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Expanding to a 3(c)(7) Fund: A Tax-Free Transaction? Maybe Not!

By Maury Cartine, CPA

VIRTUALLY ALL DOMESTIC hedge fund partnerships (hedge funds) enjoy exemption from a number of laws and regulations that promote their appeal to a wide variety of investors. One key exemption that hedge funds enjoy is the exemption from registration under the Investment Company Act of 1940 (the Act). Most older hedge funds and even many newer hedge funds rely on the specific exemption provided under Section 3(c)(1) of the Act. Under this Section, a hedge fund is not required to register so long as the total number of partners does not exceed 100 (a 3(c)(1) fund). The 100 partner limitation may serve a hedge fund well in the early years, but as soon as investor's take note of the hedge fund manager's performance and the assets under management grow, the hedge fund may come precariously close to exceeding the 100 partner limit. For many years, there was no good solution to this conundrum. Faced with few alternatives, an investment manager would have to consider throwing smaller investors out of the fund. Imagine the goodwill created by tossing out the original contributors of capital from a successful hedge fund!

Fortunately, Congress rescued hedge funds from the 100 partner limit by adoption of Section 3(c)(7) under the National Securities Markets Improvement Act of 1996. Section 3(c)(7) permits a hedge fund to have an unlimited number of partners provided all the partners are "qualified purchasers" (a 3(c)(7) fund). The select group of "qualified purchasers" includes individuals with at least five million dollars of investments and institutions with at least twenty-five million dollars of investments. The number of partners in the 3(c)(7) fund is effectively limited to 499 by the registration requirements under the Securities and Exchange Act of 1934. Even the most insatiable hedge fund manager will want to avoid the registration of the partnership interests.


Maury Cartine

Suppose you are a hedge fund manager with a great track record, a long list of qualified purchasers waiting to get into your hedge fund and an existing Section 3(c)(1) fund (old fund) with close to 100 partners comprised equally of partners who are qualified purchasers and non-qualified purchasers. You decide that you want to get your 3(c)(7) fund (new fund) up and running and you want to free-up some partner slots in your old fund. The best way to accomplish your goal is obvious. You simply transfer your qualified purchasers out of the old fund and into your new fund. You consult with your attorney and your accountant and a new 3(c)(7) fund is set up to accept the transfer of securities and qualified purchasers from the old fund. To complete the transaction, the securities are transferred from the old fund to the new fund and the old fund receives a limited partnership interest in the new fund. Simultaneously, the old fund distributes pro-rata shares of the limited partnership interest in the new fund to the qualified purchasers. Your attorney and your accountant reassure

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Energy Hedge Funds: Short or Long-Term Minded?

By Steven M. Levitt

IN RECENT TIMES, hedge funds have been accused of short-term opportunistic trading that hurts end consumers. This past June 26, House Speaker Nancy Pelosi – and over 20 other representatives – accused hedge funds for partial responsibility for the rising commodity prices hurting American end consumers. Heated political debate resulted in the approval by a vote of 402 to 19 of a bill – H.R. 6377 Act—designed to strengthen powers of the Commodity Futures Trading Commission to help prevent market disturbances caused by commodities traders.

These politicians are mistaken in their over-generalization of the negative consequences of energy trading by hedge funds. In fact, many of the most successful energy hedge fund traders are long-term minded and actually promoting market efficiencies which benefit not only American but global consumers and industries over the long term.

Global energy investing is attractive as oil, gas, and other commodities hedge against inflation and currency depreciation. As global GDP growth is expected to slow from 5% in 2006 to 3.7% in 2008 according to the IMF, more investors are likely to be seeking opportunities to hedge with commodities. However, as sophisticated investors, hedge funds in the energy sector fundamentally understand that profits are earned over the long term and are less short-term driven than some believe.

According to Barclays, surprisingly only 80 hedge funds globally focus on energy out of a universe that exceeds 9,000. Of the six largest hedge funds, only one, D.E. Shaw, has a primary focus on energy, power, and commodities. In the case of oil, energy hedge funds are not materially impacting oil prices as some claim. Rather, these prices are rising for three main reasons:

1) World oil demand exceeds supply by 1.3 million barrels per day
2) Current global inventories are known to be low
3) Substantial political risk exists in the Middle East and Nigeria

Energy is a risky business and profit is uncertain. For all the vast fortunes made through energy, many have been lost as well. Successful energy hedge funds count years of knowledge and experience in their sub-areas of expertise which include traditional oil and production to energy technology and alternative energy. Some hedge funds focus on emerging markets or even more narrowly on energy in India or China. The successful energy hedge funds know what they are doing and do not take wild bets.

An example of one very successful energy hedge fund with specialized expertise is Eight Winds Partners. This fund, which returned over 79% in 2007, invests in high-tech energy-related projects: hybrid electric vehicles, nano-tech batteries, synthetic fuels, coal-to-liquids, thin-film photovoltaic, and electrochemical energy conversion devices. Passport Capital is another fund that also benefited from energy-efficient technologies. This fund achieved returns in 2007 in excess of 60% by creating global portfolios with a long-term orientation investing in oil, alternative energy sources, and the development, manufacture, and promotion of energy-efficient technologies.

The most successful energy investors, like Eight Winds Partners and Passport Capital, are winning through deep industry knowledge and risk management expertise in specialized areas rather than short-term moves in the market. For instance, an investor in electricity needs to have specialized knowledge of structure of contracts and competitive legislation in a given jurisdiction. In the case of liquefied natural gas, an investor needs to understand government and market incentives that impact consumer market demand for natural gas versus other energy sources.

Finally, because energy trading is relatively new, asymmetry of information remains an issue. Hopefully, energy markets will continue to become more and more efficient over time. Lawmakers should focus on promoting efficiency and competition rather than strengthening bureaucratic powers. Perhaps Harry Browne, a past independent Presidential candidate, said it best: "The free market punishes irresponsibility. Government rewards it." MK

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Expanding to a 3(c)(7) Fund: A Tax-Free Transaction? Maybe Not!

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you that the transaction is income tax-free and their advice is generally correct provided that the transfer of securities does not run afoul of some very complex rules: the investment partnership rule (e.g., distributions of securities from partnerships that do not qualify as investment partnerships are treated as a distributions of money resulting in taxable gain or loss) and the investment company rule (e.g., only substantially identical securities are transferred to the new fund or alternatively, no one security equals more than twenty-five percent of the transferred portfolio of securities and no five or fewer securities equal more than 50% of the transferred portfolio). The adverse tax consequences resulting from the complex investment partnership and investment company rules can generally be easily avoided in the transfers of securities from the old fund to the new fund.

You may at this point be inclined to think exactly what can go wrong?

Suppose your old fund transfers a pro-rata share of each security. This certainly would appear to be the equitable thing to do. The securities transferred have, as would be expected, a total fair market value equal to the book value of the capital accounts of the qualified purchasers moving into the new fund. The old fund had been hugely successful and the transferred securities were highly appreciated. Unfortunately, the qualified purchasers moving to the new fund were not so lucky. They were relatively new partners who had not shared in the huge success. In fact, some of the partners had experienced a small loss in the old fund. As might be expected, these partners had little or no unrealized gain in their capital accounts (the partners' book and tax basis capital accounts were virtually equal). At the same time, the securities transferred to the new fund had a relatively low tax basis and a very significant unrealized gain. Like most modern era investment partnerships, the old fund and the new fund allocate gains and losses under the aggregation method.

The