

Alternative Structures for Funds of Hedge Funds

It may be time to take a fresh look at FOHFs. As investors seek avenues for diversification through alternative investment strategies, a FOHF that invests in offshore funds may be a wise choice, despite some potential problems.

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INTRODUCTION

Given the turmoil and uncertainty of all financial markets over the past year, what is an investment manager to do to generate alpha? Where are the positive returns, and how can they get access to them? It would appear that investing in alternative investment strategies including commodities and currencies may provide at least a partial solution, but, in the context of a mutual fund or Regulated Investment Company (RIC), direct access to these strategies is severely limited by Section 851(b) of the Internal Revenue Code.¹ Indirectly, a RIC can potentially

¹ Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the IRC).

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gain access to commodities exposure either through debt or other financial contracts classified as securities and linked to the performance of commodities ("Structured Notes"), organizing a wholly owned foreign subsidiary corporation ("Controlled Foreign Corporation" or CFC²),³ or, finally, by investing in certain Qualified Publicly Traded Partnerships (QPTPs).⁴ These alternatives can prove expensive, however, and may only provide limited exposure because of the shrinking number of counterparties who can enter into Structured Notes, and due to the asset diversification tests of Section 851(b)(3). These requirements place limitations on how much value can be put into a CFC, and how much in total a RIC may allocate to QPTPs.⁵

Beginning around 2001, sponsors of 1940 Act⁶ registered investment companies went looking for new sources of positive returns, and several developed and offered 1940 Act registered funds of hedge funds (FOHFs). This product involved either an open- or closed-end RIC (for liquidity reasons, a

² A CFC is any foreign corporation where more than 50 percent of the total voting power of all classes of stock or of the total value of the stock of the corporation is owned or considered as owned by one or more United States shareholders on any day during the taxable year of such foreign corporation. IRC § 957(a). For this purpose, a "United States shareholder" means a U.S. person who directly, indirectly, or constructively owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. IRC § 951(b).

³ Rev. Rul. 2006-31, 2006-1 CB 1133; PLR 200842014 (July 17, 2008); PLR 200923011 (Feb. 18, 2009); PLR 200912003 (Nov. 13, 2008).

⁴ IRC § 851(b)(2)(B).

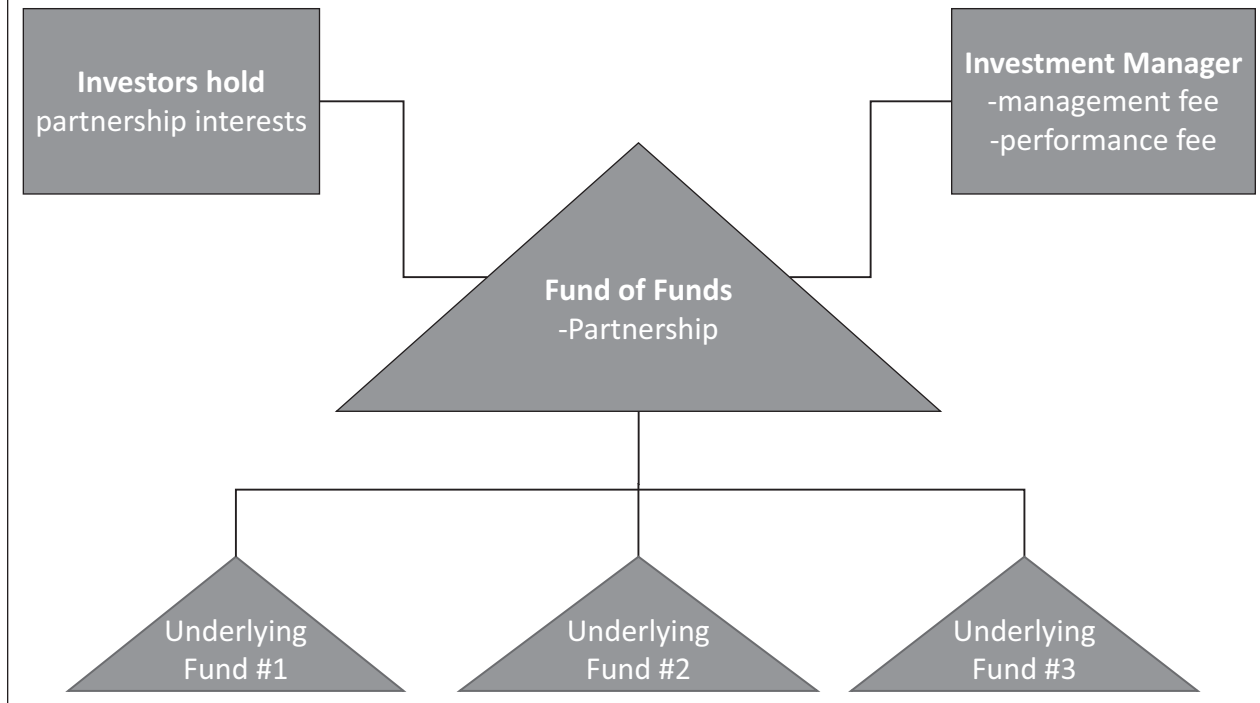
⁵ IRC § 851(h).

