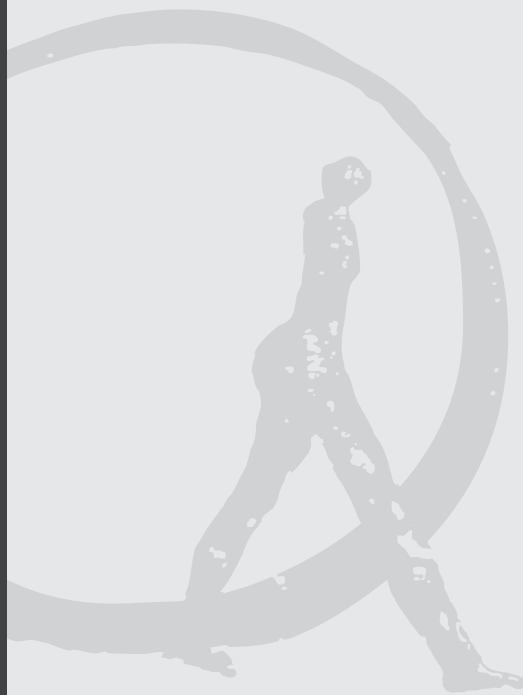


A Primer on the Tax Framework of Offshore and Onshore Hedge Funds

June 2016



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Abstract

This paper reviews the legal and operational structures typically used by hedge funds, their managers, sponsors and investors in order to optimise their tax setup. We discuss in particular the case of U.S. domestic hedge funds set up as a limited partnership as well as the case of offshore funds based in the Cayman Islands.

JEL classification: G23, G28, K22, K34

Keywords: taxes, hedge fund, regulation

We thank Caroline Farrelly for her insightful comments, which helped us improving significantly this article.

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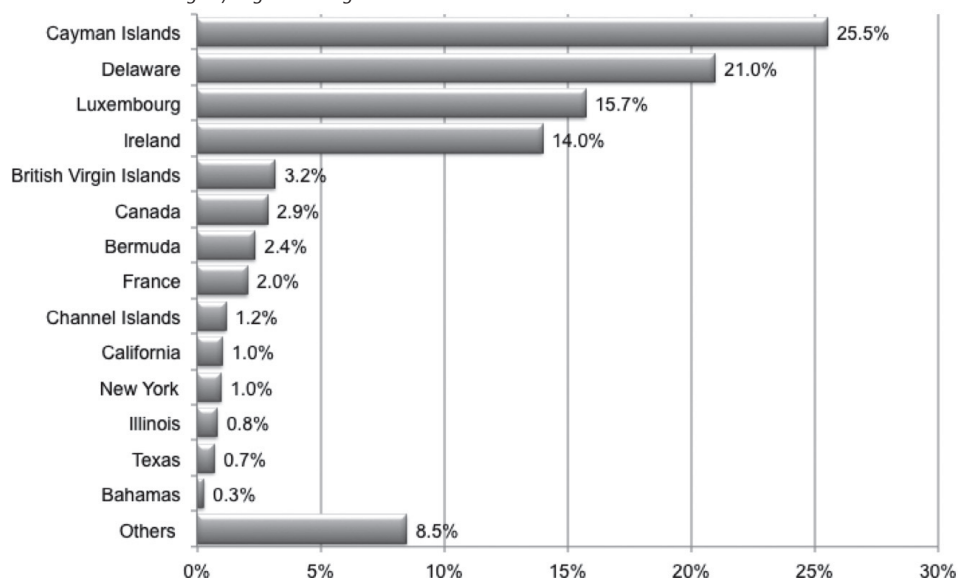
1. Introduction

The term "hedge fund" is commonly used today to describe a variety of investment vehicles that share a series of common characteristics. They are privately organised investment pools created by a sponsor for the purpose of attracting investors' capital and managing it for a fee. Typically run by a group of investment professionals, their investment policy is flexible and relies on a wide range of financial instruments and/or trading strategies.

Previously considered as marginal players, hedge funds now exert a significant influence on the markets in which they operate. Today, there are more than 8,000 so-called hedge funds in the world, running in aggregate close to US\$ 3trillion of capital, excluding leverage. These funds form a rather heterogeneous industry, to the point that it is becoming difficult to keep track: some follow high-risk strategies, whereas others are quite conservative. Some use leverage, derivatives and short positions and others just buy plain vanilla securities. Some turn their portfolio several times in a day, while others behave like long-term investors. Some run multi-billion dollar portfolios, while others are in desperate need of additional assets. Some are hedged against the variations of traditional asset classes, such as stocks and bonds, while others chase directional opportunities in global financial markets.¹

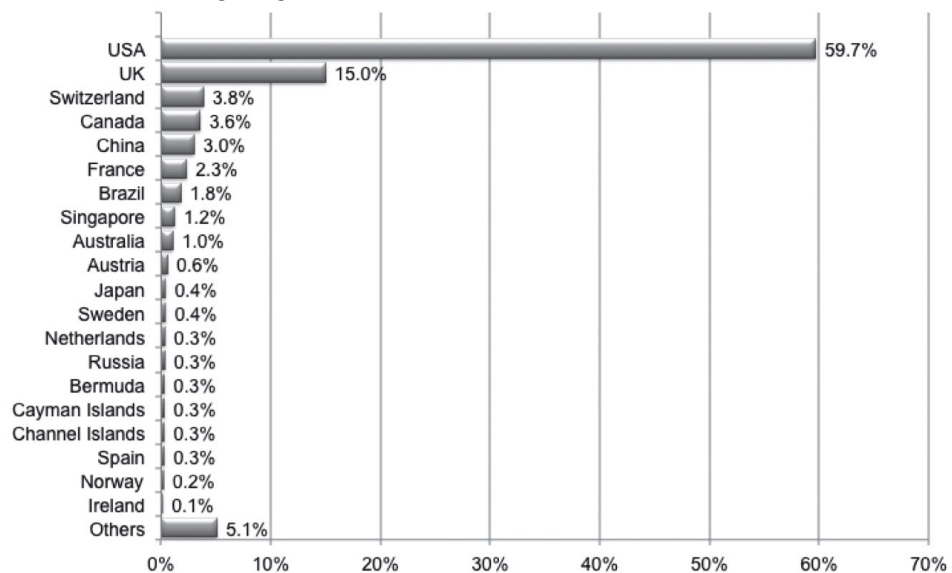
In this paper, we will primarily focus on tax matters. Albert Einstein used to say: "the hardest thing in the world to understand is the income tax". The complexity of a hedge fund's legal and operational structure does not improve the situation and often leads to severe misunderstandings and criticism. As an illustration, the Street's perception is that hedge fund managers pay little or no taxes. An item of particular recurring attention is carried interest, essentially a share of profits that hedge fund sponsors receive from their investors as compensation for their services. Some claim that hedge fund carried interest could apparently be deferred as long as desired, ultimately to be taxed on capital gains rather than income. 2016 U.S. presidential candidates Clinton, Bush, Sanders and Trump have all called U.S. carried interest tax rules "a tax loophole for the wealthy". President Obama has tried to change them in every budget he has proposed, as yet with no success. Another item regularly criticised is the fact that most hedge funds are domiciled in tax haven or tax-light jurisdictions, which many interpret as a sign of illegal tax avoidance. Figure 1 shows the situation as estimated as of December 2015. Approximately 26 per cent of the hedge funds were legally domiciled in Cayman Islands, followed by 25 per cent in the U.S. (with a strong preference for Delaware), 16 per cent in Luxembourg and 14 per cent in Ireland. In fact, as illustrated in Figure 2, most of these funds were effectively managed elsewhere, typically in well-established but less tax-friendly financial centres where they paid little taxes.

Figure 1: Major locations used to legally register hedge funds.



1 - See Lhabitant (2002, 2004, and 2006) for an extensive discussion of hedge fund legal and operational structures, investment strategies and potential risks.

Figure 2: Major locations used to manage hedge funds.



Not surprisingly, hedge fund managers and investors disagree with the idea that they should pay more taxes. They claim that the returns on hedge fund investments already generate huge tax bills because the returns themselves are high, the investments rarely qualify for tax exemptions, and the nature of the investment style of hedge funds is shorter-term, implying a higher tax rate. Last but not least, hedge fund managers also recall their fiduciary duty and fundamental right to optimally structure their funds – as long as they respect the law. Indeed, their goal is to deliver as large as possible after-tax returns to their stakeholders, who come from across the globe and are compliant with their tax obligations in their respective countries. Consequently, when setting up, operating or investing in a hedge fund, it is essential to cautiously analyse the operational and legal structures involved in order to (i) understand the potential tax issues; (ii) minimise tax leakages that ultimately erode investment returns; (iii) align tax interests for the parties involved; and (iv) minimise potential liabilities for investors and managers in the event of losses. In an ideal world, one would like to achieve a “pass through” tax treatment of investment returns² and limit the liability of investors to the amount of their investment. Unfortunately, the ideal one-fits-all tax-efficient structure may not be possible, as hedge funds investors, sponsors, and managers all have their individual tax profiles and concerns. Nevertheless, adopting an appropriate structure may go a long way towards solving the most common of tax problems.

The goal of this paper is to provide an introduction to the typical legal structures used by hedge funds and their major tax implications for the fund, for fund managers, for sponsors and for various investor types. Most of our discussion is centred on U.S. federal income taxes; we will occasionally discuss state or local taxes. Obviously, other countries have different tax laws that may provide different or specific tax outcomes, and it is beyond the scope of our paper to review them. We will first examine the situation of hedge funds based in the U.S. (“onshore funds”) and then follow up with the case of hedge funds based outside of the U.S. (“offshore funds”). In the latter case, we will focus specifically on the Cayman Islands as an illustration, since this is the largest offshore centre for hedge funds. Ultimately, we will discuss the case of hybrid hedge funds, as well as some recent international tax and regulatory developments such as BEPS and FATCA and their impact on hedge funds.

2. U.S. Hedge Funds (“Onshore Funds”)

2.1 The typical U.S. hedge fund structure

In the U.S. several types of legal structures are technically available to setup a hedge fund but some of them are rarely chosen for the following reasons.

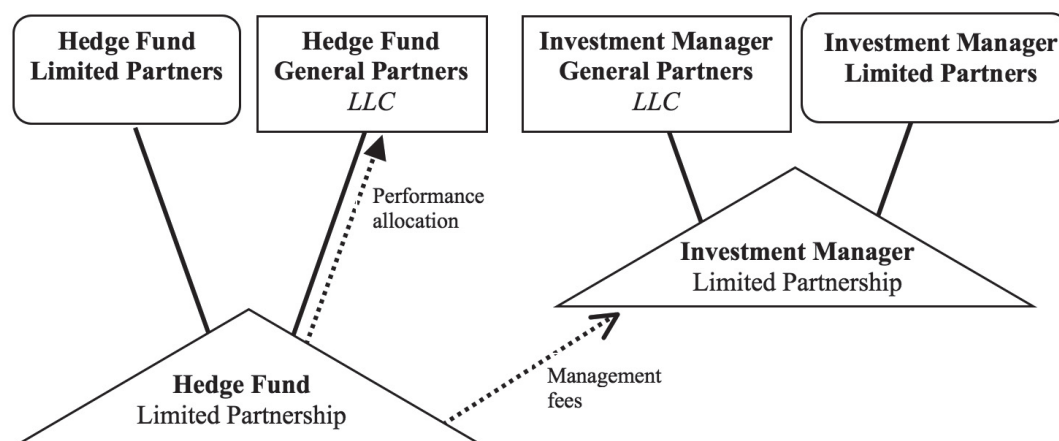
2 - A pass-through structure does not pay any direct corporate tax. Its income is passed to its partners, who in turn are taxed individually at their respective marginal tax rate.

- The sole proprietorship is a pass-through entity, but its owner remains personally liable for all the business's debts;
- The Subchapter C Corporation ("C Corp") creates a double taxation issue, as it pays a full corporate tax on its profits³ but all dividends and distributions to shareholders are taxed once again at the shareholder level when remitted;⁴
- The Subchapter S Corporation ("S Corp") is a pass-through entity. It offers its shareholders the traditional liability shield of a corporation, but has a cap on the number of investors (limited to 100), restrictions on the nature of investors (only natural persons who are citizens or residents in the U.S., so precludes institutional and foreign investors), and may only have one class of shares. In addition, in some states, S Corps are subject to a franchise tax (CA) or even full corporate income tax (NY);
- The S.E.C. Regulated Investment Company (a.k.a. "mutual fund") is strictly regulated and incompatible with the flexibility required by a hedge fund. In particular, the U.S. Investment Company Act severely limits the range of permissible investment strategies.

