

# Proskauer's Hedge Start: Key Tax Issues

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Different hedge fund investors have different tax concerns that must be taken into account when structuring a hedge fund and its portfolio investments. Hedge fund investors generally fall into three categories:

- **U.S. taxable investors** who 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, since that gives them essentially the same tax treatment as if they owned the underlying assets directly.
- **U.S. tax-exempt investors** (such as foundations or pension plans) who generally prefer to invest in an offshore fund — most typically a corporation organized 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 corporate fund acts a “blocker” that permits a U.S. tax-exempt investor to avoid “unrelated business taxable income” (UBTI) that the tax-exempt investor would otherwise incur if it invested directly in a fund that is treated as a partnership for U.S. tax purposes, and if the fund incurs leverage in the form of borrowing or engages in certain other activities.
- **Non-U.S. investors** who generally desire to invest in an offshore fund — and typically invest in the same offshore fund as U.S. tax-exempt investors.
  - The offshore fund acts as a “blocker” protecting non-U.S. investors from certain potentially adverse U.S. tax consequences described below.

## Tax Flexibility

U.S. tax rules can permit a significant degree of flexibility in structuring hedge funds and how they invest.

- U.S. tax rules permit some entities that would otherwise be treated as a corporation for U.S. tax purposes to elect instead to be treated as a partnership, and similarly permit some entities that would otherwise be treated as a partnership to elect to be treated as a corporation. Some entities can even elect transparent treatment for tax purposes in one country and non-transparent tax treatment in another country,

permitting creative tax planning.

- Hedge funds can invest through a holding company (a “blocker”) created to hold one or more specific investments. If structured correctly, the blocker can hold the investment only on behalf of certain investors (typically U.S. tax-exempt investors and non-U.S. investors) in order to protect them from certain adverse tax consequences (although the blocker will typically incur some tax liability).
- Under certain circumstances, swaps or other derivative instruments can be used to protect against certain tax consequences of specific investments.

### **Which Investments Create Tax Issues?**

Certain types of investments create adverse U.S. tax consequences for non-U.S. investors (including a typical “offshore” fund through which U.S. tax-exempt investors may invest). In general, non-U.S. investors (including an offshore fund) should avoid investing directly in anything that results in their being deemed to be “engaged in a trade or business” within the United States, as that will result in the non-U.S. investor becoming subject to U.S. net-basis income tax and being required to file a U.S. tax return. The key categories of investments that can raise issues for non-U.S. investors are:

- **U.S. Real Property Interests.** A non-U.S. investor’s gain from “U.S. real property interests” is treated as U.S. trade or business income. Accordingly, a non-U.S. investor should not invest (directly or indirectly through a fiscally-transparent entity such as a partnership) in U.S. real property interests.
  - U.S. real property interests generally include interests (other than as a creditor) in U.S. real estate and in any stock of a U.S. corporation which is a U.S. “real property holding corporation” (i.e., the assets of which consist principally of U.S. real estate at any time during a testing period consisting of the five years prior to the disposition of the stock (or, if shorter, the taxpayer’s holding period)).
  - There is, however, an exception for holdings of 5% or less of a class of stock of a corporation if such class is “regularly traded” on an established securities market. Accordingly, a non-U.S. investor can avoid these issues by owning regularly traded stock meeting the “5% or less” threshold. Although not entirely clear, this 5% test is typically applied at the partnership level (e.g., in a master-feeder structure, at the master fund level, not at the feeder or investor level).
- **REITs.** Certain adverse tax consequences to non-U.S. investors can result from an investment in a real estate investment trust (“REIT”).