⁶ The Investment Company Act of 1940. 15 U.S.C. §§ 80a-1 through 80a-64.

Exhibit 1

Hedge Fund Structure

Fund of Hedge Funds



closed-end RIC probably was more common) which invested solely in hedge funds that were organized as partnerships. This type of investment made hedge fund returns available to investors that otherwise did not have access to the hedge fund market due to the various Securities Act restrictions generally associated with private investment funds; however, managing RIC status and the calendar year distribution requirements imposed on a RIC proved to be a serious challenge. As a result, many of the FOHFs that were created at that time are no longer in existence (this is not intended to suggest that the only reason many are no longer in existence is due solely to the “back-office” issues associated with operating the funds).

Despite these drawbacks, a fresh look at this product may now be warranted, given that overall positive investment returns may require a degree of diversification available only through alternative investment strategies that include currencies and

commodities. A very slight twist to the FOHFs may provide greater access to these strategies—without running afoul of either the RIC qualification requirements under Section 851 or the RIC distribution requirements under Section 852, and without the difficulties of trying to meet the calendar year distribution requirements associated with investing predominately in partnerships.

Before we go down that road, it will be useful to revisit the current FOHF structures, and their advantages and disadvantages.

FOHFS USING A PARTNERSHIP AS THE CHOICE OF ENTITY

For investors who cannot afford the required substantial minimum investment of a traditional hedge fund, a FOHF (whether registered or not) may be an option. This is a fund that invests in other hedge funds, often allowing investors to invest for \$100,000 or less.

Through a FOHF, investors gain access to managers who would otherwise be unavailable (e.g., because of high minimum investment requirements or funds closed to new investors), although they still may pay a performance fee and a management fee on top of the fees of the underlying funds. Also, investors can obtain diversification without having to invest large sums of money with each manager.

The FOHF is typically organized as either a limited partnership or a limited liability company and is taxed as a partnership. It may be registered under the 1940 Act, but it cannot be publicly offered. Registration under the 1940 Act may also create restrictions. It will invest in the hedge funds (“Underlying Funds”) that are also taxed as partnerships that the investment manager offers to U.S. investors. See Exhibit 1 for an example of a FOHF structure.

Underlying Funds may use all different types of investing/trading strategies⁷ and purchase and sell a wide variety of assets.⁸ These Underlying Funds will furnish Schedule K-1s to their investors including the FOHF.

Disadvantages of Using Partnership Form. The biggest disadvantages of the partnership choice of entity for a FOHF involve the preparation of the Schedule K-1s for the FOHF and the preparation of tax returns by its investors. The preparation processes can become time consuming, costly, and difficult to administer based on the complexity of the distributable items from the Underlying Funds, the number of Underlying Funds, and the number of investors in the FOHF. Also, the Underlying Fund may not receive all of these Schedule K-1s until mid to late summer, which of course will delay its ability to prepare and furnish its Schedule K-1s to its investors. Ultimately, this will delay the investors’ filing of their own tax returns.

The Underlying Funds pass through all their tax attributes to the FOHF.⁹ The FOHF then passes through all these tax attributes to its investors. The FOHF is required to compile information from all the Schedule K-1s received, including, but not limited to:

- State-sourced income;
- PFIC Income (Form 8621);

⁷ Trading strategies include: long/short, market neutral, convertible arbitrage, event driven (merger arbitrage), fixed-income arbitrage, dedicated short bias, emerging markets, global macro, relative value, distressed securities, aggressive growth, 130/30, market timing, opportunistic, and multi strategy.

⁸ Assets may include stocks, bonds, options, futures, forwards, swaps, real estate, private equity, commodities, currencies, loans, physical assets, collateralized debt/loan obligations, and other investment funds.

⁹ IRC § 702(b).

- Unrelated Business Taxable Income (UBTI);¹⁰
- Rental real estate income;
- Trader expenses and investor expenses;
- Reportable Transactions (Form 8886); and
- Contributions to foreign partnerships (Form 8865) and foreign corporations (Form 926).

Based on the items listed above, the FOHF’s Schedule K-1 may be complex, which makes preparing the investors’ own returns potentially more complex and costly. First, if there is state-sourced income, the investors may be required to file tax returns in numerous states in addition to their state of residence. Second, if an Underlying Fund passes through UBTI, tax-exempt investors (e.g., IRAs, pensions) may be required to file Form 990-T, Return of Organization Exempt from Income Tax, and pay tax when normally they would not. Third, depending on the items reported on its Schedule K-1 (including footnotes and attachments)¹¹ allocated by the FOHF, the investor may be required to report contributions to foreign corporations and

The biggest disadvantages of the partnership choice of entity for a FOHF involve the preparation of the Schedule K-1s for the FOHF and the preparation of tax returns by its investors.

partnerships (on Forms 926 and 8865), PFIC income (on Form 8621), and reportable transactions (on Form 8886).