Historically, the overwhelming majority of U.S. hedge funds were established as limited partnerships ("LP"), a structure that regroups a series of limited partners and at least one general partner, governed by a limited partnership agreement ("LPA"), negotiated and signed by all involved. Limited partners are the external investors who contribute their capital to the fund and receive in return partnership interests and a capital account. They are not involved in the fund's investment decisions or other day-to-day activities, so are shielded from personal liability for the fund's debts and actions, except to the extent of their capital contribution, plus any distributions made by the partnership to the limited partners. In contrast, general partners run the day-to-day activities of the fund and have the power to bind the partnership and the other partners in contracts that are made during the ordinary course of business. Consequently, they assume personal liability for all of the debts and other obligations of the fund. To mitigate such risk down to negligible economic liability, many general partners are formed as a limited liability company governed by a private operating agreement.⁵ Most of the time, general partners will have also contributed some capital alongside limited partners, if only for the purpose of aligning interests.

For state tax and local reasons to be discussed later, the general partner often appoints an associated entity as investment manager.⁶ Common practice is to set up the investment manager as another partnership, with some of the investment professionals as limited partners and another limited liability company as the general partner – once more limiting potential liabilities. The resulting bifurcating structure is illustrated in Figure 3.

Figure 3: Typical structure of a U.S. hedge fund setup as a limited partnership



3 - With the exception for reduced taxation on U.S. sourced dividends paid by companies in which it has an ownership stake ("dividends reduced deduction").

4 - Note that C Corp owners may reduce their tax bills with a combination of salary-and-distributions and a reduced taxable gain on the sale of certain qualifying stock, but the conditions are quite restrictive – see Section 1202 of the Internal Revenue Code ("I.R.C."), Title 26 of the U.S. Code.

5 - In practice this construction only offers the appearance of limited liability as for liabilities under the securities laws, the ultimate general partner can be held personally liable irrespective of the legal form of the entity that serves as the general partner.

6 - In practice, this separation is of no particular significance for federal tax. It is crucial for state and/or local taxes, as some exemptions are available – e.g. New York City and its 4 per cent unincorporated business tax (UBT). For a discussion on the separation of funds and management and the rationale behind it, please see Morley (2014).

The compensation arrangements of a hedge fund are described in its limited partnership agreement. They may vary from fund to fund but usually comprise two economic entitlements, often referred to as "two and twenty"⁷:

- The investment manager performs services for the hedge fund and receives a management fee, typically used to pay for overheads, salaries and other manager expenses that are not charged directly to the fund. The fee level varies greatly from one fund to another, although a commonly heard figure is two per cent p.a. of the assets under management;
- The general partner of the fund is entitled to receive some percentage of the annual performance of the fund. Typically they keep 20%, leaving 80% for the investors. The goal is to reward the general partner for good performance and incentivise him to perform well instead of chasing additional assets. For the protection and benefit of investors, performance sharing may be limited through a loss carry forward provision ("high-water mark"), subject to achieving a minimum specified return ("hurdle rate"), and/or give investors the ability to recoup a portion of the earlier-shared performance if the fund experiences a downturn later on ("claw back"). Note that in practice, this may be structured as a fee (a.k.a. an "incentive fee" or a "performance fee") or an allocation (a.k.a. an "incentive allocation", a "performance allocation" or a "carried interest"). The pre-tax economics are the same, but the tax treatment will fundamentally differ, as discussed in more detail below.

As shown in Figure 1, Delaware is the most popular U.S. state for the incorporation of a limited partnerships and its associated general partner LLC.⁸ Delaware's pro-business corporate laws,⁹ low costs, quick turnaround times, proven limited liability protection and dedicated state court's sophisticated history in corporate law jurisprudence are obvious advantages, compared to other states.¹⁰ In addition, Delaware does not require filing a limited partnership agreement, so that these documents can remain private. Last but not least, Delaware does not require the fund to maintain a presence or an office or personnel in the domicile. In practice, the limited partnerships and its associated general partner LLC have a resident agent and a physical address in Delaware, but none of their business physically takes place in Delaware, as this state would then charge corporate taxes on the associated income.¹¹ Instead, they establish a principal place of business in another state (for instance, Connecticut) that does not impose corporate taxes on pass-through LLC entities.

In recent years, new legal structures have emerged in the U.S. as potential alternatives to limited partnerships for structuring a hedge fund. Most of them aim at segregating liability, control, and profit sharing within a single entity rather than having to create an additional limited liability entity for the general partner. The U.S. limited liability company ("US LLC") is the most popular of these new legal structures. It is an unincorporated entity in which one or more individuals, called "members", have limited liability for the enterprise's debts and claims, even if they participate in management. Unless an explicit election for corporate treatment is made in respect of federal income tax, the LLC will be treated as a partnership – that is, as a pass through transparent entity.¹² While this seems positive news, it may have significant consequences for foreign investors, particularly if the LLC is regarded as a non-transparent entity by the jurisdiction of its foreign owner and taxed there as a corporate entity. This may lead to:

- Mismatches with regard to the identity and residency of the taxpayer who recognises revenues and expenses, as well as the timing of income recognition;
- A double taxation situation and/or a potential loss of tax treaty benefits, with respect to U.S.-sourced income earned by the LLC,¹³ or inversely;

7 - See Lhabitant (2007) for a discussion of hedge fund fees and how they compare to mutual fund fees.

8 - See Cumming, Dai and Johan (2015).

9 - See in particular its Delaware Limited Liability Company Acts (DLLC) and Delaware Revised Model Uniform Limited Partnership Act (DRULPA) of 1983.

10 - Carney, Shepherd and Shepherd (2011) suggest that although the quality of its corporate law has declined substantially over recent years, Delaware continues to be the location of choice because (i) law schools primarily focus on Delaware corporate law; (ii) most lawyers rationally learn the corporate law of only Delaware, their home state, and federal law, which means they are unfamiliar with other states laws; and (iii) investors are also unfamiliar with the laws of states other than Delaware and therefore incorrectly believe that Delaware law is best.

11 - The sufficient physical presence requirement is known as « nexus ». It flows from both the Commerce Clause and the Due Process Clause of the Fourteenth Amendment. In theory, states do not have the authority to tax persons, property or transactions without a definite link ("substantial nexus") with the state. In practice, there have been numerous disputes over the last decades about what constitutes "substantial nexus".

12 - Note that an LLC with only one member ("SMLLC") can elect to be taxed as a C corporation, or be disregarded entirely as an entity separate from its owner for federal income tax purposes. In the latter situation, the SMLLC has no obligation to file federal income tax returns.

13 - See for instance the U.K. Supreme Court Anson v. Commissioners for Her Majesty's Revenue and Customs [2015] UKSC 44.

- A reduction of the overall tax paid by all parties involved as a whole, for instance through double deduction schemes, deduction/no inclusion schemes, or foreign tax credit generators.¹⁴

As a result, whenever a U.S. LLC comes into play in an international context, the interaction of domestic, foreign, and treaty provisions should all be carefully reviewed to prevent the occurrence of unintended tax consequences. The use of more traditional partnership entities such as U.S. limited partnerships is less likely to result in such hybrid mismatches. Other structures, such as the Limited Liability Limited Partnership ("LLLLP") or the Series Limited Liability Company ("Series LLC") are less common, as they are only available in some states and have been subject to fewer national or international tests.

In the following, for the sake of simplicity, we will only discuss the case of onshore hedge funds set up as limited partnerships, with one general partner and several limited partners.

2.2 Taxation of the hedge fund

Partnerships taxation is codified as Subchapter K of Chapter 1 of the I.R.C. As a general rule, a hedge fund structured as a limited partnership is not a taxable entity for U.S. federal income tax purposes.¹⁵ Therefore, it does not pay federal income tax. Instead, all its tax items (such as income, losses, deductions, and credits)¹⁶ are passed through to its partners, who must report them in their respective tax returns and will be taxed individually at their respective marginal tax rate. From a practical perspective, the limited partnership is still required to (i) calculate these tax items; (ii) allocate them to the partners' capital accounts; and (iii) report them to the partners and the I.R.S.

Calculation of tax items: The tax items calculation is done in the same manner as for an individual, except that certain items need to be stated separately, since the partners may face limitations to the degree to which they may utilise them¹⁷ and certain deductions are not allowed.¹⁸ The partnership has to make several elections affecting the computation of its income. There are a few specific ones that must be made individually by the fund partners.¹⁹

For U.S. investors, a crucial element regarding U.S. federal income tax is whether a hedge fund is classified as an "investor" fund or as a "trader" fund. To simplify, one can say that an investor fund purchases securities for long-term capital appreciation and income, whereas a trader fund buys and sells securities on a higher frequency in order to profit from short-term movements.²⁰ The distinction matters with respect to the deductibility of fund expenses for federal tax purposes. In a trader fund, fund expenses such as management and professional fees are considered as ordinary business deductions under Section 162, so are fully deductible "above the line" against income.²¹ In an investor fund, management fees and other fund expenses are stated separately as "expenses incurred for the production or collection of income," which may be claimed by investors as I.R.C. Section 212 "miscellaneous itemised deductions," but are subject to the severe limitations and in some cases disallowed entirely.²² There is therefore a clear tax advantage to being classified as a trader fund.

Another important benefit available to trader funds is the option of making a Section 475(f) election. This election allows them to mark-to-market their investments at year-end and report the resulting gains and losses for tax purposes even though those have not been realised. That is,

14 - The Organisation for Economic Co-operation and Development (OECD) has issued its Action Plan n°2 on Base Erosion and Profit Shifting (BEPS), released in May 2015. It includes important modifications to provisions of domestic law aimed at avoiding hybrid mismatches such as the ones mentioned here and achieving alignment between those laws.

15 - I.R.C. Section 701. Restrictions related to publicly traded partnerships and non-passive income will be discussed later on.

16 - This is subject to a number of limitations. See for instance I.R.C. Sections 163(d) or 709(b).

17 - For instance, some partners may have made capital gains elsewhere and may want to offset them against the partnership's capital losses.

18 - I.R.C. Section 703.

19 - I.R.C. Section 703(b). The following elections are made by each partner separately: elections under Section 108 relating to income from discharge of indebtedness, elections under Section 617 relating to deduction and recapture of certain mining exploration expenditures, and elections under Section 901 relating to foreign tax credits.

20 - Note that the Congress, either in the I.R.C. or in regulations, has never formally defined the two terms. Some courts have provided guidance – see for instance *Liang v. Commissioner* (23 T.C. 1040), or *Moeller v. United States*, 721 F.2d 810,813(Fed. Cir. 1983). However, more recent cases seem to suggest that the number of trades, the dollar amount of the trades, and the number of days on which trades occurred all contribute to whether trading is substantial or not – see *Endicott v. Commissioner, T.C. Memo 2013-199* or *Nelson v. Commissioner, T.C. Memo 2013-259*. The I.R.S. is also known to use the weighted average holding period of trades as a key criterion, with an unofficial threshold set around 50 days.

21 - I.R.C. Section 162.

22 - The I.R.C. Section 67 restricts the benefit of the deduction solely to the extent it exceeds two per cent of the investor's adjusted gross income (AGI). The I.R.C. Section 68 limitations generally add the remaining deduction to other itemised deductions, and then reduce them by the smaller of three per cent of the investor's adjusted gross income, or eighty per cent of the amount of itemised deductions otherwise allowable. Furthermore, the deduction cannot go against the nasty alternative minimum tax (AMT), an income tax imposed on individuals, corporations, estates and trusts for the purpose of ensuring that high income tax payers pay a minimum tax rate. Last but not least, many states limit itemised deductions, too.

for tax purposes, all assets held at year-end are treated as if they had been sold for fair market value on 31 December and then repurchased at that same value on 1 January. By contrast, investor funds report capital gains and losses only upon a realisation event. At first glance, making such an election may appear counterintuitive. It accelerates the tax recognition of all gains or losses that could otherwise be deferred, wiping out the opportunity to time recognition of such gains or losses in future years. However, many trading funds generate primarily short-term capital gains that would be treated as ordinary income anyway. Moreover, the election to mark their investments to market at year-end also brings significant tax benefits.²³ For instance:

- All losses are treated as ordinary losses, meaning they qualify for carrying either forward or backward as net operating losses, and are not subject to the limitations of I.R.C. Section 1211 on the deduction of capital losses for individuals;²⁴
- The wash sale rules,²⁵ the constructive sales rules²⁶ and the loss disallowance rules for transactions between related parties²⁷ do not apply;
- The uniform capitalisation rules²⁸ and interest expense capitalisation rules²⁹ are negated;
- Keeping track of the historical cost basis of each security in the portfolio becomes unnecessary, as a new basis is set for each at the beginning of every year;
- Financial and regulatory reporting requirements may be coordinated;
- Income from mark-to-market transactions is not considered self-employment income under I.R.C. Section 1402.

