

# TO DEFER OR NOT TO DEFER: AN INFORMATIVE Q & A

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DUE TO THE GLOBALIZATION of the world economy, many U.S. hedge fund managers have set up offshore (i.e., non-U.S.) funds or are in the process of doing so. Such funds are generally for non-U.S. investors and tax-exempt U.S. investors.

## SETTING UP AN OFFSHORE FUND

If you are a hedge fund manager planning to set up an offshore fund (or have an existing one), one of the many considerations to take into account, and one which can have potentially substantial benefit to you, is how to structure your fees and whether, when and how to defer some or all of your fees. Simply stated, if a fee can be deferred, it can grow significantly on a tax-free basis.

An offshore fund is generally set up so that it is not subject to U.S. Federal income tax. Since the fund is usually set up in a tax jurisdiction where it is not subject to income tax and since the investors in the fund usually have no U.S. income tax concerns, the fund can generally defer the payment of fees to the manager without adversely affecting the fund or its investors. Domestic funds generally refrain from the deferral of these fees because the investors in such funds cannot deduct the fees for U.S. income tax purposes until the fees are paid.

## WHY DEFER?

The benefit of growing on a tax-free basis can be tremendous. The longer the deferral period and the higher the rate of earnings, the more dramatic the deferral benefit can be. If the fund's earnings are largely long-term capital gains and/or unrealized gains, a manager may be better off not deferring the fees, but rather, taking the fees as a partner's special allocation. Before deferring fees, a manager should check to see whether deferral would be beneficial assuming various rates of return, lengths of deferral and tax characteristics of the fund's performance.

## CONFRONTING THE ISSUES

**Should the manager of the offshore fund be a U.S. or a foreign entity, a C corpora-**

**tion, an S corporation, a partnership or a limited liability company?** In general, the manager should be a look-through entity, preferably either a partnership or an LLC, and the entity can be either foreign or domestic.

**Should the manager use the accrual method or the cash method of accounting?** The manager must use the cash method for deferral to work. If the manager uses the accrual method, the manager would be required to accrue the fee even if it were deferred, which could be disastrous.

**Should the manager be the same entity as the manager (or one of the managers) of the domestic fund?** It is generally preferable to be a separate entity, depending on where the domestic fund is managed and where the owners of the manager reside.

**How does the manager defer its fee?** Generally, the investment management contract would provide for an annual election, at the manager's discretion, to defer its fee. In general, the election should be made before the year to which the deferred fee relates. There is a special rule for initial deferrals.

**For how long should the manager defer the fee?** This is a personal choice, the longer the better from a compounded growth perspective. Generally, the rule of thumb is that 10 years is the maximum deferral period, although there is no set rule. The investment management agreement may also provide some outs if the deferred fee is needed sooner. The investment management agreement must include certain items in order to satisfy IRS requirements. One requirement is that the right to the deferred fee must be that of an unsecured general creditor. Therefore, there is some credit risk to the deferring of a fee.

**What if the manager defers a fee for 3 years and later decides that it would like to defer the fee for more time?** There is some authority that a second deferral election can be made prior to the receipt of the initial deferral fee, but this is not the IRS's current position. It is anticipated that the IRS will issue guidance on this issue sometime in 2001, but such guidance has been anticipated before.

## How much should the manager defer?

Again, this is a personal choice. The answer would depend on the manager's other assets and financial needs. From a fund marketing perspective, it may look better to defer as much as possible.

**Do investors care?** Deferral of fees may be viewed favorably because it shows a personal commitment to the fund. Generally, an investor would not care from a tax perspective but it depends on the applicable tax rules in the investor's jurisdiction. In our experience, deferral has not been opposed by investors and is often looked upon favorably by them.

**Does the manager's option to defer fees need to be disclosed in any of the fund's documents?** The potential for deferral should be disclosed in the fund's PPM.

**How is the manager's deferred fee invested?** The fund agrees to pay interest on the deferred fee. Generally, but not necessarily always, the rate of interest chosen is the same rate of return as the rest of the fund.

**Can the manager defer fees that would go to its employees?** Briefly stated, the answer generally is yes, subject to complexity and limitations. There are corporate, tax and ERISA issues, but this deferral can be very beneficial in a number of ways. We find that employees like the tax benefit of deferral and tend to be more committed to the business after some of their earnings have been deferred and, in effect, invested in the fund.

Structuring your funds and deferring your fees can be complex and you should consult with your attorneys or accountants before doing so. ☞

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