Further, the deductibility of certain expenses from FOHFs may be limited for individual investors.¹² The IRS

¹⁰ Tax-exempt organizations are subject to tax on gross income derived from any trade or business regularly conducted, less certain deductions, that is substantially unrelated to the exercise or performance of the organization’s exempt purpose or function. IRC § 512(a). UBTI should not affect the tax-exempt status of an exempt organization, except for charitable remainder trusts. UBTI includes unrelated debt-financed income (as defined in IRC § 514), which in turn includes an exempt organization’s share of a partnership’s income and gains from its leveraged investments, encompassing dividends and capital gains from securities purchased on margin. Exempt from UBTI are dividend and interest income, capital gains, option writing, income from notional principal contracts, and profits on short sales from trading activity. IRC § 512(b).

¹¹ On occasion, these tax reporting packages can contain up to 50 pages of information.

¹² If, given the fund’s level of trading activity, the fund is deemed to be a trader of securities, expenses are deductible as trade or business expenses by the partners. If the fund is deemed to be an investor in stocks and securities, however, its expenses allocated to its individual partners are deductible only as miscellaneous itemized deductions subject to the 2-percent-of-AGI floor. The manager must use a facts-and-circumstances test to determine

recently ruled on the deductibility of management fees and interest expense in an investment fund context. Management fees charged at the entity level are considered deductible only as miscellaneous itemized deductions.¹³ Management fees incurred by the Underlying Funds are treated as either trade or business expenses or miscellaneous itemized deductions depending on whether the Underlying Fund itself is a trader or investor.¹⁴

If the Underlying Fund is considered an investor in securities, then interest expense is subject to limitation under Section 163(d) for investors who do not materially participate; if the Underlying Fund is considered a trader of securities, then interest expense is not subject to limitation.¹⁵ If investors of the FOHFs were allocated investment interest expense, it would be deducted on Form 1040, Schedule A, (i.e., “below the line”); if they were allocated trader interest expense, it would be deducted on Form 1040, Schedule E (i.e., “above the line”).¹⁶

The tax year end of the FOHF is determined by the tax year end of the investors, usually the calendar year end.¹⁷ If the FOHF had a fiscal year end different than the calendar year end, then it would have more time to wait for late-delivered Schedule K-1s before it began preparing its Schedule K-1s.

whether the fund is a trader or an investor. Mayer, 74 AFTR2d 94-6402. Investors purchase securities with the intent of holding them for capital appreciation and dividend income. They are not influenced by developments in the short-term market and do not consider the movement of a price of its securities on the daily market. Traders, on the other hand, purchase and sell securities with reasonable frequency in an effort to catch price swings in the daily market and seek profit in the short term. Factors to consider when making the determination of trader or investor status include frequency, extent, and regularity of the securities transactions; the taxpayers’ investment intent; long-term growth vs. active trading; and the type of income derived from the activity (capital gain and loss compared to interest and dividend income). *Id.*

¹³ Rev. Rul. 2008-39, 2008-2 CB 252.

¹⁴ *Id.*

¹⁵ Rev. Rul. 2008-12, 2008-1 CB 520.

¹⁶ Rev. Rul. 2008-38, 2008-2 CB 249.

¹⁷ IRC § 706(b)(1)(B) provides that, unless the partnership establishes a business purpose for a different taxable year, a partnership cannot have a taxable year other than one of the following: (1) the majority interest taxable year (pursuant to IRC § 706(b)(4)) is the taxable year, if any, which, on each testing day, constituted the taxable year of one or more partners having (on such day) an aggregate interest in the partnership profits and capital of more than 50 percent); (2) if there is no majority interest taxable year, the taxable year of all the principal partners (pursuant to IRC § 706(b)(3)), a partner having an interest of 5 percent or more in partnership profits or capital) of the partnership; or (3) if there is no taxable year described in (1) or (2), the calendar year unless the Secretary by regulation prescribes another period. Treas. Reg. § 1.706-1(b)(2) provides that, if neither IRC § 706(b)(1)(B)(i) nor (ii) apply, the partnership’s taxable year will be the taxable year that results in the least aggregate deferral of partnership income.

In computing the taxable income of a FOHF, the amounts included in its taxable income for a fiscal year with respect to an Underlying Fund are based on the income and deductions of the Underlying Fund for any taxable year of the Underlying Fund.¹⁸ For example, if a FOHF adopted a March 31, 2010, fiscal year end, it would include the 2009 Schedule K-1 information from an Underlying Fund with a December 31, 2009, year end.

Advantages of Using the Partnership Form. As stated earlier, the FOHF is a pure pass through entity, which does endow it with several important benefits:

- The character of income and expense items is passed through to the investors, including losses that the investors’ can use to offset against gains from other investments and activities.
- Because the FOHF is a taxed as a partnership, it can specially allocate items of income and expense among the partners.
- Partnerships are not subject to any entity level taxes (as opposed to a FOHF taxed as a corporation, which would be taxed at the corporate level unless it obtained RIC status).