The associated advantages and disadvantages for a given hedge fund of making a mark-to-market election under I.R.C. Section 475(f) must therefore be weighed and carefully scrutinised. For many years, revoking this election was only possible with the I.R.S. consent. Since 2015, Revenue Procedure 2015-14 allows funds that have previously made such an election to revoke it and return to a realisation approach.

Specific assets are automatically marked-to-market on a daily basis, but may benefit from a favourable tax treatment. This is the case for instance of the so-called 1256 contracts, which include regulated futures contracts, foreign currency contracts, non-equity options, dealer equity options, or dealer securities contracts, but not interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and credit default swaps. Irrespective of their holding period, these contracts are treated for tax purposes as 40 per cent short-term gain and 60 per cent long-term gain. This tax treatment opens the door to potential tax arbitrages. For instance, economic exposure to the Nasdaq 100 index through an exchange traded fund (ETF) will be subject to ordinary rates applicable on short-term capital gains, while the same economic exposure through an e-mini futures contract (CME: NQ) will benefit from the blended reduced tax rate. In addition, taxpayers are generally allowed to recognise up to US\$ 3,000 of net capital loss in a year and carry forward the excess indefinitely, but in the case of Section 1256 contract losses, a special election allows them to be carried back three years to offset any net Section 1256 gain.

Historically, a common practice for hedge funds was to park their trading activity inside banks, and arrange a basket option transaction with the banks, so as to reclaim their trading profits after year-end. This allowed them to avoid the mark-to-market rules of Section 475, defer taxation until they exercised their options, and ultimately convert short-term trading gains into long-term ones.³⁰ This game stopped with I.R.S. Chief Counsel Advice 201432016, which treats such

23 - See Soled, Goldhirsch and Tierney (2014).

24 - I.R.C. Sections 1211(b) and 1212(b) state that the capital losses of an individual taxpayer must first be used to offset the taxpayer's capital gains for the taxable year. If the capital losses for the taxable year exceed his capital gains for the year, the excess may be used to offset up to US\$ 3,000 of his ordinary income. Any excess capital loss is not deductible for the taxable year but may be carried forward as a short-term capital loss in the following taxable year.

25 - I.R.C. Section 1091. A wash sale occurs when an individual sells a security at a loss, and within 30 days before or after this sale, buys a "substantially identical" stock, either directly or through a contract or option to do so.

26 - I.R.C. Section 1259. A constructive sale occurs when an individual takes an offsetting position to an already owned position, typically to lock in investment gains without paying capital gains and/or to transfer gains from one tax period to another.

27 - I.R.C. Sections 267 and 707(b). Related party sales generally create negative tax consequences for sellers including converting capital gains to ordinary income, denying instalment sales reporting, disallowing realised losses and restricting the use of like-kind exchanges.

28 - I.R.C. Section 263A prescribes the method for determining the types and amounts of costs that must be capitalised rather than expensed in the current period.

29 - I.R.C. Section 263(g) requires the capitalisation of interest and carrying charges properly allocable to personal property that is part of a "straddle", that is, a position of two or more offsetting positions.

30 - See for instance the article "Hedge Fund Chief Testifies at Senate Tax-Avoidance Hearing", New York Times, 22 July 2014, which explains how a hedge fund was able to execute several million trades, many of them held for just a few seconds, wait until just after one year to exercise such options, and then have its profits be taxed at a long-term capital gains rate.

option transactions as part of the trader's Section 475 mark-to-market ordinary income trading activities, and taxes them accordingly.

Allocation of tax items: By default, the allocation of tax items to the partners' capital accounts follows rules set out in the partnership agreement.³¹ However, a U.S. partnership may allow an allocation that does not correspond to the partners' percentage interests in the business – a situation called a "special allocation". The I.R.S. will cautiously review such cases to ensure it is not just to hide potential tax dollars, for example by allocating all business losses to the owner in the highest income tax bracket. In order to be accepted by the I.R.S., a special allocation should either have "substantial economic effect", or be in accordance with the "partner's interest in the partnership" taking into account all facts and circumstances.³² If it does not, it is subject to adjustment by the I.R.S.³³

Information to partners and tax authorities: On an annual basis, the partnership provides a schedule K-1 (part of Form 1065, U.S. Return of Partnership Income) to the I.R.S. and to each partner.³⁴

In order to benefit from the pass through federal tax status, a partnership must avoid being classified as a "publicly traded partnership". The latter is defined as any partnership in which the interests³⁵ are either traded on an established securities market³⁶ or readily tradable³⁷ on a secondary market or the substantial equivalent thereof, with the participation of the partnership. Publicly traded partnerships are generally treated as corporations for tax purposes and subject to the 35 per cent corporate income tax. Hedge funds are therefore extremely cautious at avoiding any active secondary trading³⁸ in their partnership interests and try to rely on safe harbours.³⁹

At the state level, the tax treatment of a hedge fund set up as a limited partnership is definitely more complex, as each state is sovereign and can set its own rules, which do not necessarily follow, or fully follow, the federal treatment. Some states incorporate Subchapter K of the I.R.C. either as of a certain date, or regularly by special legislation, and generally consider limited partnerships as pass-through entities. Others levy a tax on partnerships whose offices are located within their borders or who fulfil some specific conditions. As an illustration, there is no such tax in Connecticut, which explains why so many hedge funds are located there; whereas Illinois applies a 1.5 per cent income tax to any U.S. limited partnership with offices located within the state. Similarly, Texas imposes a 1 per cent margin tax (called "franchise tax") on all entities with liability protection, including limited partnerships. The margin tax applies to the partnership's total revenue attributable to its Texas operations, less certain statutorily defined deductions and exemptions.⁴⁰

Two important questions for multistate partnerships and for owners of pass-through entities residing in a state other than where the entity does business is (i) in which states must they file

31 - Unless otherwise provided by I.R.C. Section 704(b). In the absence of a partnership agreement, the partnership's state law drives the allocation. Most state laws allocate profits and losses to the partners according to their ownership interests in the business.

32 - The conditions required for partnership allocations to be accepted by the I.R.S. are discussed extensively in O'Connor (2006). As an example, say there are two limited partners with equal ownership, a U.S. one and a non-U.S. one. They decide to allocate all U.S. income to the U.S. partner, who is taxable on his worldwide income, and all non-U.S. income to the non-U.S. partner, who will then avoid paying U.S. taxes. In addition, the foreign partner is guaranteed a 50 per cent overall profit share. This allocation, which has a tax impact but no economic impact, fails the test. It would not be allowed, and each partner would be required to take into account half of each type of income.

33 - I.R.C. Section 704-1(b)(1)(i).

34 - I.R.C. Section 701.

35 - Partnership interests include interests in capital or profits, as well as financial instruments with a value determined by reference to the partnership. It does not include non-convertible debt treated as debt for federal income tax purposes.

36 - See I.R.C. Section 7704-1(b). Established securities markets include: (i) a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934, or exempted from registration because of limited volume; (ii) a foreign exchange analogous to (i) above; (iii) a regional or local exchange; and (iv) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers.

37 - See I.R.C. Section 7704-1(c)(1) and 7704-1(c)(2). A partnership interest is readily tradable on a secondary market if the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market. For instance, (i) interests are regularly quoted by persons making a market in the interest, (ii) some persons regularly offer quotes with respect to such interests and stand ready to effect buy or sell transactions at the quoted prices, for themselves or on behalf of others, (iii) the holder of an interest has a regular opportunity to sell or (iv) buyers have a regular opportunity to buy.

38 - As an illustration, the interests in a partnership are considered as not publicly traded if all interests were issued in a transaction exempt from registration under the Securities Act of 1933, and the partnership has less than one hundred partners during the taxable year of the partnership. Interests are generally not treated as readily tradable on a secondary market if the sum of the percentage interests in partnership transferred during the partnership's taxable year other than qualifying redemptions does not exceed two per cent of the total interests in capital. Note that transfers such as gifts, bequests, transfers between family members, issuance of new interests by the partnership, distributions from a qualified plan or IRA, redemptions or repurchases under an agreement are disregarded when determining the publicly traded status of a partnership.

39 - There are two exceptions to this corporate tax treatment to publicly traded partnerships. The first one is partnerships with at least 90 per cent of their gross income from passive investments, such as dividends, interest, rents, capital gains, and mining and natural resources income. The second is partnerships that were publicly traded on 17 December 1987, who were originally grandfathered in for 10 years, and that may now elect to retain partnership treatment by paying a tax of 3.5 per cent of gross income from the active conduct of business.

40 - Texas Tax Code Ann. § 171.101. Note that the Texas Constitution art. VIII, § 24(a) prohibits an income tax on an individual's share of income from partnerships, absent a state-wide referendum approving such a tax. Since this margin tax is effectively an income tax, its constitutionality could be challenged in courts.

their tax returns, and (ii) what income must be included in the return for each state in which they are required to file. We will not discuss these two questions in this paper, but leave them for future research.⁴¹

At the local tax level, the treatment of a hedge fund set up as a limited partnership is also complex and specific, particularly in large cities with broad-based privilege or other taxes on net income from a business. For instance, New York City charges a 4 per cent Unincorporated Business Tax (UBT) on every unincorporated entity carrying out a trade, business, or profession in the city.⁴² This tax applies to limited partnerships whose partners and employees provide services from offices in the city. The tax is imposed on the net income⁴³ of business sourced from New York City. The UBT is one of the major reasons why hedge funds with offices in New York are generally structured so that the management fee income and the carried interest income are received by two different limited partnerships. The management fee goes to the investment manager and is subject to UBT, after deduction of ordinary and necessary business expenses relating to operating and managing the fund.

The carried interest goes to the fund's general partner and is *not* subject to UBT because the general partner is considered as receiving investment income and as trading for its own account.⁴⁴ Largely this results in the general partner not claiming expense deductions. Other examples of such municipal taxes include the District of Columbia's Unincorporated Business Franchise Tax (UBFT), Philadelphia's Business Privilege Tax (BPT), and Philadelphia's Net Profits Tax (NPT).⁴⁵

Finally, one should not forget that the fund might be subject to withholding and other taxes and reporting requirements imposed by the countries in which it makes investments. If these countries recognise the flow-through nature of the U.S. limited partnership, then the partners directly may become subject to non-U.S. taxes and reporting requirements. Alternatively, a frustrating situation may emerge causing difficulties in the application of provisions for double tax treaties. As an example, if the U.S. treats a partnership invested abroad as flow-through while the foreign country considers it as a separate taxable entity, there will be risk of double taxation. The taxpayers will be different (the partners in the U.S., the partnership in the foreign country), with the risk of no entitlement to treaty benefits if any.

2.3 Taxation of the hedge fund limited partners

In the following, we will separately analyse the situation of three different categories of hedge fund limited partners: U.S. taxable investors, U.S. tax-exempt investors, and non-U.S. investors. We will extensively discuss the case of the U.S. taxable investor, and then highlight the major differences with the other two categories.

2.3.1 U.S. taxable investors

U.S. taxable investors are usually either high net worth individuals or corporations. As limited partners, they contribute money, assets, or services in exchange for their partnership interest. The equity of each partner in the partnership is called the partner's capital account. It changes annually when the partnership earns income or suffers losses, as well as from withdrawals by partners.

Tax basis: an investor in a hedge fund set up as a limited partnership has a "tax basis" in his interest, commonly called the "outside basis". It is used to determine whether an investor has a taxable gain or loss on receipt of a distribution from the hedge fund, or in case of a transfer of the investor's interest to another investor. Initially, the basis equals the value of the assets the investor contributed to the hedge fund, plus the investor's share of the hedge fund's liabilities. The

41 - See Brown (2014) for a discussion of the main issues.

