 or 5471 or to comply with the specified foreign financial asset reporting requirements, the U.S. investor could be subject to significant penalties. The increased penalty applies with respect to taxable years beginning after March 18, 2010.

1. *Additional Filings—FBAR.* Any United States person who has a “financial interest” in or “signature or other authority” over any “foreign financial account” must file Form TD F 90-22.1—*Foreign Bank and*

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<sup>286</sup>I.R.C. § 6038D(a)–(b); Temp reg. § 1.6038D-2T(a)(1). For a married couple living in the United States, the threshold is \$100,000 on the last day of the taxable year or \$150,000 at any time during the taxable year. Temp. Reg. § 1.6038D-2T(a)(2). For individuals and married couples living abroad, the thresholds are \$200,000/\$300,000—individual—and \$400,000/\$600,00—married couples. Temp Reg. § 1.6038D-2T(a)(4), (5). The Service has authority to issue regulations or other guidance that would apply the reporting requirements to any domestic entity formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets, in the same manner as if the entity were an individual. I.R.C. § 6038D(f). In addition, the Service has authority to issue regulations or other guidance to except certain foreign financial assets from the reporting requirement, including situations identified by the Service where disclosure would be duplicative of other reporting requirements. I.R.C. § 6038D(h).

<sup>287</sup>I.R.C. § 6038D(e).

<sup>288</sup>Temp. Reg. § 1.6038D-1T(b).

<sup>289</sup>I.R.C. § 6038D(d).

<sup>290</sup>I.R.C. § 6038D(g). However, reasonable cause does not include the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer or another person for disclosing the information required by section 6038D.

<sup>291</sup>I.R.C. § 6662(b)(7), (j). More specifically, the increased penalty applies to the failure to disclose any asset with respect to which information was required to be provided under sections 6038, 6038B, 6038D, 6046A, or 6048. I.R.C. § 6662(j)(2).

*Financial Accounts Report* (FBAR)—if the aggregate value of these financial accounts exceeds \$10,000 at any time during the calendar year.<sup>292</sup> In Notice 2010-23,<sup>293</sup> the Service held that foreign hedge funds will not be treated as foreign financial accounts for 2009 and prior years. The final FBAR regulations issued on February 23, 2011, reserve on the question of whether a foreign hedge fund is a foreign financial account.<sup>294</sup> Personnel at the Financial Crimes Enforcement Network (FinCEN) have indicated that foreign hedge funds will not currently be treated as foreign financial accounts until regulations are issued treating them as such.<sup>295</sup>

The final FBAR regulations apply to foreign financial accounts maintained in 2010 and subsequent years.<sup>296</sup> FBARs for calendar year 2010 are due June 30, 2011. In addition, individuals who elected to defer their pre-2010 FBAR filings pursuant to Service Notice 2010-23 are permitted—but not required—to apply the final FBAR regulations in preparing their 2009 FBARs, which are also due on June 30, 2011.<sup>297</sup>

A nonwillful failure to file an FBAR is subject to a penalty of up to \$10,000.<sup>298</sup> A willful failure to file an FBAR is subject to a penalty equal to the greater of \$100,000 or 50% of the amount of the transaction at the time of the offense.<sup>299</sup>

## 2. *The Advantages of Investing Through a Foreign Corporation*

Investors that make a QEF election with respect to a foreign feeder that is treated as a PFIC report only their share of the earnings and profits of the

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<sup>292</sup> See 31 C.F.R. § 1010.350(a) (2011) (“Each United States person having a financial interest in, or signature or authority over, a bank, securities or other financial account in a foreign country shall report such relationship to the Commissioner of the Internal Revenue for each year in which such relationship exists and shall provide such information as shall be specified in a reporting form prescribed under 31 U.S.C. 5314 to be filed by such persons.”). The Treasury Form for reporting these foreign accounts is DEP’T OF THE TREASURY, REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS, TD F 90-22.1 (2012).

<sup>293</sup> Notice 2010-23, 2010-11 I.R.B. 441.

<sup>294</sup> 31 C.F.R. § 1010.350(c)(3) (2011) (reserving on the treatment of “other investment funds” as reportable accounts); see also CADWALADER, WICKERSHAM & TAFT LLP, CLIENTS & FRIENDS MEMO, FINAL REGULATIONS ISSUED WITH RESPECT TO FBAR FILING REQUIREMENTS (Feb. 28, 2011), available at [http://www.cadwalader.com/assets/client\\_friend/022811\\_Final-RegFBARFilingRequirements.pdf](http://www.cadwalader.com/assets/client_friend/022811_Final-RegFBARFilingRequirements.pdf) (discussing the final FBAR regulations in detail).

<sup>295</sup> Amendment to the Bank Secrecy Act Regulations—Reports on Foreign Financial Accounts, 76 Fed. Reg. 10234, 10239 (Feb. 24, 2011).

<sup>296</sup> Temp. Reg. § 1.6038D-1T(b).

<sup>297</sup> Service Notice 2010-23 permits an individual holding “signature or other authority” over, but no financial interest in, a foreign financial account to file pre-2010 FBARs on June 30, 2011. Notice 2010-23, 2010-11 I.R.B. 441.

<sup>298</sup> See 31 U.S.C. § 5321(5)(B)(i) (2006). The penalty may be waived if the failure to file was due to reasonable cause and the amount of the transaction was properly reported. 31 U.S.C. § 5321(a)(5)(B)(ii) (2006).

<sup>299</sup> See 31 U.S.C. § 5321(a)(5)(C) (2006). Criminal penalties may also apply. See 31 U.S.C. § 5322(a), (b) (2006).



PFIC.<sup>300</sup> Many expenses and losses of a U.S. feeder that would be denied or restricted for an individual investor in the U.S. feeder are deducted and are not subject to restriction for purposes of computing a PFIC's earnings and profits.<sup>301</sup> Thus, an investment in the foreign feeder may allow a U.S. taxable investor indirectly to deduct expenses and losses that could not be deducted directly.

a. *Avoid Federal Limitations on Miscellaneous Itemized Deductions for Regular and Alternative Minimum Tax Purposes.* As mentioned above, individuals who invest through a domestic feeder in a hedge fund that is not a "trader" are subject to limitations on their ability to deduct the miscellaneous itemized deductions that are allocated to them, and these limitations may result in an individual being unable to deduct the individual's share of expenses at all.<sup>302</sup> Miscellaneous itemized deductions are also not deductible for purposes of the alternative minimum tax.<sup>303</sup>

However, these limitations do not apply at all for purposes of determining a PFIC's earnings and profits or the Subpart F income of a United States shareholder of a CFC. Therefore, because a foreign corporation may claim a deduction for miscellaneous itemized deductions, so long as the corporation has sufficient income to offset the expenses, an individual investor who invests in a foreign feeder rather than a domestic feeder will effectively be able to deduct his or her share of the expenses of the fund that would otherwise be treated as miscellaneous itemized deductions.

b. *Avoid the Proposal to Limit Itemized Deductions to 28%.* The Obama Administration's 2013 Fiscal Year budget proposes to limit the value of itemized deductions—including, apparently, miscellaneous itemized deductions and interest expense deductions—to 28% for high income individu-

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<sup>300</sup>I.R.C. § 1293(a)(1). Of this amount, the investor reports as net capital gains its share of the PFIC's net capital gains and the rest as ordinary income.

<sup>301</sup>See TAX ADVISORS PLANNING SYSTEM 22:5.08(E) (RIA 2011); cf. I.R.C. § 1293(e)(3) (exempting sections 312(n)(4)–(6) from the determination of earnings and profits for QEFs); I.R.C. § 312(n)(4)–(6) (adjusting earnings and profits for LIFO inventory adjustments, installment sales, and completed contract method of accounting).

<sup>302</sup>See I.R.C. § 67 (providing that miscellaneous itemized deductions are generally deductible by an individual only to the extent that the aggregate amount of the deductions exceeds two percent of the individual's adjusted gross income). As mentioned in Part V.A, an individual whose adjusted gross income exceeds a specified threshold amount is required to further reduce the amount of his or her otherwise allowable itemized deductions. This additional limitation does not apply for the 2010, 2011, and 2012 taxable years; however, the full limitation will be reinstated in 2013. See The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150, amended by The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 101(a)(1), 124 Stat. 3296, 3298.