FOHF USING A RIC AS THE CHOICE OF ENTITY

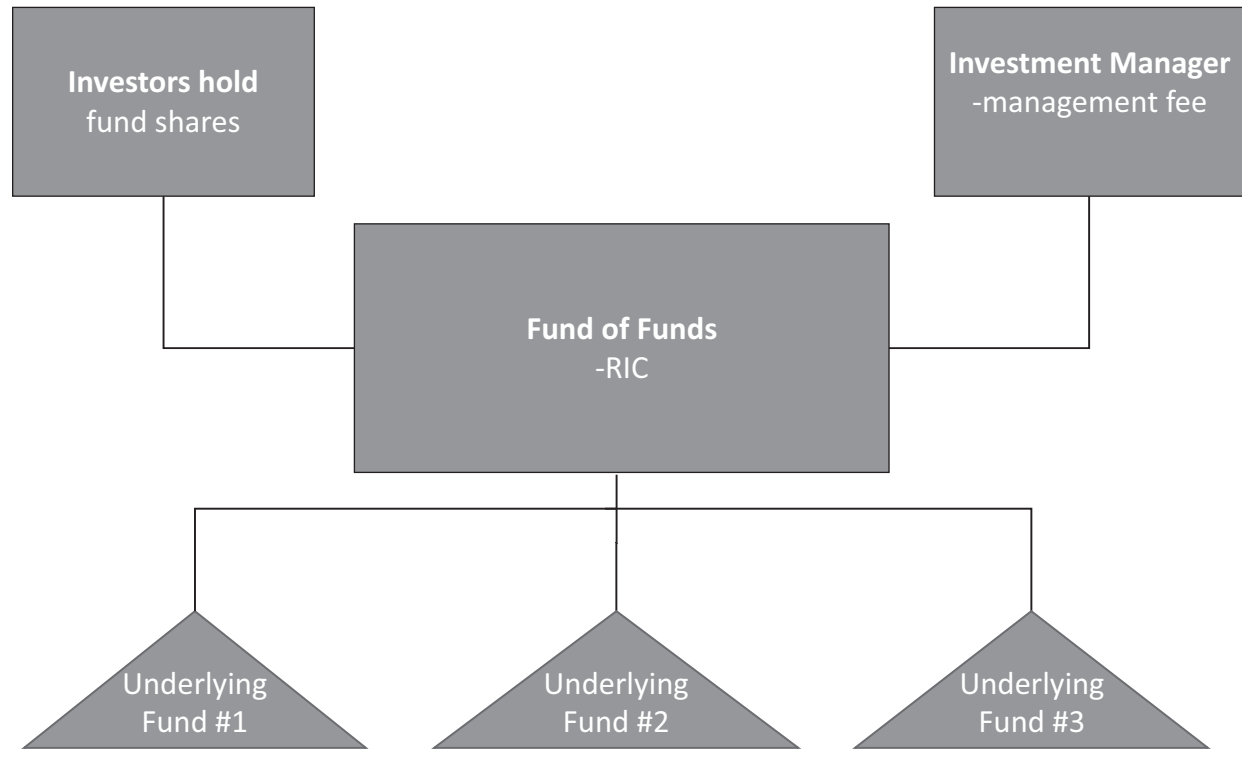
As an alternative to the partnership form, a FOHF could take a corporate form and elect RIC status for income tax purposes. See Exhibit 2 for an example of a RIC of hedge funds structure. While this form does retain some of the advantages of the partnership form (i.e., investor access to the hedge fund market, not being subject to the “Plan Assets” rule) and overcomes some of the disadvantages of the partnership form (i.e., Schedule K-1 reporting, UBTI for U.S. tax-exempt investors), the RIC form has its own distinct advantages and disadvantages.

Advantages of Using a RIC. The primary tax advantages to using a RIC as the investor fund are that (1) it simplifies information reporting to investors, and (2) because the RIC is a corporation, it effectively “blocks” UBTI for U.S. tax-exempt investors and may also block effectively connected income for foreign investors.

As discussed above, partnerships issue Schedule K-1s to their investors that can be quite lengthy, may sometimes be difficult for investors to understand, and require that investors pay tax on income and gains allocated to them even if they do not receive a distribution

¹⁸ IRC § 706(a).

Exhibit 2
RIC Structure
 RIC of Hedge Funds



from the partnership. In contrast, a RIC issues a Form 1099-DIV to its U.S. investors and a Form 1042-S to its foreign investors, both of which documents are more familiar to the general investing public and much less complicated to understand. All of the income reported to investors of a RIC is generally either dividend income or long-term capital gain dividend income and is taxed to investors only when paid.

U.S. investors would receive their Form 1099-DIV by either January 31 or February 15.¹⁹ Because a RIC is only a partial pass through entity, the Form 1099-DIV furnished will contain only a couple of items of information. Finally, even though net losses cannot be passed through, all expenses incurred by the RIC are deducted against its gross income in order to determine its dividend distribution requirements.

For U.S. tax-exempt investors, because a RIC is a corporation that only pays “dividends,” there is gener-

ally no UBTI, unless the U.S. tax-exempt investor used borrowed money to acquire its interest in the RIC.

Disadvantages of Using a RIC Form of FOHF. The primary tax disadvantages to using a RIC as the

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FOHF are maintaining RIC qualification as required by Subchapter M of the Code, making sufficient distributions as required by Subchapter M, and determining the amount of the required distribution under the excise tax rules of Section 4982.

In order to qualify as a RIC, the entity must meet certain qualification requirements under

¹⁹ IRC § 6045(b).

