A BASIC OUTLOOK ON HEDGE FUND STRUCTURE AND TAXATION ISSUES

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I. INTRODUCTION

In today’s worldwide financial arena, investing in the global and state markets has become a sophisticated and difficult task. Financial instruments have been created to satisfy the market demands for risk taking and niche investing. One of the popular financial vehicles, which allow wealthy individuals, prospering businesses, and charitable organizations to participate in diverse investment strategies, are called hedge funds. “The term hedge fund is commonly used to describe a variety of different types of investment vehicles sharing common characteristics. Although it is not statutorily defined, the term encompasses any pooled investment vehicle that is privately organized, administered by professional money managers, and not widely available to the public.”¹ Traditionally, these types of funds are highly leveraged and invest in high-risk financial derivatives. In today’s global market, hedge funds encompass different types of strategies that may fit every client’s individual investment need.

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Given the nature of this type of investment vehicle, it is important that these funds are structured in accordance with applicable securities and tax law in order to avoid complex regulatory hurdles and minimize tax liability. This work will discuss the basic aspects of a Hedge Fund’s structure and some of the fundamental issues they face in regards to United States Federal taxation.

II. HEDGE FUND STRUCTURE

A. U.S. Hedge Fund Corporate Structure

The basic hedge fund structure consists of two entities, (1) Hedge Fund, which possesses exclusively assets for the purpose of investing and (2) the Hedge Fund Manager, which administers the hedge fund’s daily operation and investment strategy. The first important step in structuring a hedge fund is deciding under which type of legal entity the fund should be organized. There are five types of entities under which a fund may be structured: (1) Subchapter C corporation, (2) Subchapter S Corporation, (3) SEC Regulated Investment Company, (4) Partnership and (5) Limited Liability Corporation (LLC)². Subchapter C corporations are usually not an appropriate legal entity to structure a hedge fund, mainly due to the high corporate tax rate and double taxation issues, as the shareholders’ dividend distributions are also taxed. Although a Subchapter S corporation may elect to be a pass-through entity, the restriction on the number and type of investors is normally unsuitable for hedge funds³. Though regulated investment companies, consisting of mostly mutual funds, are not taxed at the entity level, they are subject to limitations on investment strategies and complicated regulations.⁴

Most hedge funds are organized as limited partnerships due to a partnership’s ability to be considered a pass-through entity for tax purposes. Hence, partners are not subject to double taxation, and report their shares of the partnership’s earnings on their individual tax returns. But if the partnership is

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³ Subchapter S corporations must be a domestic corporation, only natural personas and certain trust and estates may be investors and has a limit of 100 shareholders. See Internal Revenue Service, S corporations, http://www.irs.gov/businesses/small/article/0,,id=98263,00.html (last visited Jan. 26, 2011).
considered a publicly traded partnership, it would lose its pass-through status and be subject to taxation as a Subchapter C corporation for Federal income tax purposes. Although an LLC may elect to be taxed as Subchapter C Corporations or pass-through entities, the entity may be subject to additional states taxes. Nevertheless, Hedge Fund Managers are typically established as a LLC or subchapter S corporation for liability reasons and normally elect to be taxed as a pass-through entity.

After the Hedge Fund and Hedge Fund Manager have elected their respective type of business structure, the next step is filing for registration. Typically the hedge funds are organized in states such as Delaware because of their pro-business corporate laws and its state court’s sophisticated history in corporate law jurisprudence. The Hedge Fund Manager will be the general partner in the limited partnership or investment partnership (the hedge fund). The organizations will be domiciled in Delaware, with its corresponding resident agent and physical address, but will not have a physical business in the state, since Delaware’s law imposes state corporate taxes on LLCs and partnerships. The principal place of business will be in a state like Connecticut, i.e. in a state that does not impose tax on LLC or pass-through entities and does not require the fund to register as an investment advisor in cases where the fund does not have to register with the Securities and Exchange Commission (SEC).

A hedge fund’s structure is designed to collect capital from numerous investors and pull it together to undertake a general or specific type of investment strategy. As established, the typical hedge fund structure is two entities, consisting of (1) the hedge fund manager, organized as an LLC, who will be the general partner in the hedge fund, and (2) the hedge fund as a limited partner. The hedge fund manager administers the limited partnership’s day-to-day operations and investments in exchange for management fees paid by the limited partners. The fees, voting power, power of attorney, designation of power, profit sharing and other issues are established in the partnership’s agreement, the document which governs the terms of the partnership. In the partnership agreement “investors must subscribe for a minimum dollar amount of limited partnership or limited

5 Navendu P. Vasavada, supra note 2, at 5.
6 Id. at 6.
7 Id. at 7-9.
8 Id.
9 Id.
10 Id.
11 Id.
12 David August & Lawrence Cohen, supra note 1, at 724.
liability company interests (a substantial investment threshold is generally required to maintain the nonpublic and exclusive nature of the offering), subject to the discretion of the general partner to accept a lesser amount."

