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Introduction to US tax aspects of hedge fund formation

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US federal income tax considerations for the fund, the fund's investors, and the fund's managers can play an important role in determining the appropriate structure for today's US-oriented hedge fund. This article briefly discusses these tax considerations. It only discusses a stand alone fund and does not discuss tax considerations of other structures, such as a master-feeder structure or a fund of funds, nor does it discuss all of the tax issues surrounding hedge funds.

While the term 'hedge fund' today describes a wide variety of things, the typical hedge fund is an investment vehicle managed by one or more managers that invests in passive assets. From a US federal income tax standpoint, the basic issue for the hedge fund is whether to form it as a partnership or a corporation for US federal tax purposes. As a partnership, or an entity treated as a partnership for US federal tax purposes, the hedge fund will not be subject to an entity level tax. This is why most domestic hedge funds are formed as partnerships or LLCs. On the other hand, offshore hedge funds are usually formed as corporations for federal tax purposes in order to shield certain investors (e.g., US tax-exempt investors and foreign investors) from the undesirable aspects of 'flow-through' partnership taxation. As discussed below, foreign hedge funds formed as corporations for US federal tax purposes typically are not subject to US corporate level tax because they are not engaged in a US trade or business.

A US taxable investor investing in an offshore hedge fund that is a corporation, or an entity treated as a corporation for US federal tax purposes, may face certain adverse tax consequences.

While a hedge fund's structure is not solely determined by the tax consequences to the fund or to the fund managers, the tax 'identity' of potential hedge fund investors raises some important tax structuring considerations. Generally, there are three different types of hedge fund investors: US taxable investors, US tax-exempt investors, and foreign investors.

US taxable investors investing in a domestic hedge fund generally do not present any major structuring issues. Assuming the domestic fund is formed as a partnership or an entity treated as a partnership for US federal tax purposes, each investor will report separately on its own income tax return its distributive share of the fund's net capital gain or loss and ordinary income or loss. Each US taxable investor is taxed on its distributive share of the fund's taxable income and gain annually regardless of whether it has received a distribution from the fund.

However, a US taxable investor investing in an offshore hedge fund that is a corporation, or an entity treated as a corporation for US federal tax purposes, may face certain adverse tax consequences. Most offshore funds are considered 'passive foreign investment companies' (PFIC) for US federal income tax purposes. Generally, a foreign corporation is a PFIC if in any taxable year either: (i) at least 75 percent of its gross income is passive income or (ii) 50 percent or more of the average value of its assets is attributable to assets that produce passive income or are held to produce passive income. In general, if a US taxable investor invests in a PFIC, then: (i) gain realised on the sale or other disposition of PFIC shares (and certain PFIC distributions) is treated as ordinary income and taxed as if the gain had been realised ratably over the US taxable investor's holding period; (ii) the amount allocated to the other taxable years is taxed at the highest applicable marginal rate in effect for each such year; and (iii) an interest charge is generally applicable to underpayments of tax resulting from the US investor's deferred tax payments. Thus, not only is any potential capital gain from the investment in an offshore hedge fund taxed at ordinary income rates, US taxable investors are subject to an interest charge for underpayments of tax because the gain from sale of the PFIC's shares is treated as if earned over the US investor's holding period. Presumably, a US investor would not be paying tax in its PFIC investment during its holding period. While it may be possible for the US taxable investor to avoid some, but not all, of these consequences by electing to treat the offshore hedge fund as a 'qualified electing fund', many offshore hedge funds do not provide the information necessary for US taxable investors to be able to make such election. Needless to say, not many US taxable investors invest in offshore hedge funds – they invest in domestic hedge funds treated as partnerships for federal tax purposes.

