

Tax Issues in Structuring Your Hedge Fund

by Philip S. Gross, Esq.

Whenever you are forming a fund or modifying a fund structure, unfortunately (or fortunately), taxes necessarily come into play. Tax advisors need to know many facts including who the potential investors are, where the fund will be managed, who will own the manager and/or general partner, the fees and allocations involved, whether deferral is desired, and the applicable securities exemptions.

Federal taxes obviously come into play but state and local taxes also often come into play and sometimes are the driving force behind how funds are structured or modified. A fund and its manager may start with one structure but their needs may change as they grow and the fund structure and/or the structure of the manager may be modified to address new or different concerns.

This article briefly discusses various tax concerns in forming or modifying your fund or funds. Recommended structures may change over time based on developments and changes in tax law and securities law. We start with the simple structure and then move on from there addressing more and more issues and concerns. The examples below are not exhaustive and raise many issues, many of which are not discussed herein. The structures in the examples assume that the fund and its managers are in New York City, except as otherwise specifically noted.

Pertinent Facts

Some of the pertinent facts, the impact of which are generally described below, are:

1. Who are the investors? U.S. taxables? U.S. tax-exempts? Foreign persons?
2. In which state or states will the fund be managed; in which city or cities will the fund be managed?
3. Is there one manager and where does he or she reside, is he or she married and does he or she have children?
4. Is there more than one manager? Where do they reside? What is their economic and business deal?
5. Is there a seed capital investor?
6. What is the trading style?
7. What is the fund's anticipated underlying income? Short-term or long-term gain, ordinary, unrealized?
8. What is the fee structure? (This

discussion assumes it will be "one and twenty," but many other fee structures exist.)

9. Does the manager wish to defer income?
10. Does the restructuring consist of bifurcating an existing fund or combining existing funds?

The following is a review of various fund structures:

A. Domestic fund, 1% management fee and 20% incentive fee to investment manager. If only this worked, fund structuring would be very simple. For domestic investors, the potential problem is the deductibility of the 20% incentive fee and this would put substantial pressure on the trader versus investor issue. If the fund were not a trader, the fee would be subject to the 2% limitation under Section 67 of the Code, would be subject to the 3% limitation under Section 68 of the Code, would not be deductible for alternative minimum tax purposes, and would face further state and local tax deduction limitations.

For tax-exempt investors, the problem is unincorporated business taxable income ("UBTI") if the fund uses leverage (i.e., borrows money). For foreign investors, the problems are the potential risk of U.S. income taxation if the fund were considered engaged in a U.S. trade or business, withholding on fixed or determinable annual or periodical ("FDAP") income, issuance of K-1s in their names, and possible U.S. estate tax.

For the manager, the problem is that the 1% fee and the 20% fee would be subject to the New York City unincorporated business tax ("UBT") and all the income would be ordinary income subject to self-employment tax. Also, the fund would be responsible for withholding with respect to foreign partners, which is not preferable.

B. Domestic fund, 1% management fee and 20% incentive allocation to general partner. From the investors' perspective, this structure has the same issues as Structure A except that the incentive allocation puts less pressure on the trader versus investor issue. From the manager's perspective, the entire income is still subject to UBT but a significant portion of the 20% allocation may be

allocable out of New York City based on the investment allocation factors, some or all of the 20% allocation may avoid self-employment tax, and the underlying character of the fund's income would flow through to the manager with respect to the 20% incentive allocation.

C. Domestic fund, 1% management fee to investment manager, 20% incentive allocation to general partner. From the investors' perspective, this structure has the same issues as in Structure B but there might be even less pressure on the trader versus investor issue. From the manager's perspective, the issues are the same as in Structure B except that the entire 20% incentive allocation is not subject to UBT.

D. Domestic fund, 1% management fee to GP-1, 20% incentive allocation to GP-2. From the investors' perspective, this structure has the same issues as Structure C. From the manager's perspective, if the manager or one of the managers resides outside of New York State, he or she could avoid New York State tax on the 1% fee income in addition to avoiding New York State tax on the 20% allocation. Kleinberg, Kaplan, Wolff & Cohen received a ruling on this from New York State years ago. (See an article on this topic by my colleague Jeff Bortnick entitled "Nonresident Partners in Hedge Funds May Avoid New York Tax on Services Performed There," *Journal of Multi-State Taxation* (September 1993).)

E. Foreign fund feeding into domestic fund. The foreign feeder would be for U.S. tax-exempts and foreign investors. This structure has the foreign fund feed into the domestic, instead of having the foreign feeder and domestic feeder feed into a master fund, which would usually be a foreign fund itself. The problems with this structure, from a tax viewpoint, are that it throws FDAP withholding onto the domestic fund and the manager and does not permit deferral with respect to fees for the foreign fund or at least makes it very difficult and problematic to do so. And, from a securities law viewpoint, the counting of the number of investors must include all the investors in the foreign fund, not just the U.S. ones.