According to “The Securities Act of 1933” and “The Investment Company Act of 1940”, investment partnerships can only admit certain types of investors in order to be exempt from SEC regulations. A hedge fund does not want to trigger this type of complex and rigid regulation. The investors which do not trigger SEC regulations are the following: (1) Accredited investors, defined by the SEC in regulation D as individual with more than $1 million in assets, individuals with incomes exceeding $200,000 in the most recent two years or joint income of $300,000 for the same years, banks, insurance companies, pension funds, business and non profits exceeding $5 million in assets and executive officers or director of these companies; (2) Qualified Purchasers- is an individual who owns not less than $5 million in investments or any entity that invest at least $25 million; and (3) Foreign Investors.

To accommodate the market's demand, many hedge funds will set up a feeder funds for its foreign and U.S. tax-exempt investors. A feeder fund is a fund established in a foreign jurisdiction, usually a tax haven, which has an interest in the investment partnership organized in the United States of America. This fund may accommodate its foreign investors who do not want the IRS in their personal affairs. Usually the IRS requires the names of partners in a U.S. investment partnership, but regarding foreign feeder funds, the I.R.S only requires the foreign fund's name (and not the foreign investor's name). This type of fund is also called a blocker corporation, which is of great significance to U.S. tax-exempt investor. This issue shall be discussed later on the article.

B. Foreign or Offshore Hedge Fund Structure

\[\text{id.}\]
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Establishing a foreign fund is fairly easy as there are many tax haven jurisdictions specializing in this type of organization. Although these jurisdictions are spread throughout the world, many of them are in the Caribbean. The most popular jurisdiction for hedge funds is the Cayman Islands. This jurisdiction has no corporate tax and is governed by the laws of the United Kingdom, since the Cayman Islands is a British Overseas Territory. To organize an offshore hedge fund, the same U.S. dual entity structure is used. Take the following example, where the hedge fund is to be registered in the Cayman Islands. Two organizations are registered: the hedge fund manager, registered as an exempt company and who is the general partner of the hedge fund, and the hedge fund, registered as a limited partnership or mutual fund. A partnership agreement is drafted in the same manner as in the U.S. and then it is submitted to the government for approval. Annual audit and registration fees are required for establishing the entities in the Cayman Islands, but their regulation is not as strictly enforced as those of the Securities and Exchange Commission.

The master feeder structure is the way hedge funds with a diverse group of clients are commonly organized. This structure consists of several feeder funds and one master fund. The feeder funds, usually a limited partnership (but it may be an offshore corporation), will acquire an interest in the master funds. Under this arrangement, the feeder funds will transfer all of its assets to the master fund. The master fund allocates all the feeder fund’s assets and all of the trade transactions will take place in the master funds account. This organization allows for the accommodation of different types of clients. For example, if the master fund is an offshore fund in the Cayman Islands, most likely there will be a feeder fund for U.S. investors and an offshore feeder fund organized as a corporation for U.S. tax-exempt organizations. Also, there might be another fund for foreign investors who wish to maintain a certain level of anonymity. All these investors buy an interest or a share in the feeder fund, which subsequently buys an interest in the master fund, allowing all the resources to be managed by the master fund. The location of the master funds will depend on the hedge fund’s clients and hedge fund manager’s tax strategy.

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23 Henry Smith, Cayman Island Exempted Limited Partnerships, 1683 PLI/Corp 63, 68.
24 NAVENDU P. VASAVADA, supra note 2, at 38.
25 Id. at 38.
26 Id.
It is worth addressing that section 864(b)(2)(A)(1) of the U.S. Tax Code states that foreign entities’ income derived from trading from their own account in stocks, securities and commodities are not engaged in trade or business in the United States.27 These provisions enable foreign hedge funds to establish branches in the U.S. without fear of being taxed.28 The guides clearly state that the fund may be a dealer of such financial instruments.29 This provision is most useful to offshore hedge fund managers located in the U.S.