Subchapter M, including a quarterly asset diversification test (ADT)²⁰ and an annual gross income test.²¹ While determining a RIC's status under these tests is, in and of itself, not terribly difficult, in the context of a FOHF, applying the tests can be difficult because of potential difficulties in obtaining the information necessary to compute the tests.

Where a RIC invests in one or more partnerships, the RIC generally should apply both the ADT and gross income tests on a "look-through basis" and treat the partnership as though the RIC held the assets of the partnership and earned the income of the partnership directly.²² This generally requires that the RIC obtain from each Underlying Fund a detailed listing of its assets at quarter end, and a detailed schedule of its gross income. In most instances, managers of the Underlying Funds are reluctant to provide such information; and, thus, the RIC may be forced to determine both the ADT and gross income tests in a less than optimal manner. Third parties who perform due diligence for investors do offer a service to provide this information. Unfortunately, not all of the required information may be provided. Also, it is difficult for the RIC to utilize the 30-day cure rule²³ because of its inability to sell its interests in the Underlying Funds.

²⁰ IRC § 851(b)(3). An entity will not be considered a RIC for any tax year unless at least 50 percent of the value of its total assets is represented by cash and cash items (including receivables), government securities and securities of other RICs, and other securities ("5/50 multiple issuer test"). However, investments in other securities of any one issuer are limited to an amount not greater in value than 5 percent of the value of the taxpayer's total assets and to not more than 10 percent of that issuer's outstanding voting securities. Additionally, not more than 25 percent of the value of the corporation's total assets can be invested in the securities (other than government securities or the securities of other RICs) of any one issuer or of two or more issuers that the corporation controls and that are determined to be engaged in the same or similar trades or businesses or related trades or businesses ("25 percent single issuer test").

²¹ IRC § 851(b)(2). A corporation is not considered a RIC for any taxable year unless, at least 90 percent of its gross income is derived from certain sources. Under IRC § 851(b)(2), qualifying income includes dividends, interest, payments with respect to securities loans (as defined in IRC § 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in IRC § 2(a)(36) of the 1940 Act) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies.

²² Rev. Proc. 2001-57, 2001-2 CB 577.

²³ IRC § 851(d). A fund that meets the requirements of IRC § 851(b)(3) at the close of any quarter will not lose its RIC status because of a discrepancy during a subsequent quarter between the value of its various investments and those requirements unless the discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of that acquisition. A fund that does not meet such requirements at the close of

To qualify for conduit treatment for its distributions, the RIC must distribute at least the sum of (1) 90 percent of its investment company taxable income for the tax year, determined without regard to capital gain dividends and exempt interest dividends and (2) 90 percent of the excess of its exempt interest income over the expenses (including amortization of bond premium) of earning the exempt interest.²⁴ When an investment company fails to satisfy the distribution requirements, it is ineligible to take the dividends-paid deduction and is taxed on its net investment company taxable income and net capital gains as a C corporation. In addition, failing to satisfy the distribution requirement prevents the fund from passing through to its shareholders capital gains, exempt-interest dividends, dividend income qualifying for the dividends-received deduction, or foreign taxes.

For purposes of computing investment company taxable income (ICTI) and net capital gain for fiscal year-end purposes, the RIC does not apply the approach mandated by Rev. Rul. 94-40;²⁵ rather, the RIC follows Section 706 and must wait for the Underlying Funds to issue their Schedule K-1s. The RIC can satisfy the 90 percent distribution requirement by utilizing the spillover dividend provisions of Section 855 to pay out its ICTI and long-term capital gain net income. And given the new September 15th deadline for calendar year partnership returns, there should be less of a timing issue around receipt of underlying Schedule K-1s than there may have been historically.

A different approach applies for the calendar year distribution requirements under Section 4982. Also imposed on every RIC for each calendar year is an excise tax equal to 4 percent of the excess (if any) of the "required distribution"²⁶ for the calendar year over the "distributed amount"²⁷ for the calendar year. If a RIC's tax year ends in November or December, it

any quarter by reason of a discrepancy existing immediately after the acquisition of any security or other property that is wholly or partly the result of such acquisition during such quarter will not lose its RIC status for such quarter if such discrepancy is eliminated within 30 days after the close of such quarter and in such cases it will be considered to have met such requirements at the close of such quarter for purposes of applying the preceding rule.

²⁴ IRC § 852(a).

²⁵ 1994-1 CB 274.

²⁶ IRC § 4982(b)(1). For any calendar year, "required distribution" is the sum of 98 percent of the RIC's capital gain net income for the one-year period ending on October 31 of that calendar year, 98 percent of the RIC's ordinary income for that calendar year, and any prior-year shortfall as determined under IRC § 4982(b)(2).

²⁷ IRC § 4982(c)(1). For any calendar year, "distributed amount" is generally the sum of the deduction for dividends paid during the calendar year, plus any amount taxed to the RIC as investment company taxable income or capital gains for any tax year ending in that calendar year.

may elect to compute its capital gain net income based on its tax year in lieu of the amount computed for the one-year period ending on October 31.²⁸

Where a RIC invests substantially in partnerships, the RIC must compute its ordinary income and net capital gain as though the RIC held the assets of the partnership directly.²⁹ This requires obtaining the income and net capital gain information from the underlying partnership, which may be difficult to obtain for a variety of reasons. In order to determine the amount of the required distribution, a RIC FOHF is required to treat its investment in the underlying funds as though it earned the income directly, and not under the rules of Section 706.³⁰ Because of this, the RIC must request detailed profit and loss information from the underlying hedge fund manager, on a tax basis (including, for example, wash sales) outside what would presumably be the “normal” reporting cycle for the Underlying Fund. Again, this is not something that the Underlying Fund manager would typically provide to investors.