<sup>303</sup>I.R.C. § 56(b)(1)(A)(i).

als beginning in 2013.<sup>304</sup> As with the limitation on miscellaneous itemized deductions and deductions for investment interest expense, this limitation would be entirely avoidable by a U.S. individual who incurs the expense indirectly through a profitable foreign corporation that uses the expense to reduce its earnings and profits and, consequently, the Subpart F or QEF inclusions of its shareholder.

c. *State Tax Deferral.* Some states permit deferral, even for passive income. For example, Hawaii does not impose tax on the income of a PFIC until it is distributed.<sup>305</sup> Thus, these states affirmatively encourage their residents to keep their investments abroad.

d. *Avoid State Law Limitations on Deductions.* New York denies residents with adjusted gross income of more than \$1 million 50% of their charitable contribution deduction and all of their other itemized deductions.<sup>306</sup> A number of other states limit the ability of individuals to claim miscellaneous itemized deductions.<sup>307</sup> For a high-income resident in New York or any of these other states, investing through the foreign feeder will effectively permit the resident to deduct its share of the master fund's expenses that would otherwise have been denied for state tax purposes.

e. *Avoid Limitations on Interest Expense.* A U.S. individual that borrows to make a hedge fund investment or that is allocated interest expense from the hedge fund generally will be able to deduct interest expense on the debt only to the extent of his or her gross income from the fund and other

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<sup>304</sup> See OMB EXECUTIVE BUDGET 2013, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2013, *supra* note 7. The Administration has introduced this proposal each fiscal year since 2010. See *supra* note 171.

<sup>305</sup> See HAW. REV. STAT. § 235-2.3(b)(29), (33) (2011) (Subpart F and the PFIC rules are inoperative); STATE OF HAWAII, DEPT OF TAX'N, Form N-11, 23 ("Federal law requires that shareholders of [CFCs and PFICs] recognize certain income earned by these companies before the companies distribute dividends. Hawaii has no comparable provisions.").

<sup>306</sup> See, e.g., N.Y. TAX LAW § 615(f)(3) (McKinney 2010) (denying the New York itemized deduction to taxpayers with New York adjusted gross income over \$1 million, except for the portion of the deduction attributable to a charitable contribution allowed under section 170, multiplied by 50%).

<sup>307</sup> See ARIZ. REV. STAT. ANN. § 43-1042(A) (2010); ARK CODE ANN. § 26-51-436(4); CAL. REV. & TAX. § 17073 (West 2011); 30 DEL. CODE ANN. tit. 30, § 1107 (2011); GA. CODE ANN. § 48-7-27(a) (2011); HAW. REV. STAT. § 235-2.3 (2011); IOWA ADMIN. CODE § 701-41.11 (2010); KAN. STAT. ANN. § 79-32,118 (2011); KAN. ADMIN. REGS. § 92-12-27 (2010); KY. REV. STAT. ANN. § 141.010(11) (2011); MD. CODE ANN. TAX. § 10-218(b)(3) (2011); MINN. STAT. § 290.01, subdiv. 19; MINN. STAT. § 290.01, subdiv. 22 (2011); MISS. CODE ANN. § 27-7-17(3) (2011); MO. REV. STAT. § 143.141 (2011); MONT. CODE ANN. § 15-30-2131 (2011); MONT. CODE ANN. § 15-30-2132 (2011); NEB. REV. STAT. § 77-2716.01(3) (2011); N.D. CENT. CODE § 57-38-01(12) (2011); OR. REV. STAT. § 316.695(1)(c)(A) (2011); R.I. GEN. LAWS § 44-30-2.6(c)(2)(C) (2009); S.C. CODE ANN. § 12-6-560 (2011); S.C. CODE ANN. § 12-6-570 (2011); VT. STAT. ANN. tit. 32, § 32-5811(21) (2011); VA. CODE ANN. § 58.1-322(D) (2011); VA. ADMIN. CODE § 23-10-110-143 (2011); IDAHO STATE TAX COMM'N, *Form 40* (2011).

investments that are taxed at ordinary interest rates.<sup>308</sup> This limitation does not apply at all for purposes of determining a PFIC's earnings and profits and, therefore, so long as the PFIC has net income, an individual investor who invests in a foreign feeder rather than a domestic feeder will effectively be able to deduct his or her share of the fund's interest expense and interest on borrowings used to make the investment.<sup>309</sup>

f. *Avoid Limitations on Deductibility of Organization and Syndication Expenses.* Hedge fund syndication costs are not deductible or amortizable by the fund, and if the fund's organization costs exceed \$55,000, its organization costs are not immediately deductible but must be amortized over a 180-month period.<sup>310</sup> However, all of a hedge fund's syndication and organization costs are fully deductible for purposes of determining a PFIC's earnings and profits;<sup>311</sup> therefore, an individual investor who invests in a foreign feeder rather than a domestic feeder will effectively be able to deduct his or her share of the fund's organization and syndication expenses.

g. *Avoid Limitations on Capital Loss Deductibility.* An individual is permitted to deduct only \$3,000 of capital losses against ordinary income,<sup>312</sup> and corporations cannot deduct any capital losses against ordinary income. However, capital losses of a CFC or QEF PFIC reduce the foreign corporation's earnings and profits without restriction.<sup>313</sup> Therefore, a U.S. investor in a foreign feeder will effectively be able to deduct and offset the capital losses

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<sup>308</sup> See *supra* Part V.B, for a discussion of the deductibility of interest expense by U.S. investors.

<sup>309</sup> See Reg. § 1.964-1 (providing the rules for determining earnings and profits of a foreign corporation are substantially similar to those applicable to domestic corporations, except as provided in section 952); I.R.C. § 312(f)(1); Reg. §§ 1.312-7(b), -6(b) (providing general rules for computing earnings and profits for a domestic corporation); I.R.C. § 312(f)(1); Reg. § 1.312-7(b) (the wash sale exception for a domestic corporation); I.R.C. § 964(a) (illegal bribes and kickback exception); I.R.C. § 952(c)(3) (providing special exceptions for foreign corporations for last-in, first-out rules, installment sales and the completed contract method of accounting).

Therefore, because interest expense is not in the list of excepted items, it is deductible for purposes of calculating earnings and profits.

<sup>310</sup> See *supra* Part V.C, for a discussion of the deductibility of hedge fund organization and syndication costs.

<sup>311</sup> All items are deductible for purposes of calculating the earnings and profits of a CFC and QEF PFIC, unless specifically excepted in the statute or regulations. Organization and syndication expenses are not specifically excepted and, therefore, may be deducted from earnings and profits. See *supra* note 309.

<sup>312</sup> I.R.C. § 1211(b).

<sup>313</sup> All items are deductible for purposes of calculating the earnings and profits of a CFC and QEF PFIC, unless specifically excepted in the statute or regulations. Capital losses are not specifically excepted and therefore may be deducted from earnings and profits. See *supra* note 309; see also *Inland Investors v. Commissioner*, 44 B.T.A. 654 (1941) (holding that the taxpayer was permitted to deduct capital losses from earnings and profits, even though the amounts were not deductible in the computation of taxable net income).

of the foreign feeder against the foreign feeder's ordinary income without limitation.<sup>314</sup>

h. *Avoid the Straddle Rules and the Wash Sale Rules.* The straddle rules defer the ability of investors to recognize losses on the disposition of a position in a straddle and limit the deductibility of interest expense allocable to property that is part of the straddle.<sup>315</sup> These losses and expenses are fully deductible for purposes of determining a PFIC's earnings and profits;<sup>316</sup> therefore, an individual investor who invests in a foreign feeder rather than a domestic feeder will effectively be able to deduct his or her share of any losses on straddle positions or interest expense allocable to the straddle.

i. *Avoid Other Limitations on Deductibility of Expenses—Such as AHYDO.* An “applicable high yield discount obligation” (AHYDO)<sup>317</sup> is a debt obligation that is issued by a corporation, will mature more than five years from the date of its issue, has a yield-to-maturity that equals or exceeds five percent more than the applicable federal rate (AFR) in effect for the month during which the debt is issued, and is issued with “significant” original issue discount (OID).<sup>318</sup>

Generally, the AHYDO rules deny the issuer a deduction for the OID on the AHYDO until interest is actually paid.<sup>319</sup> Moreover, if the yield on an AHYDO is greater than the AFR by more than six percent, the issuer is disallowed a deduction for the portion of the interest payable on the AHYDO in excess of six percent over the AFR—the “disqualified portion.”<sup>320</sup> However, earnings and profits are generally reduced by OID, and the AHYDO rules do not affect earnings and profits calculations.<sup>321</sup> Therefore, a corporate investor who invests in a foreign feeder rather than a domestic feeder will effectively be able to deduct these expenses of the fund.