C. Passive Foreign Income Taxation

Another aspect worth mentioning is the U.S. tax treatment of foreign investment in passive income, as the majority of a hedge fund’s income derives from passive investments. Section 871 states:

Income other than capital gains.--Except as provided in subsection (h), there is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as .... interest ..., dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income.30

This section of the code clearly states that a 30% withholding tax will be imposed on all U.S. passive income received by foreign individuals. Section 881 is the equivalent statute for foreign corporations. Capital gains have been excluded from the withholding tax due to the buyer’s uncertainty and lack of knowledge about the seller’s tax base.31 Also, section 871(h) and 881(c) exempts from taxation portfolio interests32, resulting in almost all U.S. interest received by an offshore hedge fund being tax free. An exception to section 871(h) and 881(c) has been provided to any foreign person who owns 10% or more of the shares of the

28 Id.
29 Id. See also, NAVENDU P. VASAVADA, supra note 2, at 42.
31 JOSEPH ISENBERGH, INTERNATIONAL TAXATION 84 (3rd ed., 2010).
32 U.S. source interest from debt obligations held for investment by a foreign person.
debtor. For example, if X, a foreign person, own 15% of the share of Z, a U.S. corporation, and X buys bonds issued by Z, the interest from X's investment Z's bonds will not be tax free.

Vasavada explains that the withholding of the 30% tax on passive income to foreign investors may become a structural matter that the offshore hedge funds must deal with. If the master fund is in the U.S and it admits offshore investors, then the master fund will be the withholding agent. If the master fund is the offshore hedge fund and it wants to make sure that their U.S. investors are not subject to an inapplicable tax, they must file the required 1042 withholding tax form. This form requires the names of all investors in the fund, and may also require the fund to set up a separate feeder fund for its non-U.S. investors to ensure that the only name the IRS receives is the name of the non-U.S. feeder fund. U.S. Tax-Exempt Corporations that invests in foreign feeder funds organized as corporations will have the 30% flat rate tax, since it applies to the foreign corporation. Hedge Funds managers must take this fact into consideration when designing the particular investment strategy in order to minimize as much as possible the potential tax liability to their investors.

III. US INVESTORS IN OFFSHORE HEDGE FUNDS

When offshore hedge funds take U.S. investors as limited partners, they are exposed to unpopular and uncertain dispositions of the United States Tax Code which make it difficult for the fund managers to take on too many U.S. investors. Primarily, two portions of US tax code affect the relationship between offshore hedge funds and U.S. investors: Controlled Foreign Corporations and Passive Foreign Investment Companies.

Section 957(a) defines “Controlled Foreign Corporations” (CFC) as “any foreign corporation if more than 50 percent of (1) the voting power of all class of stock...entitled to vote, or (2) the total value of the stock is owed... by United States shareholders on any day during the taxable year of such foreign corporation.” To understand this definition it's very important to also state the a U.S Share holder is defined in section 951(b) as “a United States person... who owns... 10 percent or

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33 Id. at 86.
34 NAVENDU P. VASAVADA, supra note 2, at 46.
35 JOSEPH ISENBERGH, supra note 31, at 191.
more of the total combined voting power of all class of stock entailed to vote of such foreign corporation.”

Under I.R.C. Subpart F rules, any income derived from a CFC which is considered to be tax haven income will be subject to taxation in the United States. The most significant tax haven income is the Foreign Base Company Income which, according to the U.S. tax code, is divided into the following four types of foreign income: (1) Foreign personal holding company income, (2) Foreign base company sale income, (3) Foreign base company service income, and (4) Foreign based company oil related income. Given the scope of this work, it is only necessary to discuss one of the four types of income: Foreign personal holding company income. Foreign personal holding company income is mostly gross income derived from passive investments such as dividends, interest, sale of property, rent, royalties and annuities. Although an exception exists for active financial service income, it does not apply in the case of hedge funds since most of the investment partner’s income is derived from passive investment, even though it is actively managed. This exclusion refers to more traditional banking services, such as loan origination.

In the offshore hedge fund industry, it is unlikely that rules regarding CFCs apply to participation interest in a limited partnerships or non-voting shareholders in offshore legal entities. However, since the U.S. government has been historically known to stretch its outbound power of taxation, it may not be long before new legislation is approved which imposes taxes on interest holdings in any foreign entity. It is therefore important for hedge fund managers and investors to take into consideration these rules and try to stay clear of any situation that would trigger CFC rules.

Another problem that the U.S Internal Revenue Code presents to U.S. investors in a foreign hedge fund is the effects of being classified as a Passive Foreign Investment Company (PFIC). According to section 1297(a) of the Internal Revenue Code a Passive Foreign Investment Company is defined as

Any foreign corporation if (1) 75 percent or more of the gross income of such corporation for the taxable year is passive income, or (2) the average percent of assets held by such corporation during

36 I.R.C § 957(a) (2011). See also JOSEPH ISENBERGH, supra note 31, at 191.
37 Income which is shifted from a high tax jurisdiction to low tax jurisdictions.
39 Id.
40 NAVENDU P. VASAVADA, supra note 2, at 18.
the taxable year which produce passive income or which are held for
the production of passive income is at least 50 percent.41

Therefore, any foreign entity that engages primarily in the business of
investing and trading in securities will be considered a PFIC.42 Offshore hedge
funds, for the most part, will be considered subject to the PFIC regimen for its U.S
investors' tax purpose43

