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Hedge Funds: Tax Advantages and Liabilities for Investors and Fund Managers

Leveraging Qualified Dividend Income, Net Investment Tax, Management Fee Waivers, and More

THURSDAY, DECEMBER 5, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Hedge Funds:
Tax Advantages and Liabilities for Investors and Fund Managers

December 5, 2013

Presented By
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Introduction

- Qualified dividend income after ATRA.
  - Tax treatment
  - Investment shifting
  - Non-U.S. investments
  - Holding period requirements
- Management fee waivers

Qualified Dividend Income

Qualified Dividend Income

Preferential Tax Rates

- The American Taxpayer Relief Act of 2012 made permanent the favorable tax rates applicable to qualified dividend income ("QDI").
- However, the rate upon which QDI is taxed increased for non-corporate taxpayers from 15% to 20%, to the extent the taxpayer's taxable income from all sources exceeds $400,000 for single filers or $450,000 for married taxpayers filing jointly.
  - Plus 3.8% net investment income tax
- Even though the tax rate will increase for some taxpayers, the types of dividends that are treated as QDI eligible did not change.

Qualified Dividend Income

Context

- In low interest rate environment, yield is king and hedge funds are focusing on dividend strategies.
- The individuals who are partners in the GP entity that receives the carried interest want to be allocated income that is QDI or long-term capital gain.
- Greater certainty regarding the tax treatment of QDI makes dividend strategies more attractive.
- Corporate taxpayers already have a preference for receiving dividend income because of the dividends received deduction

Qualified Dividend Income

Eligible Dividends

- A dividend is a distribution of property or cash out of the earnings and profits (“E&P”) of the distributing corporation.
- All dividends paid by domestic corporations are eligible for QDI treatment except:
  - dividends paid by corporations exempt from tax under Code §501 or 521;
  - dividends which mutual savings bank deducts under Code §591; and
  - dividends deducted under Code §404(k) as paid to an employee stock ownership plan (“ESOP”).

Qualified Dividend Income

Eligible Dividends

- Dividends from pass-through entities such as a regulation investment company ("RIC"), real estate investment trust ("REIT") or S corporation can be QDI to the extent that the dividend was attributable to a dividend received by the pass-through entity which was QDI in the hands of such entity.
- Payments in lieu of dividends cannot be QDI. See Rev. Rul. 60-177, PLR 8828003
- While extraordinary dividends as defined in Code §1059 count as QDI, any loss on selling the shares is long-term capital loss to the extent of the QDI.

Qualified Dividend Income

Eligible Dividends

- Code §702(a) generally requires a partnership to separately state some items of income, including qualified dividend income. Code §702(b) generally allows for the character of an item of income to be determined as if the income "were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."

Qualified Dividend Income

Dividends from Foreign Corporations

- Dividends from qualified foreign corporations ("QFCs") are entitled to the reduced tax rates for QDI whereas dividends from any other corporation are not.
- A QFC includes corporations
  - incorporated in a U.S. possession (*e.g.*, Puerto Rico);
  - eligible for the benefits of a comprehensive income tax treaty with the U.S. that includes an exchange of information program; and
  - whose stock is readily tradable on an established U.S. securities market.

Qualified Dividend Income

Dividends from Foreign Corporations

- In addition, the statute excludes from the definition of QFC any foreign corporation which, in either the year it pays the dividend or the preceding year, is a passive foreign investment company ("PFIC").
- Notably, controlled foreign corporations ("CFCs") are not excluded from the definition of "qualified foreign corporation," so long as they are not also PFICs.
- However, income inclusions under Section 951(a)(1) are not treated as QDI because no actual distributions have been made.

Qualified Dividend Income

Holding Period

- The taxpayer must hold the stock a minimum number of days during a window period straddling the ex-dividend date for the dividend to be QDI.
- For common and most preferred stock, the 120-day window period starts 60 days before the ex-dividend date. The taxpayer must hold the stock for 61 days during this 120-day window.