42 - New York City Admin. Code section 11-503(a). New York State once imposed a similar tax, but it has been repealed.

43 - Net income differs from federal taxable income due to some deductions allowed by the New York City administrative code, provided they are "directly connected with or incurred in the conduct of the business." See New York City Admin. Code section 11-507.

44 - The exemption is rooted in the principle that partners investing their own capital should not be subject to the payment of a business income tax on the income from that capital since they are already subject to a personal income tax on that income. This is also one of the reasons why general partners always invest some personal capital in their fund – so that their title of "partner" cannot be denied.

45 - See England et al. (2002).

basis can increase by the investor's share of the hedge fund income, as well as in the case of him making additional investments in the fund. It will be reduced by the investor's share of the hedge fund distributions or losses, but cannot fall below zero. Similarly, a hedge fund has a tax basis or "inside basis" for each asset it holds.

Contribution of cash or assets to the limited partnerships: As a general rule, U.S. taxable investors do not recognise gains or losses on the acquisition of hedge fund partnership interests for cash or cash equivalents.⁴⁶ In most situations, the same treatment applies upon the contribution of property in exchange for an interest in the partnership. However, two noticeable exceptions are:

- The acquisition of hedge fund partnership interests by contributing a portfolio of stocks and securities. The investor will recognise a gain or loss if (i) the transfer results, directly or indirectly, in diversification⁴⁷ of the transferors' interests and (ii) the transferee is an investment company;⁴⁸
- A "disguised sale". The investor may also recognise a gain if there is a contribution of money or other property to a partnership followed by a related distribution of money or other property from the partnership to the partner. These operations will be treated as a disguised sale of property⁴⁹ if, when viewed together, they are "properly characterised as a sale or exchange of property." There is an exception for contributions of securities that, in the aggregate, are an insignificant part of the total value of assets of the fund (in practice, less than 5 per cent of the total).

Allocation of profits and loss: As discussed previously, limited partners in a hedge fund must include in their taxable income, their allocable share of the partnership's income, gains, losses, deductions, and credits. The I.R.S. treats each partner as if in receipt of his distributive share each year, regardless of whether any cash distributions are actually made by the partnership. Because there is no employer to compute and withhold income taxes, each partner must set aside enough money to pay taxes on his share of annual profits. Partners must therefore estimate the amount of tax they will owe for the year and make payments to the I.R.S. (and usually to the appropriate state tax agency) each quarter – in April, July, October, and January.

Note that we have discussed the restrictions on deductibility of expenses for individual and other non-corporate investors in Section 2.2, in reviewing the difference between an investor and a trader fund and discussing the various elections the hedge fund had to make.

As long as there are no corporate partners, business income is taxed only at individual income tax rates. For individuals, the tax rates are as follows:

- Ordinary income such as interest and dividends (other than qualifying dividends) are taxed at a maximum marginal rate of 39.6 per cent;
- Qualifying dividend income⁵⁰ is taxed at a maximum rate of 20 per cent;
- Capital gains on assets held less than one year ("short term") are taxed at a maximum marginal rate of 39.6 per cent, while capital gains on assets held more than one year ("long term") are taxed at a maximum rate of 20 per cent. Capital losses may freely offset capital gains in a taxable year. If there are excess capital losses, a maximum of US\$ 3,000 of losses may be used to offset ordinary income, and the rest may be carried forward as a capital loss. Gains or losses from short sales are generally considered as capital gains or losses. Note that constructive sales and wash sales are disallowed.

Since January 2013, U.S. taxable individuals with income above statutory threshold amounts⁵¹ are subject to an additional tax of 3.8 per cent on their Net Investment Income⁵² ("NII"). NII includes in particular net income or loss from a trade or business in which a taxpayer does not materially

46 - I.R.C. Section 721.

47 - Generally, a transfer to a fund will result in "diversification" if two or more persons transfer non-identical assets to the Fund. For this purpose, a portfolio of stocks and securities excluding cash and cash items is considered as being diversified if (i) not more than 25 per cent of the value of its assets is invested in stock and securities of any single issuer, and (ii) not more than 50 per cent of the value of its assets is invested in stock and securities of five or fewer issuers.

48 - A Fund is treated as an "investment company" if: (i) it would be classified as a regulated investment company under the Investment Company Act of 1940 or as a real estate investment trust under I.R.C. Section 856 if it were organised as a corporation, or (ii) more than 80 per cent of the gross asset value of the fund is attributable to stocks and securities held for investment.

49 - I.R.C. § 707(a)(2)(B)(iii). On 29 January 2014, the IRS has issued proposed regulations (REG-119305-11) that significantly affect the disguised sale rules applicable to contributions and distributions from entities treated as partnerships for federal income tax purposes. These are still under discussion.

50 - Qualifying dividends essentially include dividends paid by a U.S. corporation and by some qualified foreign institutions if their common shares were held for more than 60 days during the 120-day period before the ex-dividend date, or their preferred shares were held for more than 90 days during the 180-day period before the ex-dividend date. See Tax Code para. 1(h)(11)(B)(iii), 26 U.S.C. para. 1(h)(11)(B)(iii).

51 - US\$ 250,000 for joint filers or surviving spouses, US\$ 125,000 for a married individual filing a separate return, and US\$ 200,000 in any other case.

52 - I.R.C. Section 1411.

participate, including net income or loss from either trading or the business of trading in financial instruments and commodities. Partnerships are not required to calculate NII allocable to each partner, but must provide the information necessary for the partner to complete Form 8960 and calculate his NII.

When a partnership does have a corporate partner, the share of income allocated to that partner will be reported on the corporate tax return. For corporations, a system of graduated marginal tax rates is applied to all taxable income, including capital gains. It results in a flat 34 per cent tax rate on incomes from US\$ 335,000 to US\$ 10,000,000, gradually increasing to a flat rate of 35 per cent on incomes above US\$ 18,333,333.

Distributions: A cash distribution of hedge fund income is normally not a taxable event, unless the distribution exceeds the investor basis in the hedge fund immediately prior to the distribution.⁵³ In the latter case, it is treated as a gain from the sale of interests in the hedge fund. The distribution of securities is more complex, as it depends on whether the securities are marketable and who receives them.⁵⁴

Sale of a partnership interest: the sale of a partnership interest can generate a capital gain or a loss, based on the difference between the amount realised and the partner's basis in the partnership interest.⁵⁵

Transfer of partnership interest: The transfer of partnership interests creates an interesting issue, as the transferee's basis in the partnership interest reflects unrealised capital gains and losses that were made prior to his investment. To avoid a situation where the transferee would be required to pay taxes on gains he does not enjoy (because the purchase price of the interest likely reflects the fair market value of the fund's assets), the hedge fund can make an election under Section 754 to adjust the basis of its securities on a transfer, without waiting until the assets are sold, but only for the incoming partner. This is a permanent election, only revocable with I.R.S. consent.

Liquidation of a partnership interest: if a partnership pays to the partner their balance of the positive capital account, the partner will incur a capital gain, if the amount is greater than the partner's partnership interest basis. If the payment is less than such basis, it will be recorded as a loss. U.S. laws treat payments to a partner, which are attributable to ordinary income assets, as ordinary income to the partner.⁵⁶

Historically, many U.S. taxable wealthy individuals have engaged in aggressive tax planning strategies centred around shifting hedge fund income, either from one taxable type to another taxable type ("income-type shifting"), or from one period to another ("deferral of income"). Most of the time, these strategies relied on some insurance contract. Here are a few examples:

- *Buy a private placement variable annuity linked to a hedge fund.* The investor purchases a variable annuity contract from an insurance company, usually against a single purchase payment or a series of purchase payments. During their accumulation phase, the payments made by the investor are allocated to a hedge fund and all dividends, interest and capital gains are automatically reinvested without incurring local, state or federal taxes. When the payout phase starts, the investor receives his purchase payments plus investment income and gains (if any) as a lump-sum payment, or as a stream of payments at regular intervals. Variable annuities payments are not tax-deductible and their distributions are taxed as ordinary income,⁵⁷ but they are tax-deferred, much like an Individual Retirement Account (IRA). They may also include death benefits;

53 - I.R.C. Section 731(a)(1).

54 - See I.R.C. Section 731(c)(3)(A) and Regs. § 1.731-2(d)(1) for distributions of contributed securities to the investor who contributed them; I.R.C. Section 731(c)(3)(A)(ii) and Regs. § 1.731-2(d)(3) for distributions of securities that were not marketable when acquired by the hedge fund; and I.R.C. Sections 731(c)(3)(C)(i) and 731(c)(3)(A)(iii) for distributions of securities from an investment partnership to an eligible partner.

55 - I.R.C. Sections 1221-22.

56 - I.R.C. Sections 736(a), (b)(2), 751(b).

57 - In the case of a lifetime regular payout, each payment is considered as a mix of principal (non-taxable) and interests (taxable). In the case of a lump sum amount, a last in, first out (LIFO) basis is applicable, so earnings are taxed first as ordinary income, while any amount in excess of earnings is taken from the principal amount and is non-taxable.

- *Buy private placement life insurance linked to a hedge fund.* The investor purchases an insurance policy⁵⁸ usually with a single upfront premium. After deducting the insurance broker's compensation and the applicable (small) taxes, the premium is placed in a separate account invested in a hedge fund. The cost of the at-risk insurance (generally one per cent to two per cent p.a.), which provides a death benefit above the value of the separate account, is charged periodically against that account. As long as the investor has no control over the account, the investment can grow tax-free. The policy owner is generally permitted tax-free withdrawals from the account as long as the cumulative withdrawals remain below the initial investment in the contract. The policy owner is also generally permitted to borrow from the policy. Last but not least, if the policy is kept until the death of the insured, the beneficiary receives the entire death benefits, including the hedge fund returns, tax-free. As such this offers a more comprehensive tax mitigation scheme;
- *Reinsurance wrapped around a hedge fund.* The investor sets up an offshore insurance company, which primarily invests its money into the hedge fund and occasionally partakes in insurance activities. If the offshore company were exclusively a conduit to invest in the hedge fund, it would be considered a passive foreign investment company. The I.R.C. Sections 1291 to 1298 impose U.S. taxation on U.S. persons earning passive income through a foreign corporation. However, Section 1297(b)(2)(B) provides an exception to passive income derived in the "active conduct" of an "insurance business". Since Section 1297 does not provide a definition of these two terms, investors can claim that exception, even if the insurance company has outsourced substantial management and operational functions. This will be the case even if its actual insurance activities are relatively small compared to their hedge fund investment activities, and regardless of whether the investment income dwarfs the premium income. As a result, the investor will defer any taxes until the sale of his reinsurance stake and pay the lower long-term capital gain taxes. Of course, the cost of launching a reinsurer is substantial, which restricts that construction to investors with a certain scale.

In 2003,⁵⁹ the I.R.S. scrutinised and challenged a few of these constructions, but with little consequence.⁶⁰ On April 24, 2015, the I.R.S. issued Notice REG-108214-15 titled "Exception from Passive Income for Certain Foreign Insurance Companies", which includes proposed rulemaking.⁶¹ Unfortunately, it does not define what it means to be "predominantly engaged" in an insurance business. Moreover, it fails to apply a bright line reserve to assets test to provide a reliable means to identify active insurers, and does not apply a facts and circumstances test that would allow the I.R.S. to consider other factors.

2.3.2 U.S. tax-exempt investors

Some institutions such as: pension funds, individual retirement accounts ("IRA"), ERISA-type retirement plans, endowments, foundations or charities are, generally, exempt from U.S. federal income taxation.⁶² They are nevertheless subject to U.S. federal income tax at regular corporate rates on their unrelated business taxable income⁶³ ("UBTI"). UBTI is defined as the gross income derived either directly, or indirectly, through a partnership with any organisation; it is chargeable on the profit its unrelated trade activity or other business regularly carried on by it,⁶⁴ minus the deductions directly connected with carrying out such activity. Both the gross income and the deductions are computed with certain modifications and are subject to certain exclusions.

UBTI generally does not include: interest, dividends, or gains from the sale or exchange of capital assets. Consequently, a tax-exempt investor's distributive share from a hedge fund does not class

58 - To qualify for tax advantages, life insurance policies issued after 31 December 1984, must meet the definition of "life insurance" under I.R.C. Section 7702. To purchase a U.S. private placement insurance product, the investor must be an "accredited investor" who is a "qualified purchaser" under S.E.C. rules.