The current statute that governs PFIC's imposes a distinctive type of taxation
which focuses on denying the U.S. investor the benefit of deferring taxation on their
PFIC investment. Section 1291 establishes that at the moment of distribution or sale
of a PFIC holding, a special procedure is used to calculate the tax liability of the
aforementioned investment. The income from the distribution or sale is
proportionally allocated to each number of years the U.S. investors held the PFIC's
stock or investment. Afterwards, the current year amount is included as ordinary
income and the taxpayer must pay a deferred tax amount that represents the tax
owed from the prior years plus interest.44

U.S. PFIC investors can also benefit from an alternative “check the box”
provision, allowing U.S. Investors to select taxing their PFIC holding under a current
U.S. taxation regimen.45 This option taxes the PFIC income in a manner much like
CFCs. A third option for taxing PFIC, established by section 1296, involves a mark to
market valuation of the PFIC shares, or holdings, and recognizing the unrealized
gain or loss each taxable year. By means of this option, the U.S. investor includes as
ordinary income any unrealized gains over the taxable year or deducts an ordinary
loss for any unrealized loss during the taxable year.46 Following this method, the tax
basis for the PFIC will be up-to-date if the shares are sold during future years and
there is no deferred tax to be applied. The only problem with this election is that it is
only available to PFIC that trade in a regulated market or periodically reports its net
assets value.47

Due to the compliance requirements that U.S investors trigger for offshore
hedge funds, many have decided not to include U.S. investors. Since many offshore
entities qualify as PFIC's, the IRS may require them to calculate the PFIC income for
their U.S investors and many hedge fund managers view all the additional filing

41 I.R.C. § 1297(a)(2011). See also, JOSEPH ISENBERGH, supra note 31, at 204.
42 Id.
43 NAVENDU P. VASAVADA, supra note 2, at 18.
44 I.R.C §1291 (c)(2)(2011). See also, JOSEPH ISENBERGH, supra note 31, at 204.
45 JOSEPH ISENBERGH, supra note 31, at 204.
46 Id.
47 Id.
requirements as a hazard rather than an investment, and thus shut the door to U.S investors.48

The U.S. Tax Code enables master feeder structured foreign hedge funds to be classified as a partnership or association for U.S. tax purposes and not be classified as a PFIC49. Hence, “if a U.S. Investor in an offshore fund selects the check the box provision of its classification [it] is not subject to PFIC rules.”50 Many hedge funds that use the master feeder structure can see significant gain from acquiring the IRS status as a partnership. Offshore master funds tend to set up feeder funds just for United States investors. This feeder fund, which owns a stake of the master funds, handles all the IRS filing and requirements for the U.S. Investors.51 Accordingly, the U.S. investors do not have to worry of the difficulties and complexities of the PFIC classification.

Foreign hedge funds dealing with U.S. investors seem to cause a lot of regulatory complexity, but considering the benefits received by the hedge fund managers, it is well worth it. It may seem easier to just place the master fund in the United States, but this is dependent upon each particular hedge fund and its client base.52 For example, large institutions and wealthy clients are still concerned with offshore hedge funds due to the lack of regulation and the legal remedies available in other countries, many of which are unknown jurisdictions and do not have extensive and/or sophisticated financial traditions.53 Therefore, there is still a stigma attached to investing in offshore hedge funds, especially in those which are established in small countries considered tax havens.

IV. TAX EXEMPT ORGANIZATIONS

Tax-exempt organizations are granted their status based on public interest. Section 501(c)(3) of the Internal Revenue Code establishes that:

An organization must be organized and operated exclusively for exempt purposes set forth in section 501(c)(3), and none of its earnings may inure to any private shareholder or individual. In addition, it may not be an action organization, i.e., it may not

48 NAVENDU P. VASAVADA, supra note 2, at 40-41,
50 NAVENDU P. VASAVADA, supra note 2, at 15.
51 Id. at 44.
52 Id. at 43.
53 Id. at 35-36.
attempt to influence legislation as a substantial part of its activities and it may not participate in any campaign activity for or against political candidates.\textsuperscript{54}

The government considers that granting a tax-exempt regime to charitable organizations such as universities, research foundations and pension funds will ultimately benefit the general population. Tax-Exempt Organizations represent a vast part of the U.S. economy and are of great importance to financial markets and institutions. Hedge funds derive a large portion of their investment from university endowments and pension funds.