As a result, the RIC may be forced into either:

- Estimating the Section 4982 distribution requirement; or
- Not attempting an estimate at all and paying a nondeductible 4 percent excise tax on the undistributed amount when it can be determined with reasonable accuracy.

If the RIC attempts to estimate the amount of the Section 4982 distribution requirement, it obviously runs the risk of either over-distributing or under-distributing. If the RIC under-distributes, then it just pays a nondeductible 4 percent excise tax on the shortfall, which would be less than the amount paid if no distribution were attempted at all, so this may in fact be “acceptable.” However, should the fund over-distribute, either in total or in a particular character bucket—for example over-distributing long-term capital gains—the RIC runs the risk of paying return of capital distributions or having issued incorrect information returns (Form 1099-DIV).

The second alternative is relatively simple to administer, because no attempt is made to determine the Section 4982 distribution requirement and the RIC just pays a 4 percent excise tax. Obviously, however, this is an added cost to the RIC that

most RICs rarely pay and should be considered carefully.

Finally, because of liquidity issues associated with investors’ ability to redeem from the RIC, FOHFs would typically be organized as closed-end RICs as opposed to open-end RICs. If the FOHF was fully invested in Underlying Funds (which tend to have liquidity events on a monthly, quarterly, or annual basis) and there were net redemptions, unless it held cash to pay redeeming shareholders (which could be a drag on the investment’s performance) or the ability to borrow the required amounts, it could be unable to meet those redemption requests.

In summary, using a RIC as the FOHF carries a significant administrative compliance burden that, practically speaking, may be difficult to meet due to the transparency that the Underlying Fund managers would be asked to provide. So what is a

If a FOHF organized as a RIC over-distributes, either in total or in a particular character bucket—for example over-distributing long-term capital gains—the RIC runs the risk of paying return of capital distributions or having issued incorrect Form 1099s.

fund sponsor to do? How can the sponsor manage to offer hedge fund-like returns to investors while at the same time providing the simplified and more timely tax reporting offered by Form 1099s instead of Schedule K-1s?

ALTERNATIVE TO THE CURRENT STRUCTURES: USE OF OFFSHORE FUNDS

In the past, when investment managers organized FOHFs, they generally did their investing through the Underlying Fund sponsor’s U.S.-domiciled fund. Doing so provided the advantage of preserving the character of the income earned by the underlying U.S. fund when allocating it to the RIC—but it also had the disadvantage, indicated above, of lacking in transparency to allow the RIC to perform its qualification testing under Subchapter M and its calculation of taxable income to determine the proper amount to be distributed to satisfy the 90 percent distribution test. Also, it was difficult to get accurate (or any) information from the Underlying Fund to allow the RIC to meet the calendar year distribution requirements under Section 4982.

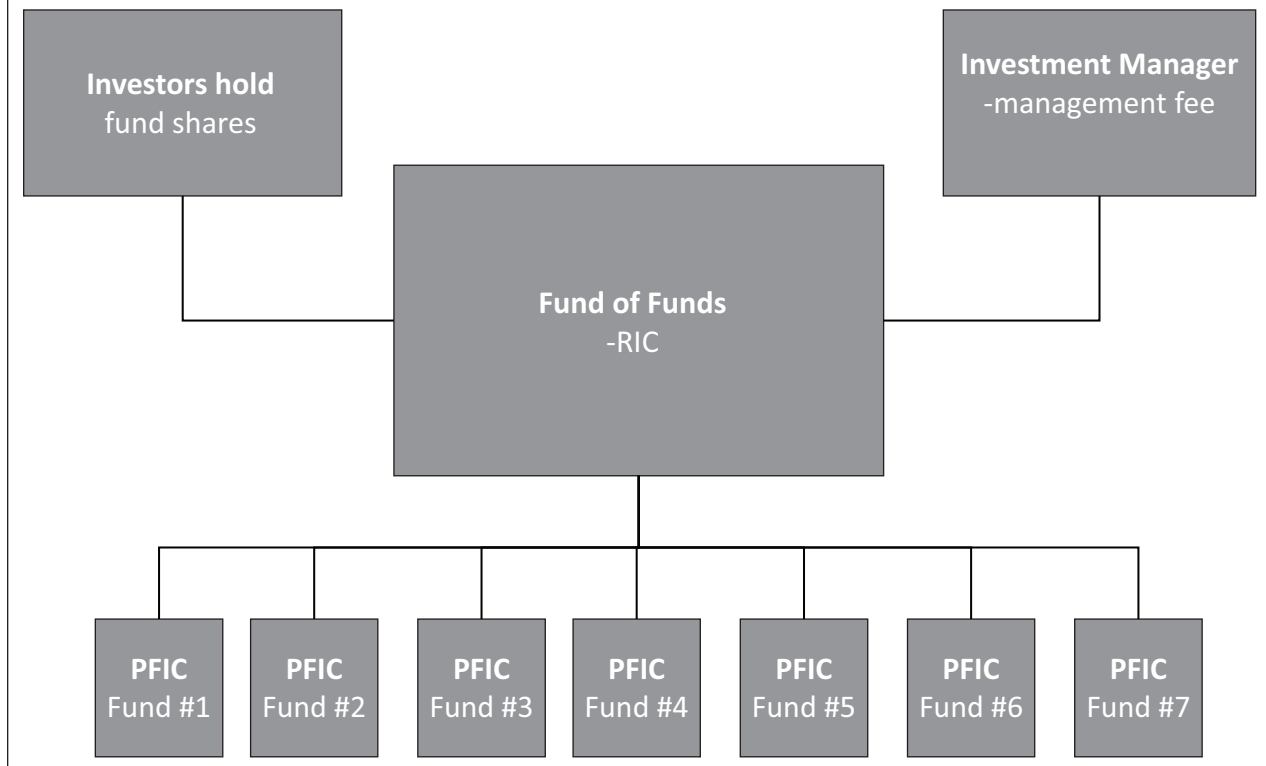
Now what if, instead of investing in the U.S. fund, the RIC invests in the Underlying Fund sponsor’s