Qualified Dividend Income

Holding Period

- Most importantly, taxpayers cannot count days during which they hedged their risk of loss in a manner Code §246(c) prohibits, especially by holding a position in substantially similar or related property.
  - Property is substantially similar or related to stock if the fair market values of the two are reasonably expected to vary inversely and reflect primarily the performance of a) a single firm or enterprise, b) the same industries, or c) the same economic factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates.
- In the case of stock held by a partnership, there is uncertainty whether the holding period requirements apply at the partnership or partner level.

Qualified Dividend Income

Investment Income Characterization

- Leveraged taxpayers claiming the reduced rates on QDI cannot count the dividend as investment income, which will in turn reduce the amount of interest expense the taxpayer may deduct.
- However, taxpayers can elect to forego the reduced rates on QDI if they want to include the dividends in investment income and free up investment interest expense deductions they would otherwise lose.
- Accordingly, a hedge fund investor that borrows to make his or her investment in a hedge fund or who is allocated interest expense from the hedge fund will be able to deduct the interest expense on the debt to the extent of his or her gross income from the hedge fund and other investments that are taxed at ordinary income tax rates.

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Application of Self-Employment and Medicare Taxes to Hedge Fund Investors and Managers

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12/5/13

Self Employment Taxes

General Rules and Rates

-- Sections 1401-1403 of the tax code imposes taxes on net earnings from self employment derived by an individual. “Net earnings from self employment” generally means gross income, less allocable deductions, derived by an individual from any trade or business.

-- “Net earnings from self employment” also includes allocable income or loss of an individual from any trade or business carried on by a partnership of which he is a partner.

-- The general self-employment tax rates for 2013 are as follows:

- -- 15.3%, applicable to net earnings from self employment in amounts up to $113,700
- -- 2.9%, applicable to net earnings from self employment in excess of $113,700
- -- Beginning in 2013, an additional 0.9% imposed on amounts above the “threshold amounts” ($250k for married filing jointly; $125k for married filing separate; $200k for single filers)

-- ½ of the SE taxes (other than the 0.9%) is allowed as a deduction, thereby reducing the overall “effective rate”

Self Employment Taxes

Exemptions for "Investment" or "Passive" Income

--Consistent with its focus on "earned" income, several categories of "passive" or "investment" type income is exempt from self-employment taxes.

-- dividends on stock, interest on notes/debt, and rents from real estate are all exempt, as are gains from the sale of "capital assets."

-- Section 1402(a)(13) also exempts a "limited partner's" distributive share of partnership income.

--*Renkemeyer* 136 T.C. 137 (2011) held that individuals who were formally designated as "limited partners" in a Kansas law partnership but who were active in the law business of the partnership were not, in substance, "limited partners" within the meaning of Section 1402(a)(13). Thus, their allocable shares of the partnership's income from law services were subject to self-employment taxes.

Self Employment Taxes

Application to Hedge Fund Investors

--U.S. individual investors typically invest in Hedge Funds through vehicles which are treated as "partnerships" for U.S. tax purposes. Thus, the income, gain, loss, deduction and other items generated by the Hedge Fund partnership will be allocated to the U.S. individual investors and tax purposes will have the same character to the investor as to the Hedge Fund.

--The types of income generated by the Hedge Fund partnership (e.g., dividends, interest, capital gains, etc.) which are allocable to U.S. individual investors therefore are typically exempt from SE taxes.

--But, as noted below, for tax years beginning on or after 1/1/13, such amounts are now likely subject to an equivalent 3.8% tax under new Section 1411.

Self Employment Taxes

Application to Hedge Fund Managers

--U.S. individuals who manage Hedge Fund typically do so through one or more entities which are typically treated for tax purposes either as "partnerships" or "S" corporations (both of which are "flow-through" tax vehicles). Thus, the items of income, gain, loss, deduction derived by these management entities will be allocable to the U.S. individual owners of these entities and for tax purposes will have the same character to such owners as to the management entity.