“A 2006 study of national endowments conducted by the National Association of College and University Business Officers (NACUBO) reveals that, of the 755 endowments included in the survey, those with greater than $1 billion in investment pool assets had an average of 22.4% of those assets invested in hedge funds.”\textsuperscript{55}

The difficulty with U.S. tax-exempt organizations investing in hedge funds is that U.S. hedge funds are mostly organized as limited partnerships, because of the benefit of reducing or eliminating double taxation to its U.S. investors. The main problem arises from the use of debt by tax-exempt organizations. Since most hedge funds strategies rely heavily on leverage and a limited partnership being a pass-through entity, the investment partnership (hedge fund) use of debt may trigger “Unrelated Business Taxable Income” for tax-exempt organizations. “Unrelated Business Taxable Income” (UBTI) is defined as “the gross income derived from any unrelated trade or business, regularly carried on by the exempt organization, less the deductions directly


connected with carrying on the trade or business.”\textsuperscript{56} UBIT has exceptions which include passive income from: rent of real property\textsuperscript{57}, mixed leases\textsuperscript{58}, dividends, interest, royalties, income from lending securities, gain or loss from the disposition of property, income from research grants, income from federal authorized licenses, and membership in mutual or cooperative electric companies.\textsuperscript{59}

In the past, tax-exempt organizations were not taxed on any income, including the income derived from a Feeder Corporation that owned an unrelated business, as long as it was all distributed to the tax-exempt entity. This situation angered many Americans since many of these tax-exempt organizations were competing with fully taxable business. Congress in 1950 enacted the UBIT rules, limiting the number of business activities a tax-exempt organization could undertake.\textsuperscript{60} After this enactment, a number of financial transactions emerged to reduce tax liability by sale-lease back agreements. Another mechanism that may be used to limit the UBIT liability was the transferring or sale of the assets of an unrelated business subsidiary to the holding tax-exempt organization and the holding organization’s lease of the assets back to the subsidiary. This created passive income for the tax-exempt organization and increased the operating expenses of the subsidiary, limiting its UBIT tax exposure.\textsuperscript{61} Due to all these creative legal transactions and pertinent jurisprudence validating these transactions, Congress enacted the “Tax Reform Act of 1969” that includes all debt-financed income from property not related to the organizations trade or business as UBIT.

\begin{itemize}
\item \textsuperscript{57} This rent only includes fixed rent and rent from a fixed percentage of gross receipts or sales. \textit{See Id.}
\item \textsuperscript{58} Mixed leases are completely only excludable from UBIT if only 10 percent or less of the rent is from personal property. If personal property accounts for 10-50 percent of the rent only the part of the rent is derived from the real property is excludable from UBIT calculations. Finally, if more than 50 percent of the rent is derived from personal property none of the income is excludable from UBIT calculations. \textit{See Id.}
\item \textsuperscript{59} I.R.S., Publication 598, supra note 23.
\item \textsuperscript{60} I.R.C. § 513, cited in La. Credit Union League v. United States, 693 F.2d 525, 540 (5th Cir. 1982). \textit{See also}, Summer A. LePree, \textit{supra} note 52, at 819.
\item \textsuperscript{61} Summer A. LePree, \textit{supra} note 22, at 819-20.
\end{itemize}
The problems related to tax-exempt organizations and hedge funds have been easily solved by having hedge funds invest in blocker corporations. Structuring a blocker corporation for a master feeder structured hedge fund is fairly simple. The fund would have to organize a separate offshore feeder fund as a corporation, which in part has an interest in the master fund’s limited partnership. The income that is generated by the limited partnership (master fund) is pass-through to the corporation, which then distributes the income as a dividend to the tax-exempt organization, without activating any UBIT rules. It is important that this offshore feeder fund be located in a tax haven jurisdiction. It would be pointless to establish the offshore feeder in a high tax jurisdiction like the U.S., due to the high corporate tax that would have to be paid on the earnings distributed from the master fund to the corporation. When this structure is established correctly, no significant tax emerges on the tax-exempt organization’s investment. This offshore blocker structure has been authorized by the IRS in private letter rulings 20025116 to 20025118, which have served as the basis for all of the offshore tax-exempt organizations investing in hedge funds.

In I.R.S. Private Letter Ruling 200251016, the ruling was requested by a Charitable Remainder Units Trust, who held interest in a limited partnership M. In the ruling, they requested authorization to form a Foreign Corporation N, which would be owned by limited partnership M. Corporation N would then make contributions to other limited partnerships and corporations (investment funds), financed by debt. The IRS stated that:

[u]nder sections 512(c), 512(b)(4), and 514, income from N would be UBTI to M if received directly by M because it is debt-financed income. However, here the income will arrive at M indirectly through N, which will pay dividends to M. Dividend income is not taxable under section 512(b)(1) of the Code or subject to the “controlled organization” rules of section 512(b)(13). Further, M has not itself incurred debt in financing its interest in N, and thus such

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62 Id. at 840.
63 Id.
65 Id.
dividend income is not debt-financed income described in section 514.”

