Proskauer

Proskauer's Hedge Start: Key Structuring Issues

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A key initial decision for a manager launching a new hedge fund is to decide between:

- **A “master-feeder” fund structure**: In a typical “master-feeder” structure, an onshore “feeder” fund and an offshore “feeder” fund both co-invest through a single jointly owned “master” fund, or
- **“parallel” fund structure**: In a “parallel” fund structure, the manager manages two separate accounts, an onshore fund and an offshore fund.

Key Tax Considerations

The need for two funds, one onshore and one offshore, is generally driven by U.S. tax considerations:

- **U.S. taxable investors** generally prefer to invest in an onshore fund (typically a Delaware limited partnership or limited liability company) that is treated as a partnership for U.S. tax purposes.
    - U.S. taxable investors in a partnership generally receive the same tax treatment as if they owned the underlying assets directly.
- **Non-U.S. investors** and **U.S. tax-exempt investors** generally desire to invest in an offshore fund (typically organized as a corporation in a no-tax jurisdiction such as the Cayman Islands) that is not transparent and is treated as a corporation for U.S. tax purposes.
    - The offshore fund acts as a “blocker” protecting non-U.S. investors and U.S. taxable investors from certain potentially adverse U.S. tax consequences.

Advantages of Master-Feeder Structure

There are numerous advantages to a master-feeder structure, including:

- **Trading Only One Account**: In a master-feeder structure, the portfolio manager manages all assets in a single account, thereby avoiding the need to allocate each transaction between separate accounts for the onshore and offshore funds.

- **Automatic Rebalancing of Positions**: In a master-feeder structure, all securities positions are held by the master fund and are therefore automatically “rebalanced” every time either feeder fund experiences subscriptions or redemptions.
    - This avoids any need for the manager to go into the market to buy or sell positions regularly in order to rebalance individual securities positions in each account, as would typically be necessary in a parallel fund structure. This can save significant brokerage commissions and other transaction costs, and can be particularly important if certain assets in the portfolio are relatively illiquid or no longer available in the market.

- **Brokerage and Counterparty Arrangements:** In a master-feeder structure, all brokerage and counterparty arrangements are established once at the master fund level, avoiding the need to enter into separate arrangements for the onshore and offshore funds in a parallel fund structure.
    - This can be particularly beneficial for funds trading complex derivatives or with multiple complex counterparty credit and trading arrangements.

- **Customized Feeder Funds:** Additional feeder funds can be created under different names, subject to different economic terms (such as different fees or redemption provisions) or structured to meet specific tax, regulatory or business concerns of specific investors or for other purposes.

- **Non-U.S. Person Status**: The master fund is typically organized outside the United States and can therefore qualify as a non-U.S. person for purposes of SEC Regulation S.
    - This permits the master fund to purchase non-U.S. securities offered to non-U.S. persons under SEC Regulation S.

- **QIB Status**: The master fund, by combining the assets of both feeder funds, may be able to reach the $100 million threshold required to qualify as a “qualified institutional buyer” (QIB) under SEC Rule 144A at an earlier stage.
    - This can be a significant potential benefit to fund managers that want to trade Rule 144A securities.

Disadvantages of Master-Feeder Structure

- **Cost:** The master-feeder fund structure involves the additional expense and administrative burden of organizing and administering the master fund. In particular, net asset value must be calculated for the master fund in addition to the net asset value for each feeder fund.

    - But the additional cost is typically more than offset by the savings from managing and administering only a single underlying investment portfolio instead of two separate portfolios.

- **Tax Flexibility**: The parallel fund structure permits more flexibility than a master-feeder structure since it allows the manager to make different investment decisions on behalf of each fund.
    - For example, a manager could decide on behalf of the onshore fund to hold certain investment positions for more than 12 months in order to benefit from lower U.S. tax rates on long-term capital gains or decide on behalf of the offshore fund to sell certain stocks prior to the record date for dividends in order to avoid a withholding tax. In a master-feeder structure, by contrast, all actions are generally taken at the master fund level.

- **U.S. Trade or Business*:*** A fund can cause adverse tax consequences to non-U.S. investors if the fund engages in certain activities that cause it to be deemed to be engaged in a U.S "trade or business" for U.S. tax purposes unless certain steps are taken to prevent such a result, such as investing through a "blocker" corporation to protect the non-U.S. investors. The same adverse tax consequences do not generally apply to U.S. taxable investors. These activities include:
    - origination of loans;
    - investment in entities engaged in a U.S. trade or business that are treated as a partnership for U.S. tax purposes, including master limited partnerships;
    - investment in U.S. real estate, real property holding companies (with an exception for under 5% positions in a publicly traded class of stock) and certain REITs (with an exception for under 10% positions in a publicly traded class of stock); and
    - receipt of fees for services (such as break-up fees or transaction fees).

- **Tax Treaties**: The master fund in a master-feeder structure is typically formed in a no-tax jurisdiction, such as the Cayman Islands. The master fund therefore will likely not be entitled to the benefits of any tax treaties.

The Takeaway:

On balance, most managers choose the master-feeder fund structure, but it is important to work with experienced legal and tax advisors to understand and consider the implications of each structure as they relate to your investment strategy.

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