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<sup>314</sup>To illustrate, assume that, had a U.S. investor invested in a master fund through a domestic feeder, the U.S. investor would have been allocated \$100 of ordinary income and \$100 of capital losses. Assuming that the U.S. investor had no other income—and leaving aside the investor's ability to use \$3,000 of capital losses to offset ordinary income—the investor would have reported \$100 of ordinary income—on which the investor would have been required to pay tax at ordinary income rates—and a \$100 capital loss, which the investor could not have immediately used. However, if the investor invested in the foreign feeder, the investor would not have reported any income or loss. Thus, effectively, the \$100 of capital losses offset the \$100 of ordinary income.

<sup>315</sup> See *supra* Part V.F.2, for a discussion of the straddle rules.

<sup>316</sup> All items are deductible for purposes of calculating the earnings and profits of a CFC or QEF PFIC, unless specifically excepted in the statute or regulations. See *supra* note 309. Losses from a straddle and interest expense are not specifically excepted and, therefore, may be deducted from earnings and profits.

<sup>317</sup> See I.R.C. § 163(e)(5), (i).

<sup>318</sup> See I.R.C. § 163(i).

<sup>319</sup> I.R.C. § 163(e)(5)(A)(iii).

<sup>320</sup> I.R.C. § 163(e)(5)(A)(ii).

<sup>321</sup> I.R.C. § 163(e)(5)(E).

## VI. Tax Issues for the General Partner and the Investment Manager

### A. *Choice of Entity for the General Partner and the Investment Manager*

The general partner and the investment manager are typically organized as limited partnerships or limited liability companies treated as partnerships for U.S. federal income tax purposes. Structuring these entities as partnerships for tax purposes enables their individual members to avoid the double tax on profits that a corporate structure would entail and allows the members to be taxed at more favorable rates on qualified dividends and long-term capital gains attributable to the performance allocation and other income.

### B. *Compensation Issues for the Manager*

#### 1. *Current Federal Income Tax Law*

Hedge fund management professionals typically receive two types of compensation in return for structuring the fund and managing its assets. In a “2/20” compensation structure, the “2” and the “20” refer to each of the components.

First, the management professionals acting through the “investment manager” receive a periodic management fee normally calculated as a percentage of the fund’s net asset value at the time the fee is paid. The typical fee ranges from 1% to 2% per year. This portion of the manager’s compensation is the “2” of the “2/20.” The fee does not depend upon the performance of the fund. The management fee is generally characterized as ordinary income and taxed at ordinary income tax rates.<sup>322</sup>

Second, the management professionals acting as the general partner typically receive a performance payment in exchange for services provided to the fund, such as 20% of profits. This portion of the management professional’s compensation is the “20” of the “2/20.” This portion of the compensation, referred to as the “carried interest,” is often structured as a “profits interest” in the partnership. As mentioned above, this treatment allows the investment manager to (1) avoid section 457A,<sup>323</sup> (2) avoid reporting current taxable income attributable to the value of the profits interest when it is granted, and (3) under current law, report its share of long-term capital gains and qualified dividend income of the fund as such and, therefore, benefit from reduced rates of tax. This final benefit has been proposed to be changed.<sup>324</sup>

A profits interest is an interest in a partnership that does not entitle the partner to a current capital account, to a share of the hedge fund’s liquidation value on the date of the grant, or to a share in any existing gain in the partnership’s assets, but instead entitles the partner to a specified share—for example, 20%—of the future net income of the fund. Under current law, neither the

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<sup>322</sup>MARK JICKLING, CONG. RESEARCH SERV., RS 22689, TAXATION OF HEDGE FUNDS AND PRIVATE EQUITY MANAGERS (2009).

<sup>323</sup>See *infra* Part VI.C.2.

<sup>324</sup>See *infra* Part VI.B.2.

granting nor vesting to a person of a profits interest in a partnership—that is not a publicly traded partnership—in exchange for services is a taxable event, so long as the profits interest (1) does not relate to a substantially certain and predictable stream of income and (2) is not disposed within two years of receipt.<sup>325</sup>

Proposed regulations would preserve this result but would impose additional requirements.<sup>326</sup> For example, under the proposed regulations, the partner would be required to make a section 83(b) election within 30 days of the grant date and the consent of all of the partners in the partnership would be required.<sup>327</sup> Hedge fund agreements drafted after the proposed regulations were issued usually require the fund and its partners to comply with the proposed requirements.

Under current law, income and gain allocated to a service provider that holds a partnership profits interest retains the character of the income earned by the partnership.<sup>328</sup> Accordingly, to the extent a hedge fund allocates long-term capital gain or qualified dividend income to the general partner, which is typically treated as a partnership for tax purposes, the individual members of the general partner will be taxed in respect of the allocations at applicable lower rates—which are currently taxable at a maximum rate of 15%, although an increase has been proposed—and will not be subject to self-employment tax on the income.<sup>329</sup> However, if a hedge fund generates mostly short-term capital gain or other ordinary income, the individual investment

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<sup>325</sup> Rev. Proc. 93-27, 1993-2 C.B. 343 (stating that receipt of profits interest for services in partner capacity or in anticipation of being a partner is not a taxable event for partner or partnership; profits interest relating to a substantially certain and predictable stream of income is excluded from partnership assets, profits interest disposed of within two years of receipt, and profits interest in a publicly traded partnership); *see also* Rev. Proc. 2001-43, 2001-2 C.B. 191 (clarifying that for purposes of Revenue Procedure 93-27, where a partnership grants a substantially nonvested partnership interest to a service provider, the service provider is treated as receiving the interest on the grant date, provided the parties treat the service provider as the owner of the partnership interest from the grant date and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit for the entire period during which the service provider has the interest, and upon grant or at the time the interest becomes substantially vested, neither the partnership nor any partners take a compensation deduction for the fair market value of the interest).

<sup>326</sup> In 2005, the Service issued proposed regulations and a proposed revenue procedure that would require the recipient of an unvested partnership interest received in exchange for services to make a section 83(b) election on the grant date to be treated as a partner and would apply to all issuances of partnership interests in exchange for services on or after the date final regulations are published. Prop. Reg. § 1.83-3; Notice 2005-43, 2005-24 I.R.B. 1221. The proposed rules provide that Revenue Procedures 93-27 and 2001-43 remain in effect until the proposed rules are finalized and will be obsolete thereafter.

<sup>327</sup> *See* Prop. Reg. § 1.83-2, -3; Notice 2005-43, 2005-24 I.R.B. 1221.

<sup>328</sup> Reg. § 1.702-1(b).

<sup>329</sup> The income allocated to the general partner is not treated as compensation income. Instead, the general partner is treated as receiving its distributive share of the partnership's income, which generally includes interest, dividends, and capital gains, which are not subject to self-employment tax. *See* I.R.C. § 1402(a)(2), (3).

professionals of the general partner will pay tax at rates that approximate the rate applicable to compensation income, but they would not be subject to self-employment tax on the income.

## 2. *The Carried Interest Revenue Proposal*

Beginning in 2007, there have been a series of legislative proposals to tax the carried interest allocable to a service partner from a partnership engaged in investment or real estate activities as ordinary compensation income.

In 2007, Congressmen Sander M. Levin (D-Michigan) and Charles B. Rangel (D-New York) each introduced legislation that would tax all income allocated from a profits interests to a partner that provides services to a partnership with respect to certain assets, including stock, debt, swaps, real estate, commodities, options, and derivative contracts, as ordinary compensation income and impose self-employment tax on the income.<sup>330</sup> The Rangel and Levin proposals would also have another effect on publicly traded partnerships, such as Blackstone and Fortress, that hold carried interests and provide services to underlying funds. Because the income from the carried interest would be characterized as compensation income, which is not “qualifying income” for purposes of the publicly traded partnership rules,<sup>331</sup> these publicly traded general partners that receive substantial amounts of their income from carried interests would be treated as domestic corporations and subject to a corporate tax.

On June 17, 2008, Representative Rangel reintroduced a substantially similar version of his bill.<sup>332</sup> This bill was approved by the House on June 25, 2008, but was not passed by the Senate.<sup>333</sup>

On April 2, 2009, Representative Levin reintroduced a substantially similar version of his bill.<sup>334</sup>

The Obama Administration’s Fiscal Year 2010 Revenue Proposals, introduced in May 2009, proposed to treat all income and gain from a carried interest held by a person who provides services to any partnership, not only to partnerships that provide services with respect to certain assets, as ordinary income, which would be subject to self-employment taxes.<sup>335</sup> In addition, any

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<sup>330</sup>H.R. REP. NO. 2834, at 2–3 (2007); H.R. REP. NO. 3996, at 2 (2007).