59 - See ruling 2003-91, ruling 2003-92, or I.R.S. notice 2003-34.

60 - As an illustration, according to the press, in 2012, top executives at Paulson's hedge fund invested US\$ 450 million in a Bermuda-based reinsurer they had set up, which has no employees, sells less insurance than industry norms, and invests almost exclusively in Paulson hedge funds.

61 - The new regulation defines "active conduct" with a reference to Treasury Regulation Section 1.367(a)-2T.(b)(3), which implies that the officers and employees of the corporation must carry out substantial managerial and operational activities; the activities of independent contractors, of officers and employees of related entities are not taken into account. It also defines "insurance business" as "the business activity of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with investment activities and administrative services that are required to support or are substantially related to insurance contracts issued or reinsured by the foreign insurance company".

62 - I.R.C. Section 501(a)

63 - I.R.C. Section 511(a)(1).

64 - I.R.C. Section 512

as UBTI, so is not subject to federal income tax. The common trouble spots for a U.S. tax-exempt investor are:

- Operating partnerships: if a hedge fund invests in a flow-through entity for U.S. tax purposes (this could be a partnership, an LLC or a non-U.S. entity treated as a partnership for U.S. tax purposes), if that party becomes engaged in a trade or business unrelated to the tax-exempt entity's function, the tax exempt partner's pro rata share of the entity's income would be treated as UBTI;
- Unrelated Debt Financed Income ("UDFI"): as soon as there is acquisition indebtedness,⁶⁵ the income or gain from the debt-financed investment is qualified as UBTI and subject to tax – to the proportionate extent of the borrowing. This rule applies even if such an income or gain might otherwise be considered passive investment income. For example, say a U.S. tax-exempt institution invests in a hedge fund. The hedge fund buys a stock with 50 per cent initial margin and later on sells it with a gain. Then, half of the gain on that stock (reduced by one-half of the net interest cost) that is attributed to the tax-exempt institution will be considered UBTI. However, short sales transactions involving borrowing publicly traded securities do not generally give rise to UBTI;
- Fees for services: if the general partner or manager of a fund renders management or consulting services in exchange for a fee received by the fund, the I.R.S. will consider that the fund to have engaged in a trade or business and the fees will likely result in UBTI;⁶⁶
- Insurance income: if a fund invests in a foreign company that is a Controlled Foreign Corporation⁶⁷ ("CFC") for U.S. tax purposes, and the CFC earns insurance income, then the latter may flow through as UBTI to the Fund's tax-exempt investors.

Tax-exempt institutions have to file a tax return on Form 990T as soon as they receive US\$ 1,000 or more of gross income in computing UBTI. While this does not affect their tax-exempt status on non-UBTI income,⁶⁸ it creates administrative complexity and forces them to pay taxes on their UBTI at the standard corporate rate. For that reason, even tax-exempt (U.S.) organisations tend to avoid onshore hedge funds and prefer investing through an offshore fund or a non-U.S. feeder corporation, which are generally non-pass through and trap the UBTI.

Several U.S. state and local government pension plans view their income as necessarily exempt from U.S. federal income tax and do not file any federal income tax returns. They base their exemption on (i) the exclusion under I.R.C. Section 115(1), and (ii) the U.S. Constitution, which excludes from gross income any income derived from the exercise of any essential governmental function, accruing to a state or any political subdivision thereof. Following the same logic, these institutions do not treat themselves as subject to UBIT. However, there is no clear authority that so holds and there have been several proposals to subject them to UBTI.⁶⁹

2.3.3 Non-U.S. investors

A non-resident alien owning a partnership interest in a U.S. partnership may face some serious withholding tax hurdles. Firstly, non-U.S. persons are generally subject to a withholding tax of 30 per cent (or a lower rate if there is an applicable double taxation treaty) on certain Fixed, Determinable, Annual, or Periodical (FDAP) income derived from U.S. sources. FDAP includes in particular interest paid on a U.S. bank account, interest received on a U.S. bond or dividends from a U.S. security, as well as rents and royalties. Secondly, non-U.S. investors are generally not subject to U.S. taxes on capital gains realised from the sale of U.S. securities, unless these gains are either effectively connected with the conduct of a trade or with a business within the U.S., known as Effectively Connected Income ("ECI"), or made upon the disposition of a U.S. real property interest.

Fortunately, I.R.C. Section 864(b)(2)(A) provides a safe harbour for hedge funds by mentioning that the term trade or business within the U.S. does not include trading in stocks or securities or

65 - Note that the term "indebtedness" is not defined in the I.R.C. or in Regulations. One therefore has to look to the substance of the transaction.

66 - A common practice is that the manager of the fund, rather than the fund itself, receives such fees. Then, the management fees owed by the fund to its manager are reduced by the amount of the received fee. In our opinion, there is a risk that the I.R.S. could attempt to recast such fees as having been earned by the fund, as opposed to its manager (in which case the tax-exempt partners of the fund could be subject to UBTI).

67 - A CFC is defined as a corporate entity that is registered and conducts business in a different jurisdiction or country than the residency of the controlling owners. Control of the foreign company is defined, in the U.S., according to the percentage of shares owned by U.S. citizens. Please see Section 3.3.1.

68 - One exception is the case of charitable remainder trusts, who become taxable on all of their income as soon as they receive UBTI or UDFI

69 - See for instance the draft proposal of the Tax Reform Act of 2014 issued on 26 February 2014, by Congressman David Camp, the Republican Chairman of the House Ways and Means Committee.

commodities through a resident broker, commission agent, custodian, or other independent agent, or otherwise trading for one's own account.⁷⁰ For a non-U.S. investor there may be issues arising from:

- Investments in operating partnerships: if a hedge fund invests in a flow-through entity for U.S. tax purposes (a partnership, an LLC, or a non-U.S. entity treated as a partnership for U.S. tax purposes) that is engaged in a trade or business within the U.S., a non-U.S. partner's pro rata share of the entity's income would be classed as ECI. In addition, the I.R.S. takes the position that any gain from the sale of the fund's interest in the entity, and the applicable portion of such a gain realised by the investor upon the sale of its interest in the fund, would also be classed ECI;
- Investments in "U.S. real property interests": under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), gains or losses realised by a non-U.S. person from the disposition of a "U.S. real property interest" is generally taken into account, as if it were effectively connected with a trade or business from within the U.S. Note that "U.S. real property interest" includes certain U.S. corporations ("USRPHCs") in which the value of the corporation's U.S. real estate is at least 50 per cent of the value of the total business assets.⁷¹ This can also include such items as: leasehold interests, options and improvements (such as underground telephone and cable lines) and personal property associated with the use of the real property;
- Fees for services: if the general partner or manager of a fund renders management or consulting services in exchange for a fee, and the fee is paid to the fund (including through a reduction of its management fee), the fund would likely be treated as engaged in a trade or business so the fees would probably be treated as ECI to non-U.S. investors;
- Permanent establishments: many U.S. income tax treaties provide that the U.S. may not tax the income of a resident of the other treaty country unless the income stems from a permanent establishment of the resident in the U.S. For example, the office of a partnership in the U.S. would likely be considered a permanent establishment of the non-U.S. partner for this purpose.

The existence of ECI has the following consequences:

- The partnership is obligated to file an annual Form 1042 *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*. This form requires the names of all investors in the fund;
- The partnership is obligated to withhold and pay over tax on the non-U.S. partner's distributive share of net business income, at the maximum tax rate applicable to such person;⁷²
- The non-U.S. partner must file a tax return in the U.S. reporting his ECI, and claiming credit for the withheld tax. Not surprisingly, most non-U.S. investors are unwilling to become subject to U.S. filing obligations and the consequent I.R.S. audit jurisdiction;
- Ultimately, the ECI will be taxed to the partner at the graduated tax rates that apply to U.S. citizens and residents.

The non-U.S. partner will likely also have to report his U.S. limited partnership income in his home country. This may create additional difficulties as U.S. reports such as form 1065 Schedule K-1 are established following U.S. tax rules, not foreign rules. With the cooperation of the partnership, these difficulties may be overcome, but will typically increase both the complexity and cost of filing the non-U.S. partner's personal tax return. Ultimately, depending on his home country, the non-U.S. partner may be able to report the U.S. taxes paid on his U.S. income and take them as a foreign tax credit to avoid double taxation.

As most non-U.S. investors would rather avoid paying taxes to Uncle Sam and retain their anonymity, they usually prefer investing through an offshore fund. Foreign governments and controlled entities wholly owned by a non-U.S. sovereign are exempt from income and withholding taxes under U.S. domestic laws.⁷³ However, if an integral part of a foreign government derives

70 - This exception does not apply if the taxpayer is either a dealer in securities or commodities, or if it has a fixed place of business in the U.S. through which the transactions in securities or in commodities are affected.

71 - The problem may be solved by using a specific "blocker" corporation, or by holding suitable real property investments through a privately offered REIT, more than half of which is directly and indirectly owned by U.S. persons.

72 - I.R.C. Section 1446. Generally, the withholding rate is 30 per cent from the gross amount paid to a foreign payee, unless the payment can reliably be associated with documentation that establishes either that either the payee is a U.S. person, or the payee is a foreign person that is the beneficial owner of the income and is entitled to a reduced rate of withholding.

73 - I.R.C. Section 892.

some income as a result of "commercial activity", it will lose its exemption on that portion of income. The exemption will be lost in its entirety in the case of a "controlled commercial entity," meaning an entity engaged in commercial activities inside or outside the U.S., of which at least 50 per cent is under the control of a foreign government.

2.4 Taxation of the hedge fund general partners

In exchange for his work, the general partner of a hedge fund receives compensation from the limited partners.⁷⁴ Compensation structures vary from fund to fund, but as discussed previously, the standard is typically set at 20 per cent of the annual realised and unrealised profits of the fund.

This compensation may be structured as a contractual payment in cash. It then constitutes ordinary income to the general partner, taxable at ordinary income tax rates. The general partner may be able to defer that income, which opens the door to other tax issues.⁷⁵ Alternatively, and this is the preferred route, this compensation may be structured as a grant of partnership interests with no equity contribution. That is, limited partners provide 100 per cent of the capital but will only receive 80 per cent of future profits while the general partner provides no equity but will receive 20 per cent of future profits. This specific structure, also known as carried interest or incentive allocation, offers several tax advantages not just for the general partner, but also for limited partners.

No initial tax for the GP at grant time: If a partner contributes future services in exchange for a share of the capital and profits of a partnership, he is said to have received "capital interests" and this constitutes a taxable event.⁷⁶ However, if a partner contributes services in exchange for rights to receive future profits, without such a capital contribution element, he is said to have received "profits interests". Performance fees paid to general partners clearly fall in the second category. The question then becomes whether the receipt of a partnership profits interest is a taxable event or not.

Only a handful of cases have ruled on this issue. Initially, the U.S. Tax Court opinion was that partnership profits interests received in connection with the performance of future services were not taxable on receipt.⁷⁷ However, it repudiated that opinion a few years later.⁷⁸ The taxpayer appealed to the Seventh Circuit, which affirmed the Tax Court but did not describe the basis for its holding. Unfortunately, a proposed regulation was considered, but never finalised.⁷⁹ So the fight shifted from the theoretical to the practical, namely, how to calculate the value of the received partnership profit interest? In practice, the I.R.S. rapidly acknowledged that taxing partnership profits interest at the point of being granted was extremely complicated for at least three reasons: (i) Profits interests are almost impossible to value *ex ante*, as they depend on the hypothetical profitability of some future investments which may be extremely speculative. Their liquidation value at the time of grant should therefore be zero, despite some potential future positive fair market value. (ii) Should profit interests be taxed when initially granted, a complex mechanism would be needed to prevent double taxation of profits, when they are later realised. (iii) The general partner may end up in the position of having phantom gains with no income to support its tax bill. In parallel, the Tax Court continued to send mixed messages by concluding on some occasions that the recipient of the interest was not taxable on receipt,⁸⁰ on others that it was taxable but valued at zero,⁸¹ or alternatively that it had some value that should be included in the recipient's income.⁸² Ultimately, the Eight Circuit Court of Appeals reversed course and provided

74 - Managers that are registered as investment advisers are generally prohibited from collecting incentive allocations, except if from qualified clients or "knowledgeable employees" of the investment manager. Rule 205-3 of the Investment Advisers Act defines a qualified client as one of the following: (i) investors whom the adviser believes has a net worth of US\$ 1.5 million or is a qualified purchaser as defined in Section 2(a)(51) of the Investment Company Act (ICA); (ii) people who invest more than US\$ 750,000 in the hedge fund. See Lhabitant (2006) for a discussion of these restrictions.