This ruling has resulted in tax-exempt organizations becoming one of the largest client groups in the foreign hedge fund market. These type of rulings have given large tax-exempt institutions like universities and pension funds, a certain peace of mind when it come to taxation issues regarding UBIT and foreign hedge funds. However, they still face concerning issues in regards to the legal environment and lack of regulations under which non-U.S. jurisdiction based hedge funds operate.

It is beneficial to state that not all hedge fund strategies trigger UBIT rules for tax-exempt institutions; only when a hedge fund borrows money to acquire a security investment will it trigger UBIT rules, if a tax-exempt organization has a direct interest in the partnership. Most investment strategies such as shorting, investing in options, future contracts and notions contracts will not be considered to set off UBIT rules.

V. Hedge Fund Manager’s Compensation and Carried Interest

Hedge Fund managers are compensated by means of management fees (fixed fees) and performance fees. Management fees are normally established at a rate of 2 percent per annum of the fund’s net assets value; moreover, this type of fixed fee is the amount charged by the hedge fund manager to cover the basic expenses of running the fund. Fixed fees are taxed at ordinary income tax rates. On the other hand, performance fees are tied to a percentage rate of the funds net realized and unrealized profits after fixed fees, usually at 20 percent. However,

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67 See Summer A. Lepree, supra note 55, at 819.
68 I.R.C. § 514.
69 Id. at 853.
71 Net asset value = funds assets-funds liability.
72 NAVENDU P. VASAVADA, supra note 2, at 46-77.
73 Tax Report, supra, note 68.
these profits are subject to certain restrictions, such as watermark\textsuperscript{74} and hurdle rate\textsuperscript{75}. For example, a partnership/management agreement may establish that performance fees shall only be paid from the fund’s profits in excess of the one year Treasury bill rate.

Performance fees are usually collected in the form of carried interest. Carried interest can be defined as an income derived from an interest in a partnership, that returns a disproportionate amount of income relative to the capital invested to acquire the interest.\textsuperscript{76} The carried interest in performance fees is subject to preferential rates due to the legal and economic characteristics of said compensation. Given the high amount of performance fees hedge fund managers receive, manager compensation has been a problem of much debate for years and has recently been a topic of scrutiny and intense discussion. Many believe that such a high amount of wealth should be taxed as ordinary income and not as capital gains.\textsuperscript{77} However, not all hedge fund managers receive enormous performance fees, but those managers who outperformed the market will most likely receive very preferable and accommodating performance compensation, made up mostly of carried interest.

Carried Interest, as previously defined, is income derived from an interest in a partnership which returns a disproportionate amount of income relative to the capital invested to acquire the interest. Most of the income is subject to long-term capital gains rates, since the tax treatment for partnerships establishes that the partner must pay taxes on income as it is characterized at the partnership level. Furthermore, the long-term capital gains tax rate is significantly lower than the ordinary income tax rates.\textsuperscript{78}

The debate on the tax treatment of carried interest has its roots in profits interest that is rendered as a compensation for a service performed to a partnership. Thus, it is necessary to establish the difference between carried interest and profit interest. Profit interest, by definition, “interest in respect of

\textsuperscript{74}Watermarks are a provision to performance fee calculation that establishes that performance fee can only be paid if the funds profits surpass the funds highest net asset value. Usually this changes with each investor depending on the net asset value of the date of admission to the fund. See NAVENDU P. VASAVADA, supra note 2, at 46-77.

\textsuperscript{75}Hurdle rate are economic benchmark that the fund manager must surpass to be able to collect performance fees. Commonly, hurdle rates are express as Libor + or minus, or t-bills rates. See NAVENDU P. VASAVADA, supra note 2, at 46-77.

\textsuperscript{76}Matthew A. Melone, Success Breeds Discontent: Reforming the Taxation of Carried Interest - Forcing a Square Peg into a Round Hole, 46 DUQLR 421 (2008), at 423.

\textsuperscript{77}Tax Report, supra note 68.

\textsuperscript{78}Id.
which the manager has paid nothing and would get nothing if the entity were liquidated immediately after the interest was issued.” Therefore, the main difference between a profit interest and a carried interest is that the latter takes into consideration that some capital was invested and if the partnership is liquidated, there would be a justifiable claim to some of the proceeds. Carman argues that:

[The general practice has developed to view the disproportionate allocation that is part of the carried interest as a separate profits interest subject to the two revenue procedures. Although no formal statement has been made on the issue, representatives of the IRS have informally indicated that they would not challenge such a position if the disproportionate rights of the carried interest were separately transferable.]

It is essential to discuss that partnership tax law differentiates the services rendered for a capital interest in a partnership and a profit interest. Section 83 states that a person who receives compensation for services provided in the form of a capital interest in a partnership are considered to have received income. The recognition of income occurs when the capital interest is transferable or not subject to a substantial risk of forfeiture, in other words, when the capital interest becomes vested, and thus the amount or the recognition of such depends on the application of section 83.