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F. Foreign fund, for foreign investors and U.S. tax-exempt investors, investment manager gets 1% fee and 20% performance fee. From the investors' perspective, this structure generally avoids UBTI concerns for investments by U.S. tax-exempts and avoids U.S. estate tax concerns for foreign investors. U.S. tax-exempt investors may have some reporting requirements even though they are tax-exempt. Using an offshore fund should generally work even if all the investors are U.S. tax-exempts (although some advisors raise this as an issue) and even if the foreign fund is a controlled foreign corporation. From the manager's perspective, he or she can have the option to elect to defer fees (although caution is needed to monitor proposed legislation and other developments in this area). All of the manager's income would be ordinary and would also be subject to self-employment tax (see below for a discussion concerning the structuring of the manager).

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G. Foreign fund, offshore master just for foreign fund and manager is member of master. Same issues as for Structure F but this structure enables the manager to receive his performance income without deferral as an allocation with the same tax character as the fund's underlying income. (This aspect was discussed in "Rethinking Hedge Fund Structures" by Marc Teitelbaum in this Publication's fourth quarter 2003 edition.) Basically, with new lower tax rates on long-

term capital gains and qualified dividend income, deferral of fees may not always be beneficial. Some of the same permutations as discussed above when using a domestic fund would be applicable to the manager.

H. Foreign fund with U.S. taxable investors. The taxation of U.S. taxable investors in foreign funds can be very complex. The general assumption is that U.S. taxable investors should not invest in offshore funds. However, this assumption should not always be followed and indeed may be wrong in certain circumstances. A recent article I wrote on this topic, "Tax Planning for Offshore Hedge Funds - the Potential Benefits of Investing in a PFIC," 21 Journal of Taxation of Investments 187 (Winter 2004), discusses this topic at length and explains potential real tax benefits of investing offshore for federal and state tax savings. Investing offshore may be very beneficial depending upon the underlying character of the income of the fund, the trader versus investor risk, the applicable state and local tax rates, and the interest charge under the passive foreign investment company rules. There are many hurdles and issues to consider in deciding whether to invest offshore but they are not insurmountable.

I. Other state and local tax issues in structuring. There are many potential state and local tax pitfalls and opportunities. We have seen limited liability companies used in Texas. That's clearly a no-no. We have seen funds structured in states where nonresidents of the states would be taxable in that

state. And, we have seen this in states where partnership withholding of state taxes with respect to nonresidents would be required which significantly compounds the problem, can affect the performance fee and can throw potential liability onto the fund and the manager. Ways around this are to move to another state if feasible, lobby for changes or clarity in the taxation of investment partnerships and their investors, or modify the structure so that nonresidents are not subject to tax in that state (such as being an investor not a trader in securities, using an offshore fund, etc.). Whenever you are outside the normal hedge fund states such as New York, New Jersey, Connecticut and California, extra precaution and planning are needed.

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J. How to structure the manager. This can be a very complex topic, particularly where there is more than one owner of the manager. A manager can be the individual himself but in almost all situations this should be avoided. Fee income would flow through to his or her Schedule C (which we believe raises additional audit risks) and there would be business liability issues as well. Generally, the manager should be an LP, an LLC or an S corporation. If the manager is an LP or an LLC, generally there should be more than one owner so that the income flows through on Schedule E rather than on Schedule C. Structures vary on this, depending on the anticipated size of the fund, with the self-employment tax being the main driver and there is some controversy in this regard.

For example, possibly have the manager be an S corporation and pay out only some in salary so that some income escapes self-employment tax. Alternatively, for example, possibly have the manager be an LP, have the GP of the LP be an S corporation or an LLC, and possibly have the limited partners of the LP be the individual managers or their families and have the limited partners avoid self-employment tax. Also, where the owners of the manager reside can have a big impact on the structure of the manager.

Another big issue in structuring the investment manager is estate planning which is an extremely important topic but is beyond the scope of this article. In addition, a related issue is continuity planning for the fund and/or the manager (the "what if the manager is hit by a bus" issue). Another key issue is when there is more than one owner of the manager: what is their business and economic deal — which can range from the very simple to the very complex (how do they share profits, what if one dies or becomes disabled, what if one wants to retire, what if one wants to leave and start up her own fund, who gets the track record, what if one wants to defer but the other does not,

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what if one resides in the state where the fund is and one does not, what if one is a U.S. tax person and the other is not, what if they want family members or trusts to own their portion ... the list of issues goes on and on). Additional major complexity arises if there is seed capital.

Conclusion

The above discussion only briefly addresses some of the tax issues that need to be taken into account when structuring a fund, when modifying a fund structure (such as forming a 3(c)(7) fund, forming a foreign fund, forming a multi-strategy or series fund, letting in another manager, allowing employees to defer, handling private placement life insurance policies and clone and non-clone insurance funds, etc.), when structuring a manager, and when investing in a fund. Investors and managers need to consult experienced hedge fund tax and corporate advisors in addressing these issues. (MK)

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