- A non-U.S. investor will not be subject to U.S. tax on gain from the sale of stock in a REIT if either (i) the REIT is “domestically controlled,” or (ii) the class of REIT stock is, as mentioned above, regularly traded on an established securities market, and the non-U.S. investor owns (during the testing period) 10% or less of the shares of such class of REIT stock. A REIT is domestically controlled if U.S. persons own directly or indirectly 50% or more of the value of the REIT’s stock. Often, it is not possible to be certain about the domestically controlled issue in a publicly-traded REIT, but if the non-U.S. investor owns 10% or less of the shares of a class of regularly traded REIT stock, then there is no U.S. tax on gain from the sale of such stock.
  - Dividends from a REIT are subject to U.S. dividend withholding tax.
    - The portion of a REIT distribution representing ordinary earnings is subject to a 30% rate. The portion representing a return of capital is subject to a 15% refundable withholding tax (FIRPTA withholding), unless the REIT is domestically controlled. The portion representing the REIT’s capital gain generally is subject to a 21% withholding rate.
    - These rates are subject to reduction by applicable U.S. tax treaty, although the normal offshore fund is formed in a no-tax jurisdiction without a U.S. tax treaty.
- Generally, however, if a non-U.S. investor satisfies the 5% rule and owns publicly-traded stock, then there are no severe disadvantages. Most REITs try to minimize capital gains (through tax-deferred like-kind exchanges) in order to avoid having to distribute the amount of the capital gain. On the other hand, dividends from a REIT often represent a large portion of the return, and these are subject to U.S. withholding tax.
- **Partnerships.** A non-U.S. investor should not invest in a partnership, limited liability company, grantor trust or other fiscally-transparent (i.e., tax flow-through) entity that carries on business (as opposed to investment) activities.
  - This would include most publicly-traded partnerships, or “MLPs”, such as pipeline and resource partnerships. These generally are considered to be engaged in business but are allowed to be publicly-traded in partnership form. (In 1987, the law was changed to make most publicly-traded partnerships taxable as corporations, but exceptions were made for investment, timber, real estate, resource, pipeline and similar partnerships.)
- **Fee Income.** A non-U.S. investor should not receive any fee income, such as directors’ fees, transaction fees, commitment fees, syndication fees, or break-up

fees. Typically, offshore funds are structured so that such fees are received by the manager, generally with some reduction in the manager's fixed fee from the fund.

- **Lending.** A non-U.S. investor should not engage in any activity that might be deemed to be in the business of "lending" or originating loans.
  - Generally, this means that purchases of loans should generally only be made in secondary-market transactions (i.e., purchases from sellers that have closed and funded the loan prior to the time of the purchase by the non-U.S. investor) and that a non-U.S. investor should avoid originating bank loans, assisting in the formation of lending syndicates, entering into commitments to make a loan, receiving commitment fees or acting as agent for a lending syndicate.
- **Portfolio Interest.** U.S.-source interest (including original issue discount) that does not constitute "portfolio interest" is subject to U.S. withholding tax at a 30% rate (unless a reduced rate or an exemption applies under an applicable U.S. tax treaty).
  - Generally, in order to qualify as "portfolio interest," the underlying debt must be in registered form (i.e., the issuer or an agent maintains a register with respect to the debt indicating outstanding principal and interest and the name and address of each participant). Also, a non-U.S. investor will be subject to withholding tax received from an issuer even on registered debt if the non-U.S. investor also owns directly or indirectly 10% or more of the voting power (or, in the case of issuers which are partnerships, 10% or more of the value or voting power) of the outstanding stock of the issuer.
- **Physical Commodities.** Income from trading physical commodities will ordinarily not give rise to U.S. taxation (since such trading will not typically give rise to a U.S. trade or business). This exception may be inapplicable, however, if the type of physical commodities traded is not traded on a regulated futures exchange.
- **REMIC Residuals.** Income from real estate mortgage investment conduits (REMICs) allocable to non-U.S. persons is subject to complex rules and potentially very high rates of withholding tax.

## The Takeaway

Investments may be possible in each of these categories of investment with appropriate tax planning, such as investment through a "blocker" corporation to avoid or limit the adverse tax consequences.

- **Christopher M. Wells**

Partner

- **Caryn J. Greenspan**

Partner

- **Jennifer Dunn**

Partner

- **Kelli L. Moll**

Partner