“The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The receipt of a capital interest in a partnership in exchange for services is taxable to the recipient. The amount of such income is the fair market value of the interest in capital so transferred”.

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80 Id.
83 Treas. Reg. § 1.721-1(b)(1) (as amended 1996), See Melone, supra note 76, at 448.
As mentioned before, under section 83, in properties which are issued as compensation for services, the excess of the value over the amount paid will be considered gross income for the taxable period in which the property is transferred or has substantially vested. Section 83(b) establishes that a taxpayer may elect to include the income related to the property in the first taxable year the property was issued but not fully vested.84

The notion that issuance of profit interest as compensation is not a taxable event was first established in Hale v. Commissioner,85 and the language in section 721-1(b)(1). Later, in Diamond v. Commissioner86, a service provider was issued a 60 percent profit interest in a real estate deal for helping the partnership secure the financing for the project. Shortly after the issuance of the profit interest, Mr. Diamond sold his profit interest for $40,000. The court held that Mr. Diamond recognized $40,000 income when he received the profit interest as compensation. Consequently, the court established that profit interests are a taxable event upon receipt. However, it has been argued that the profit interest established in Diamond may have been a capital interest. Gunn's rationale is that since the interest in the partnership was tied to the sale of a building, the partnership's only asset, the issuance of the profit interest gave Diamond some notion of capital in the partnership.87

Following the great upset represented by Diamond, Campbell v. Commissioner88, gave hope to tax lawyers around the country. The court held that a profit interest in a tax-shelter partnership was not taxable upon receipt because of its lack of fair market value. Although this opinion did not overturn Diamond, it opened a gate for service providers to defer tax on profit interests.89 Due to the amount of resources and time invested in the litigation of this tax issue, the government saw fit to release a set of

84 I.R.C. § 83(b) the rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual, See Cartman, supra note 79, at 31 n. 15.
85 Hale v. Commissioner, 24 T.C.M. 1497, 1502 n. 3 (1965)
86 Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974).
87 ALAN GUNN & JAMES R. REPETTI, supra note 82, at page 30, note 21 (discusses outcome of Diamond v. Commissioner).
88 Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991).
guidelines for taxpayers dealing with this issue. Rev. Proc. 93-27 defines a capital interest as an interest in a partnership that would yield proceeds if all the assets were sold and the partnership liquidated.\textsuperscript{90} Also, it defines profit interest as interest in a partnership that is not a capital interest. Furthermore, Rev. Proc. 93-27 establishes that profit interests issued to service providers are not a taxable event. This rule does not apply if (1) the profits interest is an interest in a substantially certain and predictable stream of income from partnership assets such as high quality debt securities or a high quality net lease, (2) the partner disposes of the profits interest within two years of the grant, or (3) the profits interest is a limited partnership interest in a publicly traded partnership.\textsuperscript{91} Rev. Proc. 2001-43 sheds light on the fact that the determination of whether an interest is a profit interest can be made the moment the profit interest is granted and that neither the issuance of a profit interest nor the vesting of that interest shall be considered a taxable event.\textsuperscript{92}

I.R.C. § 409A, created by “The American Jobs Creation Act of 2004”\textsuperscript{93}, establishes a set of rules which a deferred compensation taxpayer must follow, or consequently risk a 20 percent penalty plus interest on any current or past deferred compensation. Under the scope of this legislation, deferred compensation plans which meet the requirements must:

(1) not permit early distribution. Pursuant to this requirement, a plan may permit distribution only upon separation from service, disability, death, unforeseeable emergencies, change in control of the service recipient, or pursuant to a fixed schedule;\textsuperscript{94} (2) the plan may not permit the acceleration of benefits, except as a result of separation of service, death, disability, change in control, or unforeseeable emergencies;\textsuperscript{95} and (3) deferral elections must be made within prescribed

\textsuperscript{91} Paul Cartman, \textit{supra} note 79, at 37.
\textsuperscript{92} \textit{Id.}
time limits, generally by the end of the service provider's tax year immediately preceding the deferral year.96

Nevertheless, the I.R.S. has not expressed whether this statute is applicable to partners and partnerships. Accordingly, income from profit interest in a partnership shall not considered deferred compensation pursuant to the 409A legislation,97 unless the I.R.S. releases specific guidelines that enable its applicability to partners and partnerships.