US tax-exempt investors are generally not subject to US federal income taxation on dividends, interest, capital gains and similar income realised from securities investment or trading activity. Fortunately, these are the most typical categories of income a hedge fund would generate. However, a US tax-exempt investor would be subject to tax on its 'unrelated business taxable income' (UBTI). The types of UBTI that most often appear in the hedge fund context are income derived from debt-financed property and gain from the disposition of such property. If a US tax-exempt investor invests in a domestic fund that is a partnership, or treated as a partnership for US federal tax purposes, and the fund borrows money to leverage its portfolio, the US tax-exempt investor is deemed to ▸▸

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have borrowed its pro rata share of the fund's borrowings to purchase its pro rata share of the fund's investments. This would lead to the US tax-exempt investor owning debt-financed property. Thus, rarely would a domestic fund that is formed as a partnership, or treated as a partnership for US federal tax purposes, admit US tax-exempt investors if that fund's managers intend to leverage its investments. However, subject to a narrow exception for certain insurance company income, income derived from the ownership of the shares of a foreign corporation should be treated as UBTI so long as the US tax-exempt investor does not borrow to make its investment. Hence, it is very common for US tax-exempt investors considering different hedge fund investments to primarily consider offshore funds formed as corporations or entities treated as corporations in order to avoid UBTI.

Foreign investors also face some tax hurdles when deciding the appropriate hedge fund form in which to invest. In general, the federal income taxation of a foreign investor investing in a domestic fund depends on whether that investor is engaged in a trade or business in the US as a result of its investment in the fund. In general, the foreign investor would be deemed to be so engaged if the fund is so engaged. Not only would this increase the US tax cost for the foreign investor because such investor would be subject to US federal income tax on its share of the fund's income on a net basis as if such investor were a US person, it would also subject the foreign investor to US tax return filing requirements. However, if the fund's principal activity is investing and/or trading in stocks, securities and commodities for its own account, then a 'safe harbour' applies that exempts foreign investors from being treated as engaged in a US trade or business as a result of their investment in the domestic hedge fund, provided that such foreign investors are not dealers in stocks, securities or commodities. Nevertheless, the foreign investor would be subject to US withholding taxes on its share of the fund's US source dividends and certain interest income. In some cases, a tax treaty may reduce the rate of this withholding tax. In addition, this withholding requirement becomes an obligation of the domestic fund and many fund managers do not want to undertake such obligation. Thus, it is common for foreign investors to invest in offshore hedge funds.

A foreign investor in an offshore hedge fund is usually protected by the same 'safe harbour' described above. However, if the offshore fund is engaged in a US trade or business, then the fund (but not the investors) would be subject to US federal income tax on its 'effectively connected' income on a net basis as if the offshore fund were a US person, thereby lowering the net return to foreign investors. In this case, the attendant US tax return filing requirements would be imposed on the offshore fund and not the investors themselves. Furthermore, any US withholding taxes on US source dividends and interest would generally not be the offshore fund's responsibility since that tax would be withheld prior to distribution to the fund. Thus, these are two tax-related reasons why many foreign investors invest in offshore hedge funds instead of domestic ones.

From the hedge fund manager's standpoint, the most important tax issue is the precise structure of their compensation arrangements (for purposes of this article, we assume that the fund managers are all US persons subject to US taxation). Fund managers generally receive two types of compensation for their services. First, they receive annual performance-based compensation (typically 20 percent of profits). The structure of this compensation depends on the type of fund. Usually, a domestic fund formed as a partnership will have its managers participate as the general partner or managing member of the fund. In this case, the performance-based compensation is typically structured as an allocation of income to the fund manager. As an allocation, the character of the performance-based compensation is the same as the character of the underlying profit of the fund. That is, if the fund only generates long-term capital gain, then the performance-based compensation should be long-term capital gain to the fund manager, taxable at favourable (currently 15 percent for individuals) long-term capital gain rates. In an offshore fund, the fund manager usually will not be an equity owner of the fund because of the aforementioned 'passive foreign investment company' concerns. Instead, the fund manager generally enters into an investment advisory agreement with the fund and manages the fund's portfolio under this contract. The fund manager's performance-based compensation would then be a fee subject to federal income tax at ordinary income rates. Second, fund managers also typically receive a management fee that is based on a percentage (usually 1-2 percent) of the fund's assets under management. This is usually structured as a fee to the fund managers subject to US federal income tax at ordinary income rates.

In conclusion, there is no 'one size fits all' formula for hedge fund structures either from the investors' or the managers' perspective. Instead, the exact structure used will depend on the nature of the hedge fund's investors and the types of investment strategies the hedge fund will employ. As always, a little up front attention to tax consequences can be an important factor in the fund's successful future operation. ■

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