<sup>331</sup>As discussed above in Part II.A.2, a publicly traded partnership that has more than 10% “active” income—or, stated more precisely, less than 90% “qualifying income”—is treated as a corporation for U.S. federal income tax purposes and subject to an entity and corporate tax. Qualifying income for this purpose includes interest, dividends, real property rents, and gain from the sale or other disposition of real property. I.R.C. § 7704(d). Qualifying income does not include compensation income received for services, and therefore, income received from carried interests would not be qualifying income.

<sup>332</sup>H.R. REP. NO. 6275, at 203 (2008).

<sup>333</sup>*Id.*

<sup>334</sup>H.R. REP. NO. 1935 (2009).

<sup>335</sup>DEPT OF THE TREASURY, *General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals* (May 2009), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2010.pdf>.

gain recognized on the disposition of the carried interest would be taxed as ordinary income and not as capital gain. However, to the extent the partner invested capital in the partnership, income attributable to the invested capital would not be recharacterized. The Obama Administration's Fiscal Year 2011 Revenue Proposals, introduced in February 2010, included the very same proposal.<sup>336</sup>

In June of 2010, Senate Finance Committee Chair Max Baucus (D-Montana) and Representative Levin each introduced bills that would tax carried interest allocations at a "blended rate" of taxation, and on May 28, 2010, the House of Representatives passed legislation that would, beginning in 2013, tax 75% of the net income from an "investment services partnership interest" (ISPI) as ordinary compensation income that is subject to self-employment tax with the remainder being taxed as it is under current law—that is, taxed based on the type and character of the underlying income of the partnership.<sup>337</sup> For taxable years beginning before January 1, 2013, the percentages would be 50% and 50%.

An ISPI was defined in the bill as any interest in partnership which is held directly or indirectly by any person who would be reasonably expected, at the time of acquisition, to provide directly or indirectly a substantial quantity of any of the following types of services with respect to the partnership's directly or indirectly held assets: (1) advising as to the advisability of investing in, purchasing, or selling any "specified asset,"<sup>338</sup> (2) managing, acquiring, or disposing of any specified asset, (3) arranging financing with respect to acquiring specified assets, or (4) any activity in support of these services. Similar rules would apply to any gain on the disposition of an ISPI and on any gain on any in-kind distribution of property with respect to an ISPI. However, allocations of items of net income with respect to the portion of an ISPI that is a "qualified capital interest" would not generally be recharacterized.<sup>339</sup>

On June 8, 2010, a Senate Amendment to the House-passed bill was

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<sup>336</sup>DEPT OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (Feb. 2009), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2011.pdf>.

<sup>337</sup>American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong., amended by S. AMEND. 4369, 111th Cong. (2010).

<sup>338</sup>*Id.* "Specified assets" generally include the following: corporate stock; partnership interests; notes, bonds, debentures or other evidences of indebtedness; notional principal contracts; financial instruments with respect to, and certain hedges of, these assets or any currency; real estate held for rental or investment; commodities; and options or derivatives with respect to the foregoing.

<sup>339</sup>The legislation defined a "qualified capital interest" as the portion of a service partner's partnership interest that is attributable to the sum of any money and the fair market value of any other property contributed to the partnership in exchange for the interest, amounts included in income under section 83 with respect to the transfer of the interest, and the amount of net income or gain taken into account by the service partner, less any net deductions or loss taken into account by the service partner and less any distributions with respect to the partnership interest. *Id.*



released.<sup>340</sup> The Senate Amendment, which was not approved, would have treated 50% of the carried interest as ordinary income until 2013 and 65% as ordinary income thereafter. The balance of the carried interest would have continued to be taxed as provided under current law. The percentages would be 50% and 50% for taxable years beginning before January 1, 2013. In addition, the Senate Amendment contained a special rule for gain from the sale or exchange of partnership property held for at least seven years. Under this rule, beginning in 2013, any gain on the sale of partnership property held for at least seven years would be taxed 55% as ordinary income and the remaining gain would continue to be taxed as under current law.

The Obama Administration's Fiscal Year 2012 Revenue Proposals, introduced in February 2011, would treat income and gain from an ISPI received in exchange for services as ordinary income beginning in 2012.<sup>341</sup> The proposal would apply only if (1) more than 50% of the partnership's assets are investment-type assets, such as certain securities, real estate, and partnership interests, and (2) more than 50% of the contributed capital is from parties whose partnership interests are passive assets held for the production of income.<sup>342</sup> The proposal would also require the partner to pay self-employment taxes on income in respect of the carried interest, and any gain recognized on the disposition of the carried interest would be taxed as ordinary income and not as capital gain.<sup>343</sup>

In September 2011, Representative John Larson (D-Connecticut) introduced in the House and Senator Harry Reid (D-Nevada) introduced in the Senate virtually identical bills as part of the American Jobs Act of 2011.<sup>344</sup> These bills are substantially the same as the 2007 Levin–Rangel proposals, except that they apply only to partnerships in which substantially all of the assets are real estate held for rental or investment, interests in partnerships, commodities, cash or cash equivalents, or options or derivative contracts with respect to any of the foregoing and more than half of the contributed capital is attributable to partnership interests that “constitute property held for the production of income.” Thus, the Larson–Reid bills narrowed the first prong of the Fiscal 2012 Revenue Proposals provision from “more than 50%” to

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<sup>340</sup>S. AMEND. 4301, 111th Cong. (proposed June 8, 2010). Similar amendments were proposed on June 16, 2010 and June 23, 2010; *see* S. AMEND. 4386, 111th Cong. (proposed June 23, 2010); S. AMEND. 4369, 111th Cong. (proposed June 16, 2010). All of the amendments have been tabled or withdrawn.

<sup>341</sup>*See* OMB EXECUTIVE BUDGET 2012, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2012, *supra* note 7. The Administration had introduced this proposal in Fiscal years 2010 and 2011 as well. *See* OMB EXECUTIVE BUDGET 2011, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2011, *supra* note 7; OMB EXECUTIVE BUDGET 2010, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2010, *supra* note 7.

<sup>342</sup>*See* OMB EXECUTIVE BUDGET 2012, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2012, *supra* note 7.

<sup>343</sup>*See* OMB EXECUTIVE BUDGET 2012, *supra* note 7; TREASURY REVENUE EXPLANATIONS 2012, *supra* note 7.

<sup>344</sup>H.R. 12, 112th Cong. (2011); S. 1549, 112th Cong. (2011).

“substantially all.”

The Larson–Reid bills provide—as did the 2007 Levin–Rangel proposal—that income allocated to a carried interest holder and gain on the sale of a carried interest is entirely ordinary income and is not subject to a blended rate under the 2010 proposals.

On February 13, 2012, in its Fiscal Year 2013 Revenue Proposals, the Obama Administration repropoed its Fiscal Year 2012 proposal, except that the 2013 version conforms to the Larson–Reid bills. It applies only if (1) substantially all of the partnership’s assets are investment-type assets—for example, certain securities, real estate, and partnership interests—and (2) more than 50% of the contributed capital is from partners whose partnership interests are passive assets held for the production of income.<sup>345</sup>

Finally, on the very next day, Representatives Levin and Rangel reintroduced their bill, this time entitled, the “Carried Interest Fairness Act of 2012.”<sup>346</sup> This bill is substantially the same as the Larson and Reid version.

None of the proposed carried interest legislation has been enacted into law.

### C. *Deferral of Management Fees from Offshore Entities*

#### 1. *Carried Interest as a Fee*

Prior to the enactment of section 457A, discussed below, management professionals of offshore funds who did not generate meaningful long-term capital gains or qualified dividends typically structured the incentive allocation portion of their compensation—the “20” in “2/20”—as deferred fees, rather than as a carried interest issued to the general partner. By structuring their fees in this manner, the management professionals were able to avoid paying tax on the fees until they actually received them.<sup>347</sup> The offshore hedge fund’s investors were indifferent to the management professional’s election to defer their fees and the tax deduction associated with payment because the investors generally were not subject to U.S. net income tax—that is, because they were foreigners or tax-exempt organizations—and they therefore would not benefit from a current tax deduction.

#### 2. *Section 457A—Nonqualified Deferred Compensation*

Section 457A was enacted on October 3, 2008,<sup>348</sup> and effectively ended the ability of U.S. hedge fund managers to defer compensation that is structured as deferred fees.<sup>349</sup> More specifically, section 457A generally provides that compensation of a service provider that is deferred under a “nonqualified

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<sup>345</sup>TREASURY REVENUE EXPLANATIONS 2013, *supra* note 7, at 134.

<sup>346</sup>H.R. 4016, 112th Cong. (2012).