In accordance with tax laws and regulations, hedge fund carried interest is not a taxable event at the time it is granted. But, it is important to clarify that any profits received from carried interest is subject to partnership taxation, and the income in the manager’s tax return will have the same characteristics as the income in the partnership.98 Also, although hedge fund managers’ strategies vary, many of them look to leverage short term gains to maximize profits given that those types of short term capital gains are taxed at the ordinary income level. Therefore, carried interest issues with hedge fund managers’ compensation are completely misconceived. The hedge fund industry tends to have more short-term capital gains than long-term. Moreover, certain industries, including private equity and venture capital funds, would suffer if legislation which taxes carried interest at ordinary income rates is approved. Before enacting these types of laws it is important to consider the effect that these industries have on the overall economy and if the approval of this type of legislation would displace these financial institutions (i.e. asset managers) to other countries where they cannot be taxed.

VI. HEDGE FUND MANAGER AND PUERTO RICO

Due to Puerto Rico’s current state of economic turmoil, the Puerto Rico Department of Treasury desperately needs to raise revenues and the government needs to inject capital into the struggling economy. With the exit of various pharmaceutical companies and the government’s increasing disregard towards a declining manufacturing sector, it is the right and

97 Id.
98 Id. at 422.
appropriate time for hedge fund managers to establish operations in the Island. Puerto Rico has a sophisticated financial sector and well-educated financial, accounting, and legal work forces as well as significant tax incentives for the financial management industry.

According to the “Economic Incentives Act for the Development of Puerto Rico,” eligible services dedicated to foreign markets include:

“(2) Investment banking and other financial services including but not limited to services of: (i) asset management; (ii) alternate investment management; (iii) management of private capital investment activities; (iv) management of hedging funds or high risk funds; (v) pools of capital management; (vi) administration of trusts that serve to covert different groups of assets into securities; and (vii) escrow accounts administration services.”

Under this incentive legislation, hedge fund management companies would receive a preferential fixed income tax rate of 4 percent, tax-exempt dividends and profit distributions from eligible businesses, and a 4 percent tax rate on the gains of the sale of shares, interests, and assets of the eligible businesses. These incentives create a drastic reduction of tax liability for the hedge fund manager. Furthermore, if the shareholders of a Hedge Fund Management Company organized in Puerto Rico were to qualify as bona fide residents of Puerto Rico, under sec. 933 of the U.S. Tax Code, this individual would not have to pay U.S. federal taxes on his Puerto Rico source income. He would pay federal taxes solely on his U.S. earned income. In this scenario, if a hedge fund manager moved to Puerto Rico and qualified as a bona fide resident, the tax rate on his portion of carried interest compensation (not

100 Id. at §3 (3)(a).
101 Id. §3(3)(d)(2) and (3).
deemed U.S. effectively connected income) would be exempt from U.S federal taxation, and would only be subject to Puerto Rico’s 4 percent fixed tax rate.

In order for these incentive laws to apply, the hedge fund management company must be established in and export services from Puerto Rico. This is fairly easy task using a master feeder structure, where the master fund is established in a tax haven jurisdiction like the Cayman Islands – not triggering any U.S. effectively connected income- and its feeder funds are organized according to the hedge fund’s clientele. In this structure, like in a typical U.S. hedge fund structure, the hedge fund manager established in Puerto Rico would be the general partner in the limited partnership established in the Cayman Islands. Under this organizational scheme, the Puerto Rico incentive laws would apply since the service is being exported to the Cayman Islands. Consequently, it would effectively work to legally reduce the impact of U.S. Federal Taxation.

These incentive laws create a great opportunity for hedge fund managers. Even though their compensation is under significant scrutiny, these laws would give them a chance to lower their tax liability and escape the problematic compensation issue. The main problem this proposed structure entails is Puerto Rico’s government. Political and fiscal implications may motivate the government to establish rash taxing policies that could have serious repercussions on eligible exempt businesses. This is illustrated by the enactment of Act 154 of October 25, 2010 by means of which the P.R. government changed the income sourcing rules and placed an excise tax on sales between affiliates of multinational manufacturing companies.103 Nevertheless, this is only a consideration in the complete decision to establish a Hedge Fund Management Company in Puerto Rico. It could well be asserted that the established tax incentives outweigh the risks and potential downfall.

VII. CONCLUSION

The hedge fund industry is undeniably an important part of the global financial markets, where its creative structuring and tax planning exemplify the real challenges in this field. Hedge Funds and Hedge Fund Managers deal

\[103\text{ 2010 P.R. Laws No. 154; as amended by 2010 P.R. Laws No. 157.}\]
with an immense number of issues ranging from taxation, accounting, regulations, and even public relations. It is essential that government agencies and institutions understands that this industry is one which will be long lasting and tries to encourage their practices, all the while looking out for the public's well being. A hedge fund's day-to-day business is already overly stressful and demanding, without acknowledging the legal taxation issues. These legal taxation issues further complicate the matter, even though they play a small part in the general scope of the business, taxes can boost or shatter profits.