75 - See Anderson (2007).

76 - See *United States v. Frazell*, 335 F.2d 487, 489 (5th Cir. 1964). See also *McDougal v. Commissioner*, 62 T.C. 720, 727 (1974).

77 - See *Hale v. Commissioner of Internal Revenue*, 44 TCM 1116, Tax Ct. Mem. Dec. (CCH) 39'339(M), (P-H) 82,527 (1982)

78 - See *Diamond v. Commissioner of Internal Revenue*, 492 F.2d 286, 288 (7th Cir. 1971). However, this was in a case where value was easily determined by a sale of the profits interest soon after receipt

79 - Prop. Treas. Reg. Section 1.721-1(b)(1)(i), 36 Fed. Reg. 10787, 10799 (3 June 1971). This proposal was withdrawn in 2005.

80 - See *National Oil Co. v. Commissioner of Internal Revenue*, T.C. Memo. 1986-596.

81 - See *St. John v. Commissioner of Internal Revenue*, No. 82-1134 (C.D. Ill. 1983).

82 - See *Campbell v. Commissioner of Internal Revenue*, T.C. Memo. 1990-162.

by administrative fiat that receipt of a profits interest will generally not be taxable, because the profits interests were speculative and without fair market value.⁸³ The I.R.S. then decided to clarify this uncertain state of the case law and provided the general rule that a grant of profits interests in a partnership is not a taxable event for the partner or the partnership as long as certain basic requirements are met.⁸⁴

Ability for the GP to defer taxation: Partnership taxation centres on realisation events at the partnership level and allocation of the resulting profits to partners. Consequently, until some partnership-level realisation event occurs, there is no basis for taxation to take place, regardless of how long this situation subsists. General partners may therefore benefit from a substantial taxation deferral as long as the hedge fund – which they control – does not realise its profits.

Historically, hedge fund managers were able to amplify further the benefits of deferral by electing to receive their compensation in shares of the offshore version of the onshore fund. As long as the money was held in the offshore fund and was not related to the conduct of a trade or business in the U.S., they could keep it growing tax-free. This practice stopped with Section 457A to the Code, which was originally added by the Emergency Economic Stabilisation Act to target income deferral by managers of offshore hedge funds. It also covered deferred compensation arrangements maintained by domestic partnerships. Section 457A essentially provides that any compensation deferred under a "nonqualified deferred compensation plan" of a "nonqualified entity",⁸⁵ which does not present a "substantial risk of forfeiture"⁸⁶ must be included in the gross income of the hedge fund manager for the year the income is earned.⁸⁷ This applies even if the compensation is actually paid at a later date. In addition, if the amount of such compensation is "not determinable" at the time of filing, then punitive measures are applied. The compensation will be included in income when determinable, but will then be subject to a 20 per cent additional penalty tax, plus imputed interest at the underpayment rate, plus one per cent. Deferred compensation attributable to services performed prior to 1 January 2009 must be restructured to become taxable by no later than 31 December 2017.

Lower tax rate for the GP: A key feature of pass through taxation is that realised partnership-level income retains its character (e.g. ordinary income or capital gain) as it passes through the partnership to the tax returns of individual partners, with no distinction between general partners and limited partners.⁸⁸ Consequently, if the partnership realises long-term capital gains, the general partner's allocation will be considered as made of long-term capital gains and will be taxed as such, at rates below 20 per cent. The same amount of performance-linked compensation paid in cash would have been taxed as ordinary income at marginal rates as high as 39.6 per cent.

As a side effect, a performance allocation structured as a grant of partnership interests would historically have not be subject to pay self-employment taxes on its capital gains component. The introduction in 2013 of a new 3.8 per cent tax on net investment income, which essentially mirrors the 3.8 per cent Medicare component of self-employment taxes for higher-income taxpayers, has threatened this advantage. However, general partners may not be subject to NII tax on some operating income if they are deemed to be materially participating in the business.⁸⁹ Since the test applies activity-by-activity, regrouping activities that can be viewed as one economic unit and becoming materially involved – or not – may provide significant tax savings.

83 - See *Campbell v. Commissioner of Internal Revenue*, 943 F.2d 815, 823 (8th Cir. 1991).

84 - See Rev. Proc. 93-27, 1993-2 C.B. 343 Section 4. The partnership interest must be speculative (no certain, predictable or guaranteed outcome), the profit interests must be held for at least two years, and the partnership must not be publicly traded within the meaning of Section 7704(b) of the Internal Revenue Code. See Rev. Proc. 93-27, 1993-2 C.B. 343 Section 4. The I.R.S. released additional guidance in Rev. Proc. 2001-43 to clarify the case of the receipt of a profits interest that is non-vested. The latter case is also non-taxable and that the later vesting of the interest will not be taxable either.

85 - Whether an entity will be a "nonqualified entity" under Section 457A is determined on an annual basis and may change from year to year, but non-U.S. corporations are considered as "nonqualified entities" unless substantially all of their income is either effectively connected with the conduct of a trade or business in the U.S. or subject to a "comprehensive foreign income tax". Similarly, partnerships are considered as non-qualified entities unless substantially all (i.e., 80 per cent) of their gross income is allocated to "eligible persons," which generally are persons other than foreign persons not subject to a comprehensive foreign income tax and persons who are exempt from U.S. federal income tax.

86 - There is a substantial risk of forfeiture if the compensation is subject to a service-based vesting condition. This definition is narrower than that used under the earlier deferred compensation law enacted as Section 409A or Section 83. In particular, compensation conditioned upon the achievement of performance goals may constitute a substantial risk of forfeiture under Section 409A, but this condition would not constitute a substantial risk of forfeiture under Section 457A.

87 - The New York Times reported that a single hedge fund, Citadel, has deferred at least US\$ 1.7 billion since it was founded in 1990 – see Anderson (2007). This triggered a change in regulation that included compensation deferred through foreign-chartered funds in the gross income of the hedge fund manager in the year the income is earned.

88 - I.R.C. Section 702(b) (2006).

89 - Generally, this requires more than 500 hours per year of active participation. Please refer to I.R.C. section 469 provides several tests.

This inequitable result has been extensively discussed in the press as well as in legal, political and academic circles. It would be beyond the scope of this paper to discuss the various legislative proposals aiming at closing that loophole, without success thus far.⁹⁰ The situation is technically complex, because carried interest cannot be characterised as either exclusively service income or exclusively investment income – it has features from both. Not surprisingly, the debate has gained further momentum in the U.S. presidential race.

Nevertheless, an important point to remember is that the issue is more likely to occur in private equity than in the hedge fund space. Private equity funds are by definition very long-term holders of what they buy. Most of their profits therefore qualify for the reduced 15 per cent long-term capital gains tax, which firms then extend to their general partners' compensation.⁹¹ By contrast, hedge funds tend to traffic in liquid securities like stocks, bonds, commodities and derivatives, often holding them for less than a year. Most of their profits are short-term capital gains, or interests taxed at the ordinary income rate. In addition, hedge funds may elect to be taxed on a mark-to-market basis, meaning that managers and investors recognise trading gains as ordinary income, not as capital gains, even in the absence of a realisation event.⁹² For all these reasons, the carried interest taxation debate is therefore less important for hedge funds than it is for private equity general partners.

Lower state tax rate for the GP: In several states, a contractual payment in cash to the general partner might be characterised as business income, which would be subject to a higher rate of tax than an incentive allocation. For instance, an incentive fee, but not an incentive allocation, may be subject to the New York City unincorporated business tax. The former is characterised as business income whereas the latter is considered as investment income.

Full deductibility for the LP: Limited partners are allowed to fully deduct the incentive compensation allocated to the general partner, without limitation. By contrast, a contractual payment in cash will be considered a miscellaneous itemised deduction, which would only be deductible under Section 212, with serious limitations as previously discussed in Section 2.2.

Note that a small risk exists that the I.R.S. may not recognise the general partner as a partner for tax purposes and qualify the carried interest as a simple fee paid for services. To mitigate that risk, tax advisors usually recommend that (i) the general partner makes a capital contribution to the fund, so that he becomes a full limited partner; and (ii) the general partner receives a small fee for his advisory services, which will be treated as ordinary compensation income.

An interesting variation of the above-described compensation structure is the case where the general partner gets a net income allocation in up years and a gross income allocation in down years. Is such a payment a guaranteed payment? The answer is still being debated.⁹³

2.5 Taxation of the hedge fund investment manager

If the investment manager is set up as a limited partnership, the management fee flows through the partnership to the partners. As a compensation for services, it should normally be taxed as the ordinary income rate with a maximum of 39.6 per cent, offset by deductible expenses.⁹⁴

90 - For a more detailed history, see Abrams (2009), Burke (2010), and Viard (2008).

91 - The initial public offering of groups like Blackstone or Fortress shed light on how large the accumulated performance fees were, how important was the individual net worth of the general partners of these funds, as well as on how small their tax bill was.

92 - See Tax Code Section 475(f). While such a move may appear counterintuitive, it has several benefits that must be carefully examined. Let U.S. quote some of them: (a) all losses are treated as ordinary, which makes the capital loss limitation rules of Sec. 1211 inapplicable and enables taxpayers to use the losses as net operating losses that may be carried back and forward; (b) the wash-sale rules do not apply; (c) The uniform capitalisation rules and interest expense capitalisation rules of Sections 263A and 263(g), respectively, are negated; (d) the loss disallowance rules for transactions between related parties under Sections 267 and 707(b) do not apply; (3) the constructive sales rules of Section 1259 do not apply; (4) tracking historical cost basis is unnecessary (insofar as every year the security or commodity in question is accorded a new tax basis); (5) financial and regulatory reporting requirements may be coordinated; and (6) income from mark-to-market transactions is not considered self-employment income under Section 1402. For a detailed analysis, please see Soled, Goldhirsch and Tierney (2014).

93 - In *Pratt v. Commissioner of Internal Revenue* (64 TC 203 (1975), 39 AFTR 2d 77-1258, 550 F2d 1023 (CA-5, 1977)), the Tax Court held that a payment based on a partnership's gross income is not determined without regard to the partnership's income, and therefore is not a guaranteed payment under Section 707(c). However, the I.R.S. issued Rev. Rul. 81-300, 1981-2 CB 143 which states that "payment for services determined by reference to an item of gross income will be a guaranteed payment if, on the basis of all of the facts and circumstances, the payment is compensation rather than a share of partnership profits". In 1984, Congress enacted Section 707(a)(2)(A) as part of DRA '84. The legislative history states that the transaction described in Rev. Rul. 81-300 should be treated as a transaction described in Section 707(a), and not as a Section 707(c) guaranteed payment.

94 - Note that there have been cases of managers trying to defer taxes on their fee income through offshore entities, or improperly converting management fees into carried interests because of the favourable tax treatment of the latter.

Whether the 3.8 per cent self-employment tax or the 3.8 per cent NNI tax should apply is not clear. Historically, the view was that the distributive share of partnership fee income to a limited partner in a limited partnership was not subject to self-employment tax because the partners could rely on a statutory exception often referred to as the limited partner exclusion.⁹⁵ Neither was it subject to the NII tax for partners who materially participate because the income is not passive.⁹⁶ A similar logic was applicable to members of limited liability companies that had elected to be treated as partnerships for tax purposes. However, on 5 September 2014, the Office of Chief Counsel of the I.R.S. released an internal generic legal advice memorandum, advising that the limited partner exception to self-employment tax was no longer available for members of a LLC whose income was from fees for managing investment funds. The memorandum does not discuss the case of investment professionals who are state law limited partners of a management company, which itself is a state law limited partnership.

Some managers may attempt to either defer their management fee in order to defer income taxation, or convert them into carried interest, in the form of a "fee waiver", to benefit from the capital gain treatment. Simply stated, they increase their distributive share of fund gains, rather than charging a management fee. Historically, a common practice by hedge fund managers was to defer all or a portion of their management fees for a number of years in a Cayman Islands corporation; this would act as the equivalent of a titanic tax-deferred retirement account. However, effective as of 1 January 2009, Section 457A of the U.S. Internal Revenue Code taxes any amount deferred under a nonqualified deferred compensation plan maintained by a "nonqualified entity" when the compensation vests (i.e., when it is no longer conditioned on the future performance of substantial services), rather than when it is paid.

