Overview of hedge fund tax structures

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Abstract

Purpose – *The purpose of this paper is to provide a brief overview of some common hedge fund structures and some of the tax considerations that are significant in choosing among these structures.*

Design/methodology/approach – *The focus of this article is US federal income tax considerations, particularly in the circumstance where the fund manager includes, at least in part, persons who are US individual taxpayers. The structures described here, including limited partnerships organized under US law, offshore investment companies, and master-feeder structures, serve as basic building blocks for many other variations that may be appropriate, depending on a number of factors, including investment objectives (e.g. capital appreciation versus dividend income), anticipated investors (e.g. non-US investors and investors subject to special regulatory regimes) and the composition of the investment managers (e.g. managers that include both US and non-US principals).*

Findings – *Hedge funds must be structured carefully to avoid unfavorable US tax consequences and each structure has both advantages and disadvantages.*

Originality/value – *An essential summary of tax structures for hedge fund managers and advisers.*

Keywords *Income tax, Fund management, Tax planning, United States of America*

Paper type *Technical*

Common structures

Limited partnership organized under US law

In this structure, the fund is a limited partnership organized in the USA, most often under the laws of Delaware. Typically, the fund manager will participate in the fund as the general partner, and in that capacity will be entitled to a share (e.g. 20 percent) of the fund's profits (reflecting realized and unrealized gains) each year (a so-called ‘‘carried interest’’) and also will earn a management fee (charged quarterly) reflecting a percentage of assets under management. The management fee is often considered the amount necessary to pay for the ongoing administrative expenses of operating the fund, with the carried interest serving to compensate the fund manager for good portfolio performance.

Potential advantages of a Delaware limited partnership include the following:

- Low cost and simplicity of organization.
- Flow-through of items of taxable income and loss to US taxable investors and the fund manager, including, for US individual tax-payers, long-term capital gains and certain qualified dividend income that may be eligible for a lower (15 percent) US federal income tax rate (versus the 35 percent rate otherwise applicable), and, for US taxpayers generally, items of deduction that may be used (subject to various limitations) against other taxable income of partners.

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- Flow-through of tax treaty benefits, reducing US withholding tax on interest and dividend income from US investments, for non-US investors that qualify for favorable tax treaties with the USA.

Potential disadvantages of a Delaware limited partnership include the following:

- If the fund invests with margin debt, a tax-exempt investor in the fund may as a result recognize ''debt-financed income'' that is treated for US federal income tax purposes as taxable ''unrelated business taxable income,'' or UBTI. UBTI may also result from a fund's equity investment directly (or indirectly through one or more flow-through vehicles (e.g. LLCs), rather than through corporate stock) in a US trade or business.
- A non-US investor may be concerned about the risk that the fund's activities in the USA extend beyond merely investing or trading in securities and thus constitute the conduct of a trade or business in the USA and may result in ''effectively connected income,'' or ECI. A non-US investor would be subject to US federal income tax payment and filing obligations (generally at a 35 percent tax rate) and, in the case of a non-US investor that is a corporation, to an additional US branch profits tax reflecting, in essence, deemed dividends (subject to tax treaty reduction, generally at a 30 percent rate).
- Some investors, including non-US investors, may have privacy concerns regarding the filing of a US partnership tax return by the fund, which would include Schedule K-1 information for each investor. These concerns could be addressed by using a partnership organized under the laws of a non-US jurisdiction, such as the Cayman Islands, or a ''check-the-box'' non-US company that has elected partnership status (discussed below under ''Use of Check-the-Box Entities''), but this increases somewhat the cost and complexity of establishing the fund.

Offshore investment company

In this structure, the fund is organized as a company under the laws of a non-US jurisdiction that imposes little or no tax (a ''tax haven''), such as the Cayman Islands; the offshore company is treated for US tax purposes as a non-US corporation. An offshore investment company is generally suitable for non-US and US tax-exempt investors, but is not tax efficient for investors that are US taxpayers.

Potential advantages of an offshore company include the following:

- If the fund's activities generate ECI from a US trade or business, the offshore company, and not the fund's non-US and US tax-exempt investors, will be subject to US income tax filing and payment obligations.
- If the fund's activities include leveraged investments (e.g. using margin debt), income from such investments will not result in debt-financed income that is subject to US income tax for the fund's US tax-exempt investors (or for the fund).
- The use of an offshore company may address the privacy concerns of some investors.
- With proper structuring, a US fund manager can defer the recognition of taxable income from management fees (including ''carried interest'' performance fees measured by fund profits) for significant periods of time, as discussed below under ''Deferral of Fee Income.''