--The Hedge Fund management entities typically derive two distinct types of income from the Hedge Fund which they manage: (1) allocations from the Hedge Fund, both in the management entities' capacity as an investor in the Hedge Fund, and with respect to the "carried interest" held by the management entities in the Hedge Fund; and (2) fees paid by the Hedge Fund to the management entities for management services.

--The tax characterization of items "allocated" to the management entities will be the same character as the underlying items derived by the Hedge Fund ; i.e., dividends, interest, capital gains, etc. These amounts are typically exempt from SE taxes (though now likely subject to new Section 1411). But the fee income is compensation from services performed in a trade or business and thus is generally subject to SE taxes when allocable to U.S. individuals.

Self Employment Taxes

Techniques to Minimize SE Taxes

--**LP Structures**. Formation of management entities as state law limited partnerships. Individual owners then own their interests in the entity as “limited partners” with a separate entity formed to serve as the “general partner.” Individuals then take the position that their allocable shares of the entity’s fee income from management of Hedge Funds is exempt from SE taxes under Section 1402(a)(13). This position was dubious even prior to the 2011 *Renkemeyer* decision; even more so afterwards.

--**S Corp Structures**. Formation of management entity as S corporation. S corporation pays small “wages” to individual owners, with the excess being distributed as “dividends” to the owners. Dividends are not subject to SE taxes. This technique is viable ***IF*** the amount of the wages are defensible (a big IF). Also, California imposes a 1.5% income tax on net income of the S corp, thereby eliminating much of the SE tax savings for Cal-based managers.

--**Management Fee Waivers**. Fund manager “waives” the management fee and instead takes an additional profit interest in the fund. Allocations under the additional profit interest are likely exempt from SE taxes. Pre-2013, this also was an effective technique if structured properly. However, post-2012, even if structured properly, the 3.8% tax under Section 1411 is likely to now apply.

New Section 1411

--**General Intent**. Prior to 2013, SE taxes were imposed on "earned" income, and most types of "passive" or "investment" income were exempt. Beginning 1/1/13, new Section 1411 becomes effective, with the general intent of also applying an equivalent (3.8%) tax to most types of "passive" or "investment" income.

--**General Rule**. Effective for tax years beginning on or after 1/1/13, new Section 1411 imposes a new additional tax as follows:

-- In the case of U.S. individuals, the new tax for each year is equal to 3.8% of the lesser of (A) the individual's "net investment income" for the year, or (B) the excess of the individual's modified adjusted gross income for the year over the "threshold amount." The threshold amount is: $250k for married filing jointly, $125k for married filing separately, and $200k for single filers.

--In the case of an estate or trust, the new tax for each year is 3.8% of the lesser of the estate's or trust's undistributed net investment income over the gross income of the estate/trust in excess of the dollar amount at which the highest income tax bracket applies.

New Section 1411: "Net Investment Income"

The Non-Technical Definition

--The term "net investment income" generally covers most types of "investment" income, plus income from the following two types of "trades or businesses:

-- Any trade or business which is a "passive activity" with respect to the taxpayer (i.e., the taxpayer does not "materially" participate); and

-- Any trade or business of trading in financial instruments or commodities (e.g., hedge funds).

--A trade or business which is a passive activity with respect to the taxpayer or which consists of trading in financial instruments or commodities is referred to as a "1411 Trade or Business."

New Section 1411: "Net Investment Income"

The Technical Definition

Under Section 1411(c)(1), "net investment income" means the excess of:

-- the sum of the following three amounts:

(i) gross income from interest, dividends, annuities, royalties and rents, other than such amounts derived in ordinary course of a non-1411 Trade or Business.