<sup>347</sup>See TREASURY REVENUE EXPLANATIONS 2013, *supra* note 7.

<sup>348</sup>*Id.*

<sup>349</sup>*Id.*

deferred compensation plan”<sup>350</sup> of a “nonqualified entity”<sup>351</sup> is taxable to the service provider when there is no substantial risk of forfeiture of the rights to such compensation.<sup>352</sup> If, however, the amount of deferred compensation is not determinable at the time there is no longer a substantial risk of forfeiture, under section 457A, the amount is taxable when the amount becomes determinable and, at that time, is subject to an additional 20% tax and an interest charge at the underpayment rate plus 1%. This 20% “penalty tax” effectively precludes all deferred compensation that is not subject to a substantial risk of forfeiture.

Service Notice 2009-8<sup>353</sup> confirms that section 457A does not apply to a profits interest received for services by a partner in a partnership.<sup>354</sup> For

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<sup>350</sup>A “nonqualified deferred compensation plan” for purposes of section 457A generally includes any plan, program, or arrangement under which a service provider obtains a legally binding right during a taxable year to compensation that is or may be payable in a later taxable year. I.R.C. § 457A(d)(3)(A); Notice 2009-8; I.R.C. § 409A(d); Reg. § 1.409A-1(a); Reg. § 1.409A-1(b)(1) (defining deferral of compensation). A “nonqualified deferred compensation plan” also includes any arrangement under which compensation is based on an increase in a specified number of equity units of the service recipient, including equity appreciation rights, regardless of their exercise price. I.R.C. § 457A(d)(3)(A). However, compensation is not treated as deferred under section 457A if the service provider receives payment of the compensation within 12 months after the end of the first taxable year of the service recipient during which the right to payment of the compensation is no longer subject to a substantial risk of forfeiture. I.R.C. § 457A(d)(3)(B).

<sup>351</sup>Section 457A applies only to nonqualified deferred compensation plans of “nonqualified entities.” A nonqualified entity includes a foreign corporation unless substantially all of the foreign corporation’s income is (1) effectively connected with the conduct of a U.S. trade or business or (2) subject to a comprehensive foreign income tax. I.R.C. § 457A(b)(1). A nonqualified entity also includes a partnership unless substantially all of its income is allocated to persons other than (1) foreign persons with respect to which the income is not subject to a comprehensive foreign income tax and (2) organizations that are exempt from U.S. federal income tax. I.R.C. § 457A(b)(2). Many hedge funds are organized in low-tax jurisdictions and their foreign feeder funds are treated as foreign corporations that are not subject to U.S. federal tax on their net income. Accordingly, such funds will be treated as “nonqualified entities” for purposes of section 457A.

<sup>352</sup>Compensation is subject to a substantial risk of forfeiture for purposes of section 457A if the service provider’s right to the compensation is conditioned on the future performance of substantial services by any individual. I.R.C. § 457A(d)(1)(A). For purposes of section 457A, a substantial risk of forfeiture does not include the occurrence of a condition related to a purpose of the compensation—other than future performance of services—regardless of whether the possibility of forfeiture is substantial. Notice 2009-8, I.R.B. 2009-4, part A-3(a). Thus, a performance-based condition on compensation, such as the attainment of specified earnings or market value targets, is not sufficient to create a substantial risk of forfeiture for purposes of section 457A. Any deferral of management fees or performance fees beyond the 12-month safe-harbor would be subject to current tax at the time the hedge fund manager has the legal right to the compensation—that is, no future services required—regardless of when such amounts are paid.

<sup>353</sup>Notice 2009-8, 2009-4 I.R.B. 347.

<sup>354</sup>Notice 2009-8, 2009-4 I.R.B. 347, pt. A-2(a) (permitting reliance on Notice 2005-1, 2005-2 I.R.B. A-7); T.D. 9321, 2007-1 C.B. 1123; Preamble to Proposed Treasury Regulations, 70 Fed. Reg. 57,930, § II.E (Oct. 4, 2005).

this reason, for funds formed after section 457A was enacted, incentive compensation is generally paid in the form of a carried interest or possibly currently on a mark-to-market basis—20% of any appreciation annually based on the value of the fund's assets. For deferred compensation arrangements in existence when section 457A was enacted, investment managers may try to restructure the fund by having it contribute its assets to a new partnership in which they receive their future incentive compensation in the form of a profits interest in the new partnership. The new partnership is generally referred to as a “mini master” with a carried interest.

#### D. *Self-Employment Tax*

Individuals are subject to self-employment tax under the Self-Employment Contributions Act (SECA) on their “net earnings from self employment” derived from conducting a trade or business directly or indirectly through a partnership.<sup>355</sup> The self-employment tax rate is 15.3%, of which 12.4% is for Social Security and 2.9% is for Medicare.<sup>356</sup> However, the income subject to the 12.4% Social Security tax is subject to a \$110,100 limit for 2012.<sup>357</sup> For purposes of computing the self-employment tax, taxpayers are permitted a deduction of 7.65% of their net earnings from self-employment—to account for the fact that the taxpayer, as both employer and employee, bears the entire employment tax burden.<sup>358</sup> Interest, dividends and capital gains,<sup>359</sup> and a limited partner's distributive share of any income from a limited partnership, are not subject to self-employment tax, and it is unclear whether a

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<sup>355</sup> See I.R.C. §§ 1401, 1402; Reg. §§ 1.1401-1, 1.1402-1.

<sup>356</sup> I.R.C. § 1401(a)–(b). Beginning in 2013, an additional 0.09% Medicare tax will apply to an individual's self-employment income in excess of \$200,000 for an unmarried individual, \$250,000 for a married taxpayer filing a joint return, or \$125,000 for a married individual filing a separate return. I.R.C. § 1401(b)(2).

<sup>357</sup> I.R.C. § 1402(b) (providing that self-employment income is an individual's net earnings from self-employment not in excess of an amount determined by reference to the Social Security contribution and base benefit amount for the applicable tax year); see also INTERNAL REVENUE SERVICE, PUBLICATION 15, (CIRCULAR E), EMPLOYER'S TAX GUIDE (2011). The 15.3% rate for SECA corresponds to the 15.3% tax imposed on an employee's gross wage income under the Federal Insurance Contribution Act (FICA). Half of FICA is withheld from the employee's paycheck and half is paid by the employer. The employer is permitted to deduct its share of the FICA taxes from the employer's gross income for federal income tax purposes. For the 2012 tax year, however, the Social Security tax on self-employment income is reduced by 2%—to 10.4%—making the effective self-employment tax rate 13.3%. See The Middle Class Tax Relief and Job Creation Act of 2012, Pub. L. No. 112-96, 126 Stat. 156.

<sup>358</sup> See I.R.C. § 1402(a)(12). The deduction is determined without regard to the Social Security rate reduction for 2010 and the additional 0.09% Medicare tax applicable to an individual's self-employment income in excess of specified amounts, which is effective beginning in 2013. See The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, Pub. L. No. 111-312, §§ 601(b)(1), 124 Stat 3296, 3309.

<sup>359</sup> I.R.C. § 1402(a)(2)–(3).

member's share of income from a limited liability company is exempt from self-employment tax.<sup>360</sup>

To minimize their self-employment taxes, individual hedge fund investment professionals typically organize a limited partnership to serve as the investment manager and receive management fees. The individual investment professionals will directly hold the limited partnership interests in the investment manager and will also form a limited liability company to serve as the general partner of this limited partnership. The individuals will also own membership interests in this limited liability company. The general partner—that is, the limited liability company—will typically be entitled to one percent of the net income of the limited partnership. The individuals who are limited partners in the investment manager will collectively be entitled to the remaining 99% of the net income of the investment manager limited partnership. As noted earlier, the individual investment professionals will also organize a separate limited liability company or limited partnership to serve as the general partner of the hedge fund and hold the carried interest.

The individual investment professionals take the position that they are subject to self-employment tax on the fee income that is allocated to the limited liability company that is serving as the general partner of the investment manager—that is, the one percent—but rely on the limited partnership exemption of section 1402(a)(13) to take the position that they are not subject to self-employment tax on the rest of the fee income allocated to the

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<sup>360</sup>I.R.C. § 1402(a)(13) (providing that the distributive share of any item of income or loss of a “limited partner” is excluded from net self-employment earnings). The Treasury Regulations under section 1402 do not define what a “limited partner” means in the context of an LLC. Proposed Regulation section 1.1402-2(h), 59 Fed. Reg. 67,253 (1994), provides rules defining a limited partner for purposes of section 1402(a)(13). However, these proposed regulations have not been finalized. Accordingly, it is not clear whether a member of a limited liability company would qualify for the “limited partner” exclusion under section 1402(a)(13). However, guaranteed payments for services rendered to the partnership are subject to self-employment tax.

investment manager entity.<sup>361</sup>

The individual investment professionals also take the position that they can rely on sections 1402(a)(2) and (3) to avoid self-employment tax on the dividends, interest, and capital gain allocated to the general partner of the hedge fund in respect of the carried interest.