3. Non-U.S. Hedge Funds ("Offshore Funds")

Offshore hedge funds are typically set up by sponsors that expect to manage a significant amount of capital from non-U.S. investors and/or from U.S.-based tax-exempt investors wanting to avoid UBTI. They are usually located in tax-light or even no-tax jurisdictions. In the following, we will mostly discuss the case of the most frequently used offshore destination for hedge funds, namely, the Cayman Islands. The Cayman Islands' key advantages are: (1) a robust legal system based on the English common law system;⁹⁷ (2) a well-recognised jurisdiction among hedge fund investors; (3) strong privacy protection; (4) a sophisticated business and legal infrastructure by comparison with other offshore jurisdictions; and last but not least (5) a zero taxation regime.

3.1 The typical offshore hedge fund structure

The structure for an offshore hedge fund usually involves the joint creation of a fund and a fund manager.

Most offshore funds are set up as corporations, not flow-through entities. In the Cayman Islands, the most common legal form for a fund is an exempted company. Essentially this is a limited liability company that can obtain a written guarantee of tax-exemption from the Cayman Islands government for a period of twenty years. Its requirements are quite basic. It must have a registered office in the Cayman Islands, a Board of Directors, and keep registers of its Directors⁹⁸ and any security interests granted by the company in its Cayman office. It must also maintain a register of its shareholders, but not necessary in the Cayman Islands.

Cayman Islands exempted companies may issue multiple classes of shares with different redemption rights, fees and currency denominations. Some funds only issue voting shares, while others issue a small number of management shares with voting rights, and a large number of redeemable participating shares with economic rights but with no or very limited voting rights. Investors

95 - Section 1402(a)(13).

96 - Generally, this requires more than 500 hours per year of active participation. Please refer to I.R.C. section 469 provides several tests.

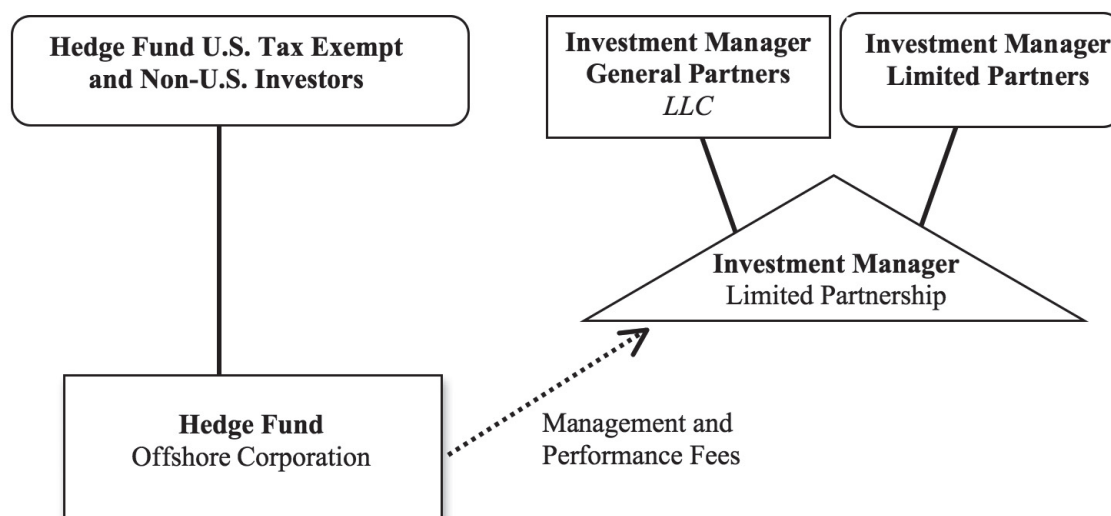
97 - The Cayman Islands are a British overseas territory. Its foreign policy is handled in London while local matters are handled through the Cayman Islands' legislature and judicial system.

98 - Note that Cayman law does not require independent or external directors. External directors, if any, may be professional directors who sit on dozens of hedge funds boards.

subscribe and redeem shares usually at their net asset value. An offering document sets out the rights and obligations of investors as shareholders in the fund, the terms of subscriptions and redemptions and the methods used for asset valuation. Profits are "credited" net of all expenses – expenses that would otherwise be caught by the two per cent limitation of I.R.C. Section 67 and the three per cent limitations of I.R.C. Section 68,⁹⁹ are deductible against any earnings, thereby reducing taxable income dollar for dollar and creating a tax liability only on net profits realised.

In the following, we will essentially discuss the case of funds setup as a Cayman offshore corporation. However, two alternative legal forms available for setting up a Cayman Islands hedge fund: the exempted limited partnership and the exempted unit trust. Cayman's limited partnerships are very similar to the Delaware ones, which makes them attractive for U.S. investors who are familiar with them. They divide the functions of ownership and control, which makes them very effective at protecting assets from seizure by creditors. Unit trusts can be seen as unincorporated open-ended mutual fund structures that give investors the right to purchase or redeem shares in the assets of the unit trust (called "units"). Unit trusts are formed under a trust deed, and therefore involve a trustee that is responsible for the overall business and affairs of the unit trust. They have wide powers of investment in order to achieve the fund's investment objectives. A fiduciary relationship means they must always act in the best interests of the unit-holders. In practice, unit trusts are often used for funds targeting Japanese investors, as it mirrors the structure commonly utilised for funds domiciled in Japan and provides beneficial taxation and accounting treatment in Japan. Both the exempted limited partnership and the exempted unit trust can ask for a 50-year tax exemption.

Figure 4: Typical structure for a pure offshore hedge fund



The investment manager is usually setup as a Cayman exempt company or as a Cayman limited partnership. It is hired by the hedge fund to manage its assets in exchange for an incentive fee and a management fee. Generally, the incentive fee is based on 20 per cent of the positive performance of the fund and the management fee is 2 per cent of the assets under management. Unlike what is commonly done in the onshore fund case, there is no need to segregate the recipients of the management and the performance fees, as there are no state taxes to be paid – or avoided.

Alternatively, the investment manager may also be setup as a principal, a limited partnership or a company based outside of Cayman Islands. In such a case, no physical presence (office space, staff, etc.) in the islands is required. No Cayman Islands laws or regulations will apply to that manager, unless the manager chooses to register itself in Cayman as a "foreign" entity.

4. Taxation of the Hedge Fund

A Cayman-based hedge fund will generally not be liable for any direct tax in the Cayman Islands. As mentioned previously, all available legal structures for hosting a hedge fund may register as an exempted entity, obtaining a written exemption by the Cayman Islands Governor in Cabinet of any law imposing any tax on profits, gains or appreciation, or which is in the nature of estate duty, or inheritance tax. This exemption is valid for a period of 20 years in the case of a corporation and 50 years in the case of a limited partnership or a trust.

A Cayman-based hedge fund may nevertheless still be liable for taxes imposed in jurisdictions where it holds its investments. This is an important issue, as the Cayman Islands have not yet signed many Double Tax treaties.¹⁰⁰ The hedge fund may therefore have difficulties eliminating or minimising any foreign taxes that may arise on a fund's underlying investments. As an illustration, let us consider the situation of the U.S.

A foreign corporation with income that is effectively connected to the conduct of a trade or business within the U.S. ("ECI") must file a U.S. tax return and is subject to U.S. taxation on that income at the same progressive rates as domestic corporations.¹⁰¹ However, there is a safe harbour provided in Section 864(b)(2)(A), under which a foreign corporation is not treated as engaged in a trade or business within the U.S. as a result of "trading in stocks and securities" for its own account. This applies whether the trading is accomplished within the U.S. directly by the taxpayer or its employees, or through a resident broker, commission agent, custodian or other independent or dependent agent, and regardless of whether the employee or agent has discretionary authority to make decisions, or if the foreign corporation has a U.S. office. Consequently, Cayman-based hedge funds should generally not be subject to the regular U.S. income tax on any of their U.S. investments trading profits.¹⁰² However, any U.S. sourced dividends received by the Cayman Islands fund will be subject to U.S. withholding tax at the U.S. non-treaty rate of 30 per cent.¹⁰³ Since there is no Double Tax treaty between the U.S. and the Cayman Islands,¹⁰⁴ this withholding tax cannot be recovered.

A hedge fund structured as a Cayman corporation may choose to be treated as a partnership for U.S. federal tax purposes. The process requires obtaining a U.S. taxpayer identification number for the Cayman corporation and then filing Form 8832 ("Entity Classification Election"). As a result, the fund will be required to file a U.S. federal partnership return and issue Schedules K-1 for each year in which it has had one or more U.S. partners. In such a case, each U.S. partner will be treated as earning a pro-rata share of the gains and losses of the "partnership".

Last but not least, offshore hedge funds generally will not have a nexus to the states and therefore no basis for taxation. However, some states require offshore hedge funds structured as limited partnerships file state partnership tax returns, if they have partners that are residents of their jurisdiction. This is regardless of whether the offshore hedge fund has a federal filing requirement.

4.1 Taxation of hedge fund investors

In an offshore hedge fund set up as a corporation, gains generally accumulate within the fund – tax-free in the case of the Cayman Islands. Thus investors generally do not pay any tax until they redeem their shares or receive a distribution. There are three different types of investors to consider: U.S. taxable investors, U.S. tax-exempt investors, and foreign investors.

4.1.1 U.S. taxable investors

Most hedge funds prohibit taxable U.S. persons from investing in their offshore vehicle, for at least three reasons. Firstly, it may force them to comply with U.S. securities law if they are considered

100 - The Cayman Islands have signed a comprehensive tax treaty with Japan in 2010, and limited tax treaties with the UK and New Zealand.

101 - I.R.C. Section 882.

102 - Exceptions include (i) gains realised from the sale or disposition of stock or non-debt securities of U.S. real property holding corporations as defined in I.R.C. Section 897 ("USRPHCs"), including stock or securities of certain real estate investment trusts ("REITs"); and (ii) U.S. lending activities, in particular loan negotiation and origination. See for instance Peaslee and Nirenberg (2011), Chapter 4.

103 - I.R.C. Section 881.

104 - The mutual legal assistance treaty between the U.S. and Cayman Islands specifically excludes fiscal matters.

as having made an offer of its securities. Secondly, it would force them to report the associated assets directly to the I.R.S. under Foreign Account Tax Compliance Act (FATCA) legislation, and automatically expose them to severe sanctions should they fail to report appropriately. Thirdly, a U.S. taxable investor invested in or effectively controlling an offshore hedge fund may potentially face a series of onerous dispositions of the U.S. Tax Code. These are related to Controlled Foreign Corporations ("CFC") and/or Passive Foreign Investment Companies ("PFIC").

Controlled Foreign Corporations: A CFC is defined as a foreign corporation with U.S. shareholders who together own more than 50 per cent of the voting power or value of the foreign corporation's outstanding shares on any day during the taxable year.¹⁰⁵ For the purpose of that definition, U.S. shareholders are defined as U.S. persons (which include individuals, partnerships, corporations, trusts and estates) each owning directly, indirectly or constructively, at least 10 per cent of the voting stock of the foreign corporation.¹⁰⁶ In a standard hedge fund, this is an unlikely but not impossible situation. If it occurs, then I.R.C. Subpart F rules require that any income derived from a CFC that is considered to be tax haven income (income which has shifted from a high tax jurisdiction to low tax jurisdictions) be subject to taxation in the U.S. Note that the offshore fund must provide the U.S. taxable investors enough information to enable them to compute their deemed share of subpart F income.

Passive Foreign Investment Companies: A non-U.S. corporation is a PFIC if either 75 per cent or more of its income is passive income¹⁰⁷ or 50 per cent or more of its assets are treated as passive assets (that is, assets held for the production of passive income).¹⁰⁸ The vast majority of offshore hedge funds will meet both tests and will therefore be considered PFICs.