(ii) net gain attributable to the disposition of property other than property held in connection with a non-1411 Trade or Business;

(iii) other gross income derived from a 1411 Trade or Business;

minus

-- the deductions allowed by subtitle A of the tax code that are "properly allocable" to such gross income or net gain.

-- gain from the sale of interests in an entity treated as a "partnership" or an "S" corporation are included in (iii) only to the extent of the net gain which would be described in (iii) if all property of the partnership/S corp were sold.

New Section 1411

Application to Hedge Fund Investors

--U.S. investors investing in Hedge Funds through vehicles treated as "partnerships" for tax purposes report their allocable shares of the Hedge Fund's items with the same character for tax purposes as recognized by the Hedge Fund (i.e., dividends, interest, capital gains, etc.). Thus, such items generally will be included as NII under Section 1411.

--Original Proposed Regulations (Dec. 2012) contained a "glitch" which subjected U.S. individual investors to the 3.8% tax on gross trading gains, without offset for trading losses. Final regulations (Nov. 2013) fixed this.

--Original Prop. Regs. (Dec. 2012) said substitute dividends and substitute interest are included in NII, but income and losses from notional principal contracts ("swaps") were not unless the fund is a "trader." Practical effect was likely minimal since non-trader funds likely wouldn't invest in swaps due to adverse income tax rules, but new Prop. Regs. (Nov. 2013) now say swap income/losses now included in NII for both trader and investor funds.

--If U.S. individual investor were to invest through an Offshore Feeder corporation, different rules apply.

New Section 1411

Application to Hedge Fund Investors – Special CFC/PFIC Rules

--If a U.S. individual invests in a Hedge Fund through a non-US corporation (such as an offshore feeder), such entity is likely to be treated for tax purposes as a "controlled foreign corporation" (CFC) or a "passive foreign investment corporation (PFIC), and if the latter, the U.S. individual will usually be well-advised to file an election to treat the PFIC as a "QEF."

--For a U.S. individual owning shares in a CFC/QEF. the investment income and net gains of the CFC/QEF are generally required, for regular income tax purposes, to be reported directly on the U.S. individual's tax returns on a flow-through basis.

--But for Section 1411 purposes, a different treatment applies. Although CFC/QEF inclusions are taxed currently for regular tax purposes, they are not included for Section 1411 purposes until distribution/sale (exception if the U.S. investor is a "trader"). Thus, benefit of deferral of the 3.8% tax, albeit with substantial complexities/administrative burdens.

--Perhaps recognizing the complexities of maintaining 2 sets of books, the regulations allow U.S. individuals to elect to include CFC/QEF inclusions currently for 1411 purposes as well. Election now made separately with respect to each CFC/QEF.