### E. *New York City Unincorporated Business Tax*

New York City generally imposes a four percent unincorporated business tax on any unincorporated business conducted in New York City.<sup>362</sup> However, there are three safe harbors, and taxpayers that qualify for a safe harbor are not treated as conducting an unincorporated business in New York City. Under the first safe harbor, an unincorporated entity that is not a dealer or taxable as a corporation is not treated as engaged in an unincorporated business solely by reason of buying stocks, notes, bonds, debentures, other evidences of indebtedness, interest rate, currency or equity notional principal contracts, foreign currencies, and interests in derivative financial instruments—including options, forwards or futures contracts, short positions, and similar financial instruments—or acquiring, holding or disposing of, other than in the ordinary course of a trade or business, interests in unincorporated entities that buy only these assets.<sup>363</sup>

Under the second safe harbor, an unincorporated entity is not subject to the unincorporated business tax if at least 90% of the value of its assets consists of the property described in the preceding paragraph, interests in other unincorporated entities that do not carry on any unincorporated business in New York City, or interests in incorporated entities held by the taxpayer as

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<sup>361</sup>This position is not without risk. In a recent case, the Tax Court held that individual law firm partners in a limited liability partnership did not qualify for the limited partner exclusion from self-employment tax. *See Renkemeyer v. Commissioner*, 136 T.C. 137, 151 (2011). In *Renkemeyer*, the individuals were partners in a limited liability partnership. Unlike a limited partnership which requires at least one general partner with unlimited liability, there is no general partner in a limited liability partnership, and none of the partners have unlimited liability. The Tax Court in *Renkemeyer* effectively held that none of the individual partners were “limited partners” within the meaning of section 1402(a)(13) because they actively participated in the partnership’s business of providing legal services. The position often taken by the individual investment professionals in a hedge fund is technically distinguishable from the facts in *Renkemeyer*. The investment professionals are 99% limited partners in a limited partnership that has a general partner, and it would be the general partner that actively participates. However, the Tax Court in *Renkemeyer* was clearly influenced by the fact that the partners’ distributive share of income did not arise as a return on the partners’ investment but arose from the legal services they performed, and the court was inclined to look through to the substance of the arrangement. Were the Service to challenge the position taken by hedge fund investment professionals, surely it would cite to the *Renkemeyer* case to contend that the income earned by the investment professionals was really compensation for their investment management services.

<sup>362</sup>N.Y. CITY ADMIN. CODE § 11-503(a) (2011).

<sup>363</sup>N.Y. CITY ADMIN. CODE § 11-502(c)(2) (2011); N.Y. CITY ADMIN. CODE § 11-502(c)(4) (2011); *see also* N.Y.C. Reg. § 28-02(g)(1).

an investor.<sup>364</sup>

Under the third safe harbor, an unincorporated entity that receives \$25,000 or less in gross receipts during the taxable year from an unincorporated business carried on in New York City is not subject to the unincorporated business tax.<sup>365</sup> Accordingly, because management fee income in excess of \$25,000 is “bad” income for purposes of the safe harbors, in order to limit their exposure to the New York City unincorporated business tax, hedge fund managers with personnel in New York City will often organize two entities to receive compensation from the fund—one entity to receive management fees—the investment manager—and a separate entity to hold the carried interest—the general partner. The individual investment professionals will pay New York City unincorporated business tax with respect to the income earned by the investment manager but take the position that one of the safe harbors applies to the general partner that holds the carried interest.

It is possible, however, that New York City could assert that the entity receiving the fees and the entity holding the carried interest are in substance a single unincorporated business.<sup>366</sup> If this assertion is successful and the management contract represents more than 10% of the assets of the combined business, all of the entities’ income and gain—including the income allocated to it under the carried interest—could be subject to the unincorporated business tax.<sup>367</sup> This risk is minimized if the ownership interests in the two entities vary or other factors demonstrate their independence of each other.

## VII. Conclusion

The structure of a hedge fund is closely related to tax efficiency—both for investors and for the fund managers. Domestic and foreign feeder funds are often used to reduce tax liability for specific classes of investors, such as U.S. taxable investors, U.S. tax-exempt investors, and foreign investors. Increasingly, U.S. taxable investors may find their effective tax rate minimized by investing through a foreign feeder fund. Carried interests remain a tax-efficient means for managers to receive their incentive compensation, although their continued vitality remains unclear.

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<sup>364</sup> N.Y. CITY ADMIN. CODE § 11-502(c)(4) (2011); *see also* RULES OF CITY OF N.Y., tit. 19, § 28-02(g)(4) (2011).

<sup>365</sup> *See* N.Y. CITY ADMIN. CODE § 11-502(c)(3) (2011).

<sup>366</sup> *See* RULES OF CITY OF N.Y., tit. 19, § 28-02(a)(4) (2011) (providing that all distinct unincorporated business carried on by an individual or other unincorporated entity treated as one unincorporated business for purposes of the unincorporated business tax).

<sup>367</sup> *See* RULES OF CITY OF N.Y., tit. 19, § 28-02(g)(5)(vi) (2011) (providing that a partnership is subject to unincorporated business tax on all of its income where it owns an interest in a second partnership with a value of \$20 and which is engaged in an unincorporated business in New York and a third partnership with a value of \$30 and which only trades in stocks for its own account).

## Exhibit

### Tax Guidelines

The purpose of these tax guidelines is to help ensure that Issuer (the “Issuer”) (i) is either treated as an “investor” for U.S. federal income tax purposes or qualifies for the safe harbor contained in section 864(b)(2) of the U.S. Internal Revenue Code (the “Code”), (ii) is not treated as a dealer in stocks, securities or derivatives, as originating loans, as providing guarantees, or as providing insurance or reinsurance, and (iii) does not invest in assets that could cause it to be treated as engaged in a trade or business in the United States or otherwise subject to U.S. federal income tax on a net income basis. These guidelines should be read consistently with that purpose.

#### Equity Interests

1. The Issuer will only acquire interests that are treated as equity for U.S. federal income tax purposes in an entity that is:
  - (i) (A) treated as a corporation for U.S. federal income tax purposes and (B) not a “United States real property holding corporation” within the meaning of section 897(c)(2) of the Code unless the stock is of a class that is regularly traded on an established securities market and the Issuer holds no more than 5% of such class of stock, all within the meaning of section 897(c)(3) of the Code,
  - (ii) (A) treated as a partnership or disregarded entity for U.S. federal income tax purposes, (B) not engaged in a U.S. trade or business for U.S. federal income tax purposes, and (C) does not own any “United States real property interests” within the meaning of section 897(c)(1) of the Code, or
  - (iii) (A) treated as a grantor trust for U.S. federal income tax purposes, (B) all of the assets of which are treated as debt instruments for U.S. federal income tax purposes and would satisfy these guidelines if acquired directly by the Issuer, and (C) all of such assets are in registered form for U.S. federal income tax purposes.

#### Real Property Interests

2. The Issuer will not acquire any interest in (i) real property located in the United States or the U.S. Virgin Islands or (ii) property (including any equity interest) that is treated as a “United States real property interest” within the meaning of section 897(c) of the Code.

#### Non-Loan Private Debt Securities

3. The Issuer will not acquire investments that are treated as debt instruments for U.S. federal income tax purposes at their initial offering unless (A) they are issued in a public offering or (B) with respect



to any other securities that are not loans (“Non-Loan Private Debt Securities”), (1) they are purchased pursuant to an offering memorandum, private placement memorandum or other similar offering document, (2) the Issuer, and the manager on behalf of the Issuer, does not communicate directly or indirectly with the borrower, its employees, agents or affiliates (including, without limitation to solicit, negotiate the terms of, or structure the security) other than customary due diligence communications that would be reasonably necessary for a secondary market investor to make a reasonably informed decision to purchase a security for its own account, (3) any comments on the terms of any such Non-Loan Private Debt Securities are made only to the placement agent or other similar person with respect to the Non-Loan Private Debt Securities, and (4)(x) the Issuer does not acquire 50% or more of any class of Non-Loan Private Debt Securities or (y) if the Issuer acquires 50% or more of any class of Non-Loan Private Debt Securities, (i) they are not the most senior class of securities being offered by the borrower, (ii) they do not constitute the “controlling class” and (iii) the Issuer’s investment in such Non-Loan Private Debt Securities represents not more than 20% of the aggregate principal balance of all classes of securities being concurrently offered by the related borrower in connection with the offering of such securities.