²⁸ IRC § 4982(e)(4)(A).

²⁹ Rev. Rul. 94-40, 1994-1 CB 274; Rev. Rul. 94-40A, 1994-1 CB 274; and Rev. Proc. 94-71, 1994-2 CB 810.

³⁰ Rev. Rul. 94-40, 1994-1 CB 274 and Rev. Proc. 94-71, 1994-2 CB 810.

Exhibit 3
Alternative Structure
 RIC of PFICs



offshore fund? See Exhibit 3 for an example of a RIC of Passive Foreign Investment Companies (PFICs) structure. Let's look at some of the advantages and disadvantages of doing so.

Advantages of Registered FOHFs Investing in Offshore Funds. First, by using offshore funds, the issues that arise around transparency when investing in the U.S.-domiciled fund go away entirely. Because the offshore fund can elect to be treated as a corporation for U.S. tax purposes, it is treated the same as any other equity investment held by a RIC. That is, distributions received from the offshore fund are generally treated as Section 301 distributions and, to the extent of available earnings and profits, the distributions are taxable as dividends. Additionally, because an equity investment (such as an investment in the offshore fund) clearly falls within the definition of a security under the 1940 Act, any gain on sale would be treated as gain from the sale of stock or securities. Both the dividends and

the gain on sale would constitute qualifying income for the RIC under Section 851(b)(2), irrespective of the investment activities within the offshore fund—a potentially very different result as compared to an investment in the U.S. fund (partnership). Because the offshore fund is treated as a corporation for U.S. tax purposes, it effectively “blocks” the character of the income as earned within the offshore fund. The offshore fund could invest solely in commodities or currencies and the distributions and gains from that fund would potentially still constitute qualifying income under Section 851(b)(2).

Furthermore, the ADT would be simplified by this approach, both as it relates to an investment in the U.S. fund and as it relates to creating and investing in a CFC. The 5/50 multiple issuer and 25 percent single issuer tests would be applied directly to the investment in the offshore fund and, presuming that a RIC could spread its investment activities among a sufficient number of offshore funds, applying ADT should not

present an issue in this context. On the other hand, an investment in the U.S. fund generally should require the application of the ADT on a “look-through” basis, which requires the Underlying Fund manager to supply quarterly details of the fund’s assets (including its portfolio listing) to the RIC, which is not something the Underlying Fund managers are generally willing to do, for a variety of reasons.

As compared to investing in a CFC, investing in the offshore fund appears to provide two benefits:

- First, the FOHF does not incur the expense associated with organizing and operating a CFC;
- Second, because of the 5/50 multiple issuer and 25 percent single issuer tests, a RIC would be forced to be limited as to the number of CFCs it could create and operate and would therefore be limited as to how much exposure it could get to commodities or currencies through the use of one or more CFCs.

Because the offshore fund would generally constitute an investment in a PFIC,³¹ and by definition could constitute “Marketable Stock” because it is held by a RIC,³² the RIC could elect to mark-to-market the stock of the Underlying Fund under Section 1296 as of the end of its taxable year and include any gain as ordinary dividend income for purposes of determining its distribution requirements under Section 852(a) and include any loss (to the extent of previous mark-to-market gains) as ordinary loss.³³ Any dividend paid by the Underlying Fund would be included on the ex-date, as it would be for any equity investment held by a RIC. Certainly this approach is a much more simplified approach, but it does come with a cost, that is, current recognition and ordinary treatment of appreciation in the offshore fund.