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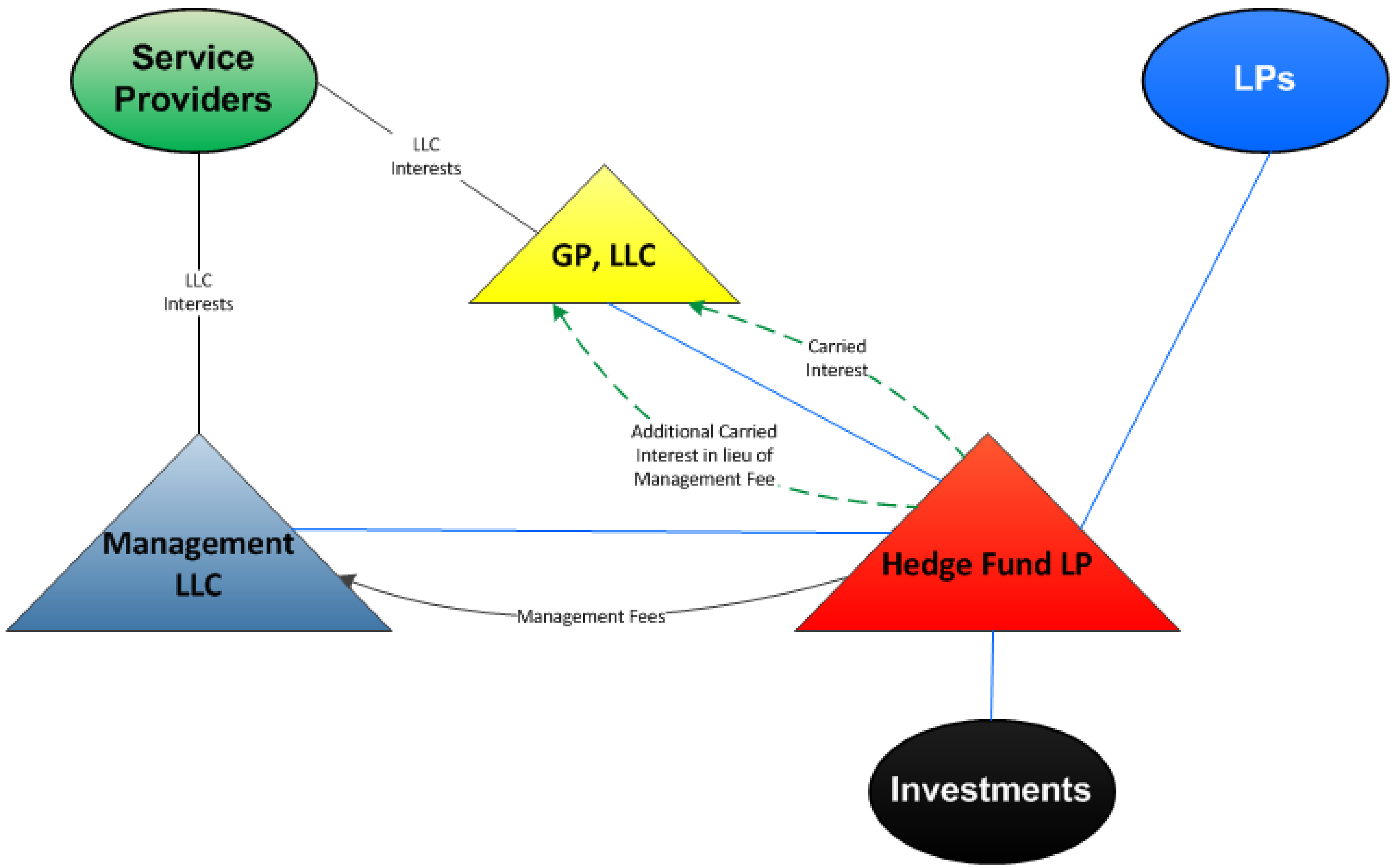
Management Fee Waivers

Management Fee Waiver Structure



Management Fee Waiver Structure

- An LLC or limited partnership that acts as fund manager waives its right to a management fee payable in a future tax year.
  - The waiver can either be “hard-wired” from the time the fund is formed or made at the election of the manager prior to the period in which the management fee will accrue.
- Instead of the fixed fee, which would be taxed at ordinary income rates and subject to self-employment tax, the manager receives an additional profits interest in the fund.
- In many cases, the receipt of an additional carried interest pursuant to a fee waiver can be used to satisfy the general partner’s capital contribution obligation.

Management Fee Waiver Structure

- The profits interest is entitled to a special priority allocation of the fund’s profits.
- In many variants of the strategy, the additional carried interest obtained as a result of the waiver results is entitled to a priority allocation of the fund’s profits from certain investments and/or during certain fiscal periods, unlike the basic carried interest.

Management Fee Waiver Structure

Tax Benefits

- Income allocated to the profits interest typically qualifies as long term capital gain or QDI.
- There also may be a deferral benefit — delaying current taxation on the waived management fee income and pushing the tax to later years when the gains that produce the additional carried interest are realized.
- Limited partners who are individuals may also avoid limitations that might otherwise apply to management fee deductions.
- The “profits interest” is not subject to employment taxes, whereas management fee income generally is.