Potential disadvantages of an offshore company include the following:

- The fund is likely to be a ''passive foreign investment company,'' or PFIC, for US income tax purposes. A non-US corporation is classified as a PFIC when more than half of its asset value or 75 percent of its gross income in any year is from passive sources (such as interest, dividends, and gains from the sale of stock or securities). As discussed below under ''Investment by a US Taxpayer in a PFIC,'' there are potentially significant adverse tax consequences for US taxpayers that invest in PFICs.
- If the fund's activities generate ECI, as a non-US corporate entity that is organized in a tax haven, it will be subject to a 30 percent US branch profits tax, in addition to US income tax on its ECI at a rate of up to 35 percent.

- Because the fund is organized in a tax haven, it will not be eligible for reduced rates of withholding tax on dividends or on interest that it receives that does not qualify for the US ''portfolio interest'' exception, and so it generally will be subject to 30 percent withholding tax on such income.
- The structure is tax inefficient for non-US investors that are eligible for favorable US tax treaties with the USA and for US investors that would not have been subject to the withholding tax had they invested in a fund that was treated as a pass-through, rather than a corporation, for US tax purposes.

Master-feeder structure

This structure combines the structures described above. Although there are variants, generally the master fund is an entity classified as a partnership for US tax purposes (such as a limited partnership), and the feeder funds include an entity classified as a non-US corporation for US income tax purposes (such as the offshore investment company described below) and another entity classified as a partnership for US tax purposes.

Potential advantages of a master-feeder structure include the following:

- The structure allows favorable tax treatment for a wide range of investors. Non-US and US tax-exempt investors can invest through the offshore investment company feeder, insulating themselves from direct US income tax on ECI or UBTI, including debt-financed income (although, as noted above, the offshore investment company itself is potentially subject to US income and branch profits taxes on ECI, as well as US withholding tax on interest and dividends). Investors that are US taxpayers can invest through a partnership feeder that preserves the favorable tax characteristics of the fund's investment income (e.g. long-term capital gains and qualifying dividends).
- The structure is flexible and allows the manager to receive deferred management fees from the investment company feeder.
- The structure permits management of a single portfolio, in a single master entity, for all investors.

Potential disadvantages of a master-feeder structure include the following:

- The master-feeder structure entails greater complexity in initial organization and ongoing administration. This is mitigated, however, by the fact that these structures are common in the marketplace and familiar to experienced professionals who work with them.

Selected tax issues and opportunities

Deferral of fee income

As noted above, one potential advantage of an offshore investment company for a fund manager is the opportunity to defer the recognition of income for tax purposes. In a typical arrangement, a fund manager that is otherwise entitled to receive a performance fee or ''carried interest,'' based on realized and unrealized appreciation of an offshore investment company portfolio, reflecting a percentage (typically 20 percent) of profits in a year, elects prior to that year to defer for five years the payment of that carried interest. The performance fee is structured as an investment advisory fee paid to the fund manager in its capacity as a third-party service provider (as opposed to an allocation of profits to a general partner in the context of a partnership carried interest). During the deferral period, the fund manager is in the same position as any other unsecured creditor of the offshore investment company, but at the end of the deferral period the fund may pay the manager an amount that reflects the deferred carried interest, increased or decreased to reflect the fund's performance during the deferral period.

Key considerations with respect to a fee-deferral arrangement include the following:

- The deferred fees, when paid, will constitute ordinary income for the fund manager, and be subject to taxation at a higher US federal income tax rate of 35 percent, even if the fund's profits consisted of long-term capital gains or qualifying dividends, which would have been subject to a lower US federal income tax rate of 15 percent had the fund manager been allocated this income as a carried interest by an investment partnership.

- The 2004 Jobs Creation Act added a new US tax code provision, Section 409A, which includes various procedural and substantive requirements for deferred compensation arrangements. These new rules, which are still in a state of flux and subject to ongoing IRS guidance, need to be carefully considered in structuring fee-deferral arrangements. This is the case, in particular, when an individual fund manager is compensated through a chain of intermediate companies.

