Proskauer

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.

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