Management Fee Waiver Structure

Common Law Challenges to the Structure

- The IRS might argue that the additional carried interest does not satisfy the relevant legal standards or satisfy the requirements for the safe harbor provided in IRS Revenue Procedure 97-23.
- Revenue Procedure 97-23 provides that a profits interest will not be subject to immediate taxation unless:
  - "the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease,"
  - "the partner disposes of the interest" within two years of receipt, or
  - the profits interests is an interest in a "publicly traded partnership" as that term is defined by Code §7704(b).

Management Fee Waiver Structure

Common Law Challenges to the Structure

- For purposes of the safe harbor, a profits interest is a partnership interest that would result in no distributions to the holder if, immediately after receipt of the profits interest, the partnership sold all of its assets for fair market value and thereafter made liquidating distributions to the partners under the partnership agreement.
- Also, the revenue procedure's safe harbor applies only “if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner.”
- Reasons why the Revenue Procedure’s safe harbor might not be satisfied include:
  - The additional profits interest is deemed to be transferred by the management company to the entity that is the GP of the fund.
  - The priority income allocation substantively violates the liquidation value test.

Management Fee Waiver Structure

Code §707(a)(2)(A)

- The IRS might also argue either that the management fee waiver is actually a disguised non-partner transaction as described in Code §707(a)(2)(A).
- That provision provides that under regulations that have not yet been promulgated, "if (i) a partner performs services for a partnership . . . (ii) there is a related direct or indirect allocation and distribution to such partner, and (iii) the performance of such services . . . and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, the allocation and distribution shall be treated as a transaction [between a partner and a non-partner]."

Management Fee Waiver Structure

Code §707(a)(2)(A)

- Use of separate management company and GP technically is not captured by Code §707(a)(2)(A).
- The legislative history provides five relevant factors to be considered in making this determination with the first factor being the most important:
  - whether the payment to the service provider is subject to "significant entrepreneurial risk";
  - whether the partner status of the service provider is transitory;
  - whether the distribution and allocation in question are close in time to the services to which they relate;
  - whether, under all of the facts and circumstances, it appears that the service recipient became a partner primarily to obtain tax benefits; and
  - the extent to which the service provider has an interest in general and continuing partnership profits.
- The application of the foregoing factors is highly dependent on the structure of the additional carried interest.

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Management Fee Waiver Structure

Code §707(c)

- An additional argument is that the arrangement is really a guaranteed payment covered by Code §707(c).
- Code §707(c), on its face, provides ordinary income treatment only to payments "determined without regard to the income of the partnership." However, a fund makes allocations to an additional carried interest only if it earns income.
- Potential support for the treatment of an interest received pursuant to a management fee waiver as a guaranteed payment is Revenue Ruling 81-300. In Revenue Ruling 81-300, the IRS adopted a policy-based conclusion and held that that an allocation of gross income qualifies as a guaranteed payment under Code §707(c).
- However, the plain language of Code §707(c) should trump the Revenue Ruling.

Management Fee Waiver Structure

Likely Success of IRS Challenge

- If the IRS were to challenge management fee waiver strategies under existing law, the success of the challenge would most likely depend on the structure utilized and the particular facts.
- The primary focus in a challenge to a management fee waiver structure is likely to be on the nature and substantiality of the conditions to the general partner's or manager's receipt of the converted carried interest.

Management Fee Waiver Structure

Likely Success of IRS Challenge

- If the payment of the converted carried interest is conditioned upon the fund having overall net profit in its entire investment lifecycle, the payment is more likely to be respected as an allocation of partnership profits than if the payment is contingent on the recognition of net profits from any individual investment or in any particular year.
- The higher the likelihood that the general partner or manager may not eventually receive the payment, the more likely it is that the conversion will be respected.
- In addition, the timing of the election should be relevant.

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