Investment by a US taxpayer in a PFIC

As noted above, an offshore company that is treated for US tax purposes as a corporation is likely to be a passive foreign investment company, or PFIC, for US federal income tax purposes. While as a general matter a PFIC is not a suitable investment vehicle for a US taxpayer, there are circumstances in which the US tax-payer may choose to invest in a PFIC, including when there is no alternative vehicle available for investment with a particular investment manager (for example, where there is no opportunity for investment through a limited partnership fund vehicle).

Key considerations for a US taxpayer investing in a PFIC include the following:

- If a US taxpayer holds shares in a PFIC and does not make one of several special elections, the US taxpayer will be subject to potentially significant additional US taxes on dividend distributions, or gains from sale, from the PFIC. The PFIC rules are intended to prevent the deferral by US taxpayers of income recognition through the use of foreign corporations. In general terms, the US taxpayer would be required to pay taxes at the highest applicable US federal income tax rate of 35 percent, rather than the lower 15 percent rate that might otherwise be applicable, in the case of an individual, for long-term capital gains and qualified dividend income, and will also be required to pay an interest charge reflecting the period of time that the US taxpayer held the shares in the PFIC (the ''PFIC Taxes''). The result, depending on the holding period for the PFIC stock, can be an increase in the effective tax rate applicable to the US taxpayer from 15 percent to well over 50 percent.
- If the PFIC makes distributions of its income (calculated in accordance with US federal income tax principles) each year to the US taxpayer, in effect the PFIC Taxes will not apply, although all of the US taxpayer's income from these distributions will be ordinary dividend income subject to taxation at the current federal income tax rate of 35 percent.
- The US taxpayer can make a qualified electing fund, or QEF, election with respect to the PFIC shares. With a QEF election, the PFIC Taxes will not apply, but instead the US taxpayer will be required to take into account its share of the offshore investment company's taxable income each year (reflecting on a flow-through basis its share of ordinary income and capital gains) regardless of whether the PFIC makes any actual distributions to the US taxpayer.
- To qualify for QEF treatment, the offshore investment company must provide the US taxpayer with annual information, prepared in accordance with US tax rules, regarding its taxable income. Many offshore investment companies are unwilling to provide this information, and a fund of funds may be unable to do so (because of the need to receive similar information from underlying funds).
- The tax treatment of a US taxpayer that holds an interest in a PFIC with a QEF election is similar to that of a US taxpayer that invests in a partnership, but is less favorable in various respects, including the inability to flow through items of tax loss or deduction or qualified dividend income.
- If the offshore investment company is publicly traded on an established securities market, a US taxpayer may instead make a ''mark to market'' election to address the PFIC issue and eliminate PFIC Taxes. The mark-to-market election, as suggested by its name, requires the US taxpayer to take into account annual increases in the market value of its

PFIC shares, regardless of whether any distributions are received or gains realized from those shares by the US taxpayer.

Use of check-the-box entities

There may be regulatory or other nontax reasons for an offshore investment company to be organized as a company under local law, where pass-through or partnership treatment would be preferable for US tax purposes. Under US tax law, it is possible to make a ''check-the-box'' election for many forms of non-US entities, and as a result elect to treat a company as a partnership or pass-through, and not as a corporation, solely for US tax purposes (without changing the local-law treatment of the entity). The ''hybrid'' nature of a check-the-box entity (corporation or company in one jurisdiction, partnership or pass-through in another) may give rise to US and non-US tax complications that require careful consideration, including regarding the possible availability of tax treaty benefits to investors in the entity.

Total return swaps and other derivative interests

Investors that are concerned about some of the tax considerations noted above (UBTI or PFIC concerns, for example) or that have nontax concerns sometimes consider structuring their investments in an investment fund through an indirect, derivative arrangement. One approach is a so-called ''total return swap,'' which attempts to replicate the economic return from a fund investment through a derivative contract with a third party, often a non-US bank. Other derivative arrangements may be intended to defer the recognition of taxable income with respect to an investment fund. The tax treatment and other issues raised by these arrangements are complex, sometimes uncertain, and the subject of continuing and potentially retroactive scrutiny in IRS pronouncements, Treasury regulations and other guidance.