All U.S. taxable investors that are PFIC shareholders are required to file a Form 8621 on an annual basis¹⁰⁹ ("Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund"). They have the choice between three alternative methods to determine the amount of income they will recognise as a result of their investment in the fund. All of them are designed to eliminate the benefits of deferral:

- *Qualified electing fund ("QEF") election.* In theory, this election gives the most favourable method of taxation for U.S. taxpayers. It allows them to report as ordinary income their pro rata share of ordinary earnings for the year, and treat as long-term capital gain their pro rata share of the net capital gains for the year, whether or not distributions of income have been made. Losses, however, are currently not deductible. To prevent double taxation, any actual distributions made by a QEF out of its previously taxed earnings and profits are tax-free to the investor. Unfortunately, in practice, very few offshore hedge funds are willing to (i) release a statement that certifies all their earnings and capital gains were calculated in compliance with the I.R.S. rules; and (ii) provide investors all of the required information to determine their share of the ordinary earnings and net capital gain;¹¹⁰
- *Mark-to-market election.* If the PFIC satisfies certain marketability criteria,¹¹¹ its U.S. taxable investors may elect to treat it on a "mark-to-market" basis.¹¹² This allows them to report all the PFIC distributions (interest, dividends, capital gains, etc.) as ordinary income, and recognise all increases/decreases to the value of the fund as a gain/loss on their holdings as if the funds were sold at the end of each year. A loss deduction is allowed to the extent that the adjusted basis exceeds the fair market value and is limited to previously recognised gains. The overall result is less favourable than the QEF election, because there is no room for capital gains treatment. In practice, most offshore hedge funds do not satisfy the marketability requirements;

105 - I.R.C. Section 957(a).

106 - In determining the 10 per cent or more ownership, the attribution rules of both I.R.C. Section 958(a) and I.R.C. Section 958(b) apply.

107 - For purposes of PFIC, passive income includes dividends, interest, royalties, rents, annuities, certain property or commodities transactions, gains from foreign currency, income equivalent to interest, or personal service contracts as described by I.R.C. §§1297(b) and 954(c).

108 - I.R.C. Section 1297(a). In addition, an asset can also be subject to the PFIC regime under the "once a PFIC, always a PFIC" rule of I.R.C. § 1298(b)(1).

109 - An exception applies if the PFIC shareholder holds, in the aggregate, no more than US\$ 25,000 in PFIC stock (US\$ 50,000 if married filing jointly), or if he owns PFIC shares through another PFIC and the value of the shareholder's proportionate share of the upper-tier PFIC's interest in the lower-tier PFIC does not exceed US\$ 5,000.

110 - I.R.C. Regs. § 1.1295-1(g)(1).

111 - The PFIC stock must be considered as marketable, which means either it is regularly traded on a qualified exchange or other market, or it satisfies certain criteria similar to treating it like a U.S. mutual fund. See I.R.C. Section 1296(e)(1)(A) and Regs. § 1.1296-2(c)(1)(i), or I.R.C. Section 1296(e)(1)(B) and Regs. § 1.1296-2(d)(1).

112 - I.R.C. Section 1296.

- *Excess distribution methodology of I.R.C. Section 1291(a)*. The default approach if neither of the other choices has been selected on a timely basis. This is also the most punitive for U.S. taxable investors. At first glance it sounds good because the basic premise is that investors pay no tax until they cash out. However, the bad news is that when tax is paid, there is no long-term capital gains treatment. All income and gains are taxed at the highest ordinary income marginal tax rate (39.6 per cent). In addition, if the investor disposes of the PFIC stock with a gain, the latter is assumed to have been earned ratably over the time the investment was held and an interest rate penalty is charged on the deferred tax amount. The same logic applies to "excess distributions" from a PFIC, where "excess distribution" is any distribution in excess of 125 per cent of the average distributions received by the investor over the immediately preceding three-year period.

Note that any income derived from an investment in a CFC or a PFIC is also subject to the 3.8 per cent net investment tax.

Clearly, PFICs are not great places for U.S. taxable investors, even if they have possible federal and state tax benefits.¹¹³ To attract U.S. individual investors in an offshore fund, it is often better to organise a separate dedicated fund that elects to be treated as a partnership for U.S. tax purposes, so that those investors receive favourable U.S. tax treatment. Such funds may have a master/feeder structure as described in Section 4.

Note that if both CFC and PFIC apply, the subpart F rules supersede the PFIC rules. However, if an investor does not own more than 10 per cent of the offshore fund, the CFC rules will not apply.

Note also that since December 2001, the Cayman Islands have signed a tax information exchange agreement with the U.S. that is enforced by the I.R.S. under the Tax Shelter Act. As a result, U.S. taxable investors cannot avoid taxation by investing through an offshore fund – another myth gone.

4.1.2 U.S. tax-exempt investors

As discussed in Section 2.3.2, U.S. tax-exempt investors favour investments in offshore hedge funds because their setup as a corporation protects them from all the undesirable aspects of flow-through partnership taxation. In particular, any UBTI is trapped in the offshore corporation and no longer creates issues for U.S. tax-exempt investors. None of the PFIC rules mentioned above apply to tax-exempt investors holding shares in a PFIC.

4.1.3 Non-U.S. investors

Non-U.S. investors investing in a Cayman based fund will generally be subject to no direct tax in the Cayman Islands. However, they will be facing tax obligations in their respective tax jurisdictions. Keep in mind that the Cayman Islands have signed over 30 bilateral agreements and arrangements for the exchange of information, on request, in respect of specific criminal or civil tax investigations. However, offshore funds set up as corporations allow foreign investors to maintain anonymity with respect to the U.S. For instance, if an offshore hedge fund makes any investments in U.S. securities, then U.S. withholding tax rules will apply to the fund. If the fund is setup as a partnership, all individual partners have to fill out U.S. forms and disclose their identity, to claim exemption from U.S. withholding and backup withholding taxes. If it is set up as a corporation, only the corporate entity will have to submit the paperwork and individual non-U.S. investors can remain anonymous to U.S. tax authorities.

4.2 Taxation of the hedge fund manager

Hedge fund managers that are setup in Cayman Islands as an exempted company or an exempted limited partnership will generally not be subject to direct tax in the Cayman Islands. The exemption is easy to obtain – essentially the manager has to declare that its business will be carried on

¹¹³ - For example, no miscellaneous itemised deductions result from investing in a PFIC because returns are realised on a net basis.

mainly outside the Cayman Islands and file an annual return to this effect. However, it is advisable to be able to substantiate the effective activity of the manager, as foreign tax authorities increasingly disregarded offshore structures on the grounds of their having been implemented for mere tax planning purposes.

Managers of a Cayman based fund that are located outside of Cayman Islands will still be facing tax obligations in their respective tax jurisdictions. Several countries have taken specific measures to prevent tax avoidance. For instance, the long-standing practice of offshore funds management and performance fees deferral is no longer possible for U.S. taxpayers. I.R.C. Section 457A provides that any compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity (such as an offshore entity) can be included in gross income, if there is no substantial risk of forfeiture of the rights to such compensation. If the amount of the compensation is "not determinable", specific punitive tax consequences apply, including a 20% additional penalty tax and imputed interest at the underpayment rate plus 1%.

5. Hybrid Hedge Funds

Many hedge funds solicit investment capital from U.S. individuals and entities, but also from U.S. tax-exempt investors and non-U.S. investors. These funds are usually structured through multiple entities, often referred to as master feeder structures. A typical construction would consist of:

- A Master Fund, set up as a Cayman limited partnership or a Cayman corporation which can elect to "check the box" (U.S. Form 8832) to be treated as a partnership for U.S. tax reporting. The sole investors in the Master Fund will be the feeder funds;
- An offshore feeder fund, set up as a Cayman exempted company and treated as a corporation for U.S. tax purposes. This feeder fund invests all its assets in the master fund. The investors in the offshore feeder are non-U.S. investors as well as U.S. tax-exempt investors;
- An onshore feeder, setup as a Delaware limited partnership. This feeder fund invests all its assets in the master fund. The sole investors in the domestic feeder are U.S. taxable investors.

Note that U.S. taxable investors could invest directly in the Master fund, but marketing and accounting are considerably simplified if they are only able to use the onshore feeder. The tax treatment of such a master-feeder follows what we have described in Sections 2 for the onshore vehicle and 3 for the onshore vehicles.

6. A World in Progress: BEPS and FATCA

6.1 BEPS

On 5 October 2015, the OECD released its final reports on all focus areas in its Action Plan on Base Erosion and Profit Shifting (BEPS). This action plan potentially affects all hedge funds, regardless of their legal setup, with respect to transfer pricing, permanent establishment, treaty abuse, and hybrid mismatch arrangements. Of particular interest are the following items:

- Permanent establishment (PE): It should be increasingly difficult for hedge funds to employ agents in various jurisdictions without triggering a PE, and therefore, a risk of local allocation of income and corresponding taxation. One key recommendation stipulates that an agent acting exclusively or almost exclusively on behalf of one or more "closely related businesses" shall no longer be considered independent for purposes of analysing whether a PE exists. The recommendations also limit the activities that do not create a PE to activities of a preparatory or auxiliary character, such as book-keeping, secretarial, and various administrative tasks;
- Double taxation treaty: The BEPS action plan will make it more difficult for hedge funds and hedge fund investors to gain access to certain countries' double taxation tax treaties in the future;
- Transfer pricing: The action plan on transfer pricing will drastically increase transparency by

providing tax administrations with detailed information regarding global business operations and transfer pricing policies, including the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations;

- Hybrid mismatches: The BEPS action plan aims at neutralising the effect of cross-border hybrid mismatch arrangements that produce multiple deductions on a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction.

However, the implementation of the BEPS action plan is still work in progress. While there has been a general consensus on the OECD recommendations, achieving similar or greater accord on their implementation will likely be much harder, as different countries will have different domestic and political considerations.

6.2 FATCA and GATCA

The provisions commonly known as the FATCA¹¹⁴ are a component of the Hiring Incentives to Restore Employment Act (the HIRE Act), which was enacted by the U.S. Congress and signed into law by President Obama on 18 March 2010. Their objective is to reduce tax evasion by U.S. individuals with respect to income from financial assets held outside the U.S.

One of the key ideas of FATCA is that all foreign financial institutions (FFIs), including funds domiciled outside the U.S., must register with the I.R.S., obtain a Global Intermediary Identification Number (GIIN), perform significant due diligence on their investors, identify those from the U.S. and report them to the I.R.S. If a jurisdiction enters into an Intergovernmental Agreement (IGA) to implement FATCA,¹¹⁵ the reporting and other compliance burdens on the financial institutions in the jurisdiction may be simplified. If located in a country that has signed a Model 1 IGA, the FFI must report its U.S. investors to its local tax authority, who will then pass the information to the I.R.S. If located in a country that has signed a Model 2 IGA, the FFI must report this information directly to the I.R.S.¹¹⁶ Such financial institutions will not be subject to withholding under FATCA. Finally, if located in a country with no IGA agreement, the FFI can still comply individually with FATCA by entering into an FFI agreement with the I.R.S.

FATCA then imposes a 30 per cent withholding tax on U.S. source payments to FFIs that do not comply with the requirements to identify their U.S. investors. Withholdable payments include in particular U.S. sourced FDAP, and gross proceeds from the sale or other disposition of any property that produces U.S.-sourced interest or dividends, with a few exceptions (interest or original issue discount on short-term obligations, income that is effectively connected to a U.S. trade or business, etc.).

As if all of this were not complicated enough, in February 2014, in response to FACTA, the OECD presented a report on a new global standard for Automatic Exchange of Tax Information between countries. This is seen as an important step from FATCA to GATCA, the future Global Account Tax Compliance Act.

7. Conclusions

Judge Learned Hand famously wrote¹¹⁷ that a taxpayer "may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes," provided the transaction is "within an exception of the tax law". While there is no 'one size fits all' formula for hedge fund structures either from the investors' or the managers' perspective, hedge funds have clearly followed Judge Learned Hand's statement, and this results in rather complex tax structures that are often misunderstood by the public. Most of the time, these structures aim to avoid double

114 - Chapter 4 of Subtitle A to the U.S. Internal Revenue Code

115 - Over 60 countries have signed IGA and 20 are still negotiating.

116 - This reporting obligation applies even if FATCA directly conflict with data protection and privacy laws in the FFI jurisdiction.

117 - See *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

taxation. In some cases, they aim at reducing taxes or deferring their impact as much as possible. However, as discussed in this paper, the creativity deployed in tax planning strategies deemed too aggressive is usually rapidly matched by the tax authorities' reactivity to them.

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