Another approach to handling the tax treatment of the offshore fund would be for the RIC to make a Qualified Electing Fund (QEF) election under Section 1295(b) and include its pro rata share of the ordinary

earnings and net capital gain of the Underlying Fund. While this approach may seem relatively simple to administer, and it has the added advantages of preserving net capital gain and not recognizing unrealized gain in the stock until the stock is actually sold, the Underlying Fund may not be willing to allow itself to be treated as a QEF for at least a couple of reasons. First, in order to make a QEF election, the underlying fund must provide a “PFIC Annual Information Statement” to its U.S. shareholders who wish to make the election and the Underlying Fund may not be willing to incur the expense of providing such a statement to a U.S. investor. Second, when providing a PFIC Annual Information Statement, the Underlying Fund must agree both to computing its earnings and profits under U.S. tax principles, and to permit investor access to its

With a mark-to-market election, a RIC can invest in an offshore fund without imposing a reporting burden on the offshore fund or the manager for the offshore fund.

books and records. This latter point may be an issue with the Underlying Fund’s management. (It may also be a factor as to why, back in 2001, FOHFs invested through U.S. funds—i.e., the Underlying Fund managers may have prohibited U.S. taxable investors like a RIC from investing in their offshore funds.) Third, the detailed information required for determining the net income of an electing offshore fund would replicate the information difficulties of using a foreign partnership investment vehicle. With a mark-to-market election, the RIC can invest in the offshore fund without imposing a reporting burden on the offshore fund or the manager for the offshore fund.

Another advantage this approach has is a more simplified means of computing the calendar year distribution requirements under Section 4982.³⁴ The RIC could elect to mark-to-market the stock of the Underlying Fund under Section 1296 as of October 31 and include any gain as ordinary income for purposes of determining the calendar year distribution requirements under Section 4982.

Finally, the FOHF using an offshore fund is able to choose any year end and is not restricted to only the calendar year end. Also, by adopting a fiscal year end, it may help with the audit and preparation of the FOHF’s

³¹ See IRC §§ 1291-1298. A PFIC is defined as any foreign corporation where (1) 75 percent or more of its gross income for any year is passive income or (2) 50 percent or more of its average assets held during the year produce or are held for the production of passive income. IRC § 1297(a). A foreign corporation is excluded from the definition of a PFIC, with respect to a direct or indirect shareholder that is a U.S. person, during which the foreign corporation is a CFC and for which such shareholder is a United States shareholder with respect to that foreign corporation as defined under IRC § 951(b). IRC § 1297(e).

³² IRC § 1296(e)(2).

³³ IRC § 1296(h).

³⁴ This approach also presents a disadvantage in terms of character and timing of income recognition, as explained later in this article.

financial statements because all of the pertinent data would become available on a more timely basis.

Disadvantages of Having Registered FOHFs Invest in Offshore Funds. Use of offshore funds does have some negatives. There are two primary disadvantages for FOHFs adopting this approach:

- First, all income and gains from the Underlying Fund will be characterized as ordinary for U.S. tax purposes if the FOHF elects mark-to-market instead of QEF treatment (subsequent losses are treated as ordinary to the extent of

The tax cost of making a mark-to-market election under Section 1296 is giving up the capital gain character while incurring current taxation on unrealized appreciation in the PFIC stock.

previous mark-to-market gains on a position, with any excess losses, including excess mark-to-market losses, treated as capital losses upon realization under general U.S. tax principles).³⁵ In addition to ordinary treatment, net losses cannot be passed through to the investors, and investors generally may only recoup losses upon a disposition of their RIC stock. As explained above, the tax cost of making a mark-to-market election under Section 1296 is giving up the capital gain character while incurring current taxation on unrealized appreciation in the PFIC stock.

- Second, by investing through the offshore fund, income earned by the Underlying Fund may be subject to a withholding tax. Because many offshore hedge funds are organized in foreign jurisdictions (such as the Cayman Islands, the British

³⁵ IRC § 1296(a).

Virgin Islands, or Bermuda) that do not have tax treaties with the U.S. or most other countries, the withholding tax cost can run as high as 30 percent of certain types income allocated to, or received by, the offshore fund.³⁶ The withholding tax also would be a drag on the Underlying Fund's investment performance.

There are three secondary disadvantages of this structure, as well. First, there could be issues in satisfying the 90 percent distribution requirement because of liquidity issues; otherwise, the FOHF would have to use net subscriptions or maintain a cash position to pay dividends. Second, it may be practically impossible to use the 30-day cure rule to help satisfy the ADT. Third, the mark-to-market election of Section 1296 only avoids the generally negative consequences of the PFIC regime at the offshore fund level itself, and not with respect to any interests in PFICs held directly or indirectly by the offshore fund—which could lead to double taxation under the PFIC regime.

Obviously, these are fairly significant tax costs and a fund manager would have to weigh these costs against other factors including the potential for market returns, the ability to invest in commodities or currencies without violating RIC status, and opportunities for marketing the fund to new investors.

CONCLUSION

A fund of hedge funds product can take many forms, including registered or unregistered, partnership or RIC, and investing onshore or offshore. While sharing certain tax advantages and disadvantages, each has its own distinct tax advantages and disadvantages that must be weighed carefully before making a decision about which form to choose, and how to invest. ■

³⁶ For U.S. tax purposes, under IRC § 1441(b), this would include dividend income and certain interest income (not excepted under IRC § 1441(c)(9)) that is fixed or determinable annual or periodical.

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