### **Special Restrictions Applicable to Loans**

4. The Issuer will acquire only loans which constitute loans of a type that bank and non-bank purchasers regularly purchase and commit to purchase in secondary market transactions.
5. Except with respect to Revolving Obligations and Delayed Draw-down Obligations described in paragraph 10, the Issuer will not acquire a loan prior to 48 hours after such loan has been fully funded and the seller thereof has completed all of its obligations with respect to such loan.
6. The Issuer will not, directly or indirectly, communicate, solicit, negotiate the terms of, or structure a loan other than customary due diligence communications that would be reasonably necessary for a secondary market investor to make a reasonably informed decision to purchase a loan for its own account.
7. The Issuer will not hold a loan, directly or indirectly, for or on behalf of, or as nominee for, any bank. Further, the Issuer will not use funds borrowed from a bank on a limited recourse or other basis, the effect of which is to shift the economic benefits or burdens of ownership of an interest in a loan to such bank, to acquire an interest in a loan.
8. The Issuer will not have a contractual relationship with the obligor with respect to a loan until the Issuer actually closes the purchase of

the loan subject to a commitment.

9. The Issuer will not be listed as an original lender.
10. The Issuer will acquire an interest in a Revolving Obligation or Delayed Drawdown Obligation (each, an "Obligation"), or enter into a commitment to acquire any risks or benefits of such an interest, only if:
  - (a) (1) the Issuer, acting at arm's length, acquires the interest or is assigned the commitment at least 60 days after the later of (x) the original legal document closing of the Obligation and (y) the last date on which the Obligation was modified in any material respect, or
    - (2) (x) the Issuer acquires the interest in the open market or is assigned the commitment in the open market at least 48 hours after the date that is the later of (A) the original legal document closing of the Obligation and (B) the last date on which the Obligation was modified in any material respect and, in the case of a forward commitment, the condition of the obligor with respect to the Obligation and market conditions have not changed between the date of such commitment and the acquisition of such Obligation in a manner that would have a materially adverse effect on the value of the Obligation, and
    - (y) (i) an associated term loan is made available for purchase by the Issuer only if the Issuer purchases the Obligation together with the associated term loan, and in connection with a sale of the Obligation, the Obligation is sold only together with the associated term loan, or
    - (ii) the cost of the Obligation to the Issuer reflects a discount or premium of at least 2% of the fair market value of the Obligation on the later of (A) the original closing of the Obligation and (B) the last date on which the Obligation was modified in any material respect, or
    - (iii) at least one advance equal to the lesser of \$5 million or 10% of the maximum amount of the Obligation is outstanding, and
  - (b) all of the terms of any advance required to be made by the Issuer are fixed as of the date of the Issuer's acquisition (or determinable under a formula that is fixed as of such date), and such Obligation does not permit the Issuer to have any discretion as to whether to make advances thereunder, provided that the fact

that certain advances under such Obligation may be made under optional bidding procedures will not disqualify the Obligation from this prohibition so long as the Issuer does not exercise any such option), and

- (c) the Issuer does not acquire any interest in the Obligation that would cause the Issuer to own more than 25% of the commitment amount in respect of the Obligation, and
- (d) on the date of acquisition, the aggregate funded and unfunded commitments under all Obligations with unfunded commitments do not constitute more than 10% of the aggregate principal balance of the Issuer's assets.
- (e) As used herein:
  - (1) "Delayed Drawdown Obligation" means an investment that pursuant to its terms requires the Issuer to make one or more future advances to the obligor thereunder, but any such investment will be a Delayed Drawdown Obligation only until all commitments to make advances to the obligor expire or are terminated or reduced to zero; and
  - (2) "Revolving Obligation" means any investment (other than a Delayed Drawdown Obligation) that is a loan (including, without limitation, revolving loans, unfunded commitments under specific facilities and other similar loans and investments) that pursuant to its terms may require one or more future advances to be made to the obligor thereunder by the Issuer; but any such investment will be a Revolving Obligation only until all commitments to make advances to the obligor expire or are terminated or reduced to zero.

### **Letters of Credit**

- 11. The Issuer will not participate in any letter of credit facility or synthetic letter of credit facility.

### **Portfolio Interest Exemption**

- 12. The Issuer will not acquire investments treated as indebtedness for U.S. federal income tax purposes if (A) the indebtedness provides for interest or other payments based on the income, cash flow, property, distributions, earnings, or similar amounts of the Issuer, or (B) the indebtedness is not in registered form for U.S. federal income tax purposes.

### **Limitation on Acquisition of Real Estate Mortgages**

- 13. The Issuer will not acquire any investment if the investment constitutes a real estate mortgage (as defined for purposes of Code section

7701(i)), unless immediately following such acquisition, no more than 50% of the debt obligations (as determined for U.S. federal income tax purposes) held by the Issuer consist of real estate mortgages as determined for purposes of Code section 7701(i), except upon advice of Issuer's Counsel or an opinion of other nationally recognized U.S. tax counsel experienced in such matters that the acquisition of such investment will not cause the Issuer to be treated as a taxable mortgage pool for U.S. federal income tax purposes.

### **Restrictions on Acquisitions of Investment From or That Were Originated By the Manager or its Affiliates**

14. The Issuer will not acquire any investment with respect to which the manager or any affiliate thereof originated, or acted as underwriter or placement agent, or from the borrower of which the manager or any affiliate thereof received any compensation (other than any compensation received in a person's capacity as a borrower or acting on behalf of a borrower), unless an affiliate (and not the manager) originated or acted as underwriter or placement agent with respect to the investment or received the compensation from the borrower and (a) the affiliate is neither directly nor indirectly owned or controlled by the manager, (b) none of the affiliate's officers, directors or employees is involved in the daily business of the manager, (c) the manager has the sole ability to designate and purchase such investment and the affiliate has no role in the designation or purchase of such investment, (d) the manager does not have any information with respect to the investment that is not available to all potential investors, and any information provided to the manager (whether in written or verbal form) by the affiliate is provided to all unrelated investors prior to their commitment to purchase, (e) there is no fee sharing in any form between the affiliate and the manager, whether with respect to this transaction or any other transaction, and the manager and its employees are not provided any incentives (monetary or otherwise) to purchase the particular investment as opposed to any other security, (f) the manager applies identical criteria to all securities and any decision to purchase such investment was made without any consideration of the role of the affiliate, and (g) with respect to loans, either (x) the Issuer does not acquire 50% or more of any class of the investment, and at least 50% of the investment is acquired by persons not affiliated with the Issuer or the manager (and that have not given discretionary trading authority to the manager) on substantially the same terms and conditions as those of the Issuer or (y) at least 10 days elapse from the time of the receipt of any fee for such origination, placement or structuring of any investment and the time of any commitment to purchase, or purchase, of such investment by the Issuer.

### **Distressed Securities**

15. The Issuer will not acquire an investment with the expectation of restructuring or “working-out” the investment. Neither the Issuer nor any affiliate thereof will negotiate with a debtor or other creditors or participate on a creditors’ committee without the Issuer having received advice of Issuer’s Counsel or an opinion of other nationally recognized U.S. tax counsel experienced in such matters that such activity will not cause the Issuer to be treated as engaged in a trade or business within the United States for U.S. federal income tax purposes or otherwise subject the Issuer to U.S. federal income tax on a net income basis.

### **Restrictions on “When Issued” Commitments to Purchase**

16. The Issuer will not acquire, or enter into a commitment, forward sale agreement, or arrangement or understanding to purchase a security (collectively for purposes of this paragraph 16, a “Commitment”), before completion of the initial closing and full funding of the security unless (i) the security is an Obligation described in paragraph 10, (ii) in case of an investment that is not a loan, such Commitment is made only in connection with a firm commitment underwriting or customary underwriter or placement agent allocation (*i.e.*, “circling procedures”) and only after the seller has committed to acquire the investment, or (iii) the condition of the borrower, the investment, and market conditions have not changed between the date of the Commitment and the date of the purchase in a manner that would have a materially adverse effect on the Issuer.

### **Restrictions on Acquisitions of Synthetic Securities**

17. The Issuer will not acquire or enter into any credit default swap, total return swap or other derivative instrument (a “Synthetic Security”) unless:
  - (a) the criteria used to determine whether to acquire or enter into any particular Synthetic Security is similar to the criteria used by any fixed-income portfolio manager to make investments in debt securities, with the expectation of profiting from holding the Synthetic Security and not to earn a fee, commission, spread, or markup over its cost;
  - (b) none of the Issuer, the manager and any other person acting on behalf of the Issuer solicit, advertise or publish the Issuer’s ability to enter into Synthetic Securities for the benefit of another person;
  - (c) the Synthetic Security is written on standard form ISDA documentation;

- (d) the direct acquisition of the investment to which a Synthetic Security is linked (the “Reference Obligation”) would not violate any of the provisions of these guidelines;
  - (e) the Synthetic Security does not require that either party to the Synthetic Security (i) determine any payment based on an actual loss incurred by either party or (ii) own the applicable Reference Obligation, hedge its position under the Synthetic Security, necessarily incur any loss or other detriment that would be avoided to the extent such party owned the Reference Obligation, or require by its terms the delivery of reports or other information relating to the Reference Obligation if the effect of such requirement is that either party would be required to own the applicable Reference Obligation;
  - (f) to the Issuer’s and the manager’s knowledge, the Synthetic Security is not entered into with a counterparty regulated or licensed to do business as an insurance company or a reinsurance company or that will treat the Synthetic Security for any purpose as other than an investment in (or short sale of) an option, a forward contract, or a notional principal contract;
  - (g) the Synthetic Security provides for physical settlement by the buyer of protection only if the direct acquisition and holding of the obligation to be delivered pursuant to the terms of the physical settlement (the “Deliverable Obligation”) is otherwise permissible under these guidelines and either (1) it also permits cash settlement (including the right of the buyer of protection to receive cash payments equal to any unpaid interest and any “write-downs” of principal on the Reference Obligation) and such cash settlement (whether or not it also permits physical settlement at the election of the credit protection buyer) is determinable based on readily available information (which may include firm offer price quotations from at least two dealers) or (2)(x) at least one Deliverable Obligation (which may include the Reference Obligation) is an obligation for which firm offer price quotations can be obtained from at least two dealers and (y) there is no economic incentive to settle with a Deliverable Obligation for which firm offer price quotations cannot be obtained from at least two dealers; and
  - (h) The Issuer will not enter into Synthetic Securities that are “long positions” with respect to equity.
18. The Issuer will not (i) acquire or enter into any Synthetic Security with a view towards finding another party to assume the Issuer’s risk with respect to the Synthetic Security (whether under the Synthetic Security or through another offsetting transaction) or (ii) enter into a

transaction that reduces the Issuer's risk with respect to the Synthetic Security unless, in either case, the positions are acquired from or entered into with a broker or similar financial institution (and not an "end user"), the Issuer is not entering into the position in order to earn a "spread" or otherwise as an intermediary or to match a buyer and seller, and either (A) the offsetting position is entered into contemporaneously with the offset position, and (x) the offsetting position is entered into solely so that the offsetting position combined with the offset position results in a net "long" position or net "short" position with respect to one or more Reference Obligations all of which satisfy the provisions of these guidelines or (y) the offsetting position and offset position acquired solely to take advantage of an "arbitrage" or "mispricing" in the market place, or (B) there has been a material change in circumstances that causes the Issuer to believe that the Synthetic Security is a less attractive position (whether absolutely or relative to other positions) than the Issuer believed at the time the Issuer originally entered into the position, in which case the Issuer may enter into an offsetting or other transaction as a means to effectively reduce or eliminate the Issuer's economic exposure under the Synthetic Security. For example, so long as these guidelines are otherwise satisfied, under paragraph 18(A)(x) the Issuer may sell credit protection and simultaneously buy credit protection with respect to the same Reference Obligation, in order to acquire net long or net short positions (and not to earn a spread). Likewise, under paragraph 18(a)(x), the Issuer could purchase a bond and simultaneously buy credit protection on that bond. Under paragraph 18(A)(y), so long as these guidelines are otherwise satisfied, the Issuer may acquire a convertible bond and simultaneously enter a short position on the common shares of the bond issuer in order to take advantage of an arbitrage or mispricing in the market between the implied convertible price of the shares under the bond and the price of the common shares.

19. The Issuer will not make any upfront payment on any Synthetic Security and will not cause the Issuer to use Synthetic Securities as a means of making advances to the Synthetic Security counterparty following the date on which the Synthetic Security is acquired or entered into. For the avoidance of doubt, the preceding sentence is not violated by (i) the posting of collateral on standard market terms with respect to Synthetic Securities (including the establishment of collateral accounts and payments to Synthetic Security counterparties from the amounts on deposit therein) that is not intended as a means to make a loan, (ii) the Issuer purchasing credit protection under a credit default swap or under a similar transaction that references an index or a tranche of a security that is consistent with standard market conventions, provides for the Issuer to make an upfront payment

and periodic payments, and is not intended as a means to make a loan, or (iii) an upfront payment on an option that provides only for a single payment on inception and a single payment at maturity.

### **Trading and Not Dealing In Securities (including Synthetic Securities)**

20. The Issuer will buy, sell and hold securities (which, for the avoidance of doubt, include Synthetic Securities) only for its own account and will not buy, sell or hold securities for or on behalf of, or as nominee for any person other than the Issuer. The Issuer will buy and hold its securities solely for investment with the expectation of realizing a profit (either with respect to a single security or a combination of securities) from income earned on the securities and/or any rise in their value during the interval of time between purchase and sale. The Issuer will buy and sell securities only through a broker-dealer or a financial institution.
21. The Issuer will not act, hold itself out, or perform services as a middleman, or as a retailer or wholesaler of any security, for any person. The Issuer will not buy securities to subdivide them and sell the components or buy securities and sell them with different securities as a package or unit. The Issuer will not make a market in any security. The Issuer will not have or seek customers for its securities. The Issuer will not be regulated as a broker or a dealer in any jurisdiction, and the Issuer will not apply for a license to operate as a broker or a dealer in any jurisdiction. The Issuer will not hold itself out as a broker or a dealer or in any other manner as ready to enter into (and will not enter into) trades or other transactions (including purchases or sales of securities or other property) at the request of, as the agent of, for or on behalf of, or otherwise for the benefit of another person.
22. The Issuer will not engage in any activities which entitle it to any fee, commission, spread, markup or servicing income (other than a commitment fee, a fee for consenting to a modification of an investment or a fee that would be included in the "stated redemption price at maturity" (within the meaning of section 1273(a)(2) of the Code)) of the investment.
23. The Issuer will not hold itself out as being willing to enter into either side of, or to offer to enter into, assume, offset, assign or otherwise terminate positions in (x) interest rate, currency, equity, or commodity swaps, or caps or (y) derivative financial instruments (including options, forward contracts, short positions, and similar instruments) in any commodity, currency, share of stock, partnership or trust, note, bond, debenture or other evidence of indebtedness, swap or cap.



**Not a Regulated Entity**

24. The Issuer will not register as or become subject to regulatory supervision or other legal requirements under the laws of any country or political subdivision thereof as a bank, insurance company or finance company. The Issuer will not be treated as a bank, insurance company or finance company for purposes of (i) any tax, securities law or other filing or submission made to any governmental authority, (ii) any application made to a rating agency or (iii) qualification for any exemption from tax, securities law or any other legal requirements.
25. The Issuer will not hold itself out to the public as a bank, insurance company or finance company. The Issuer will not hold itself out to the public, through advertising or otherwise, as originating loans, lending funds, or making a market in loans or other assets.

**Not a “Surrogate Foreign Corporation” or an “Inverted Corporation”**

26. The Issuer will not, directly or indirectly, acquire (i) 70% (or such other percentage as shall be established pursuant to regulations issued under section 7874 of the Code) or more of the properties held, directly or indirectly, by a corporation that is organized under the laws of the United States or any state thereof or (ii) 70% (or such other percentage as shall be established pursuant to regulations issued under section 7874 of the Code) or more of the properties constituting a trade or business of a partnership that is organized under the laws of the United States or any state thereof unless, based on the advice of Issuer’s Counsel, or an opinion of other nationally recognized U.S. tax counsel experienced in such matters, the acquisition will not cause the Issuer to be (i) a surrogate foreign corporation or (ii) an inverted corporation within the meaning of section 7874 of the Code.

Notwithstanding the criteria set forth above, an investment shall be eligible for acquisition, or the Issuer may engage in any activity if the Issuer has received advice of Issuer’s Counsel or an opinion of other nationally recognized U.S. tax counsel experienced in such matters that the acquisition, ownership or disposition of the investment, or such activity will not cause the Issuer to be treated as engaged in a trade or business within the United States for U.S. federal income tax purposes or otherwise subject the Issuer to U.S. federal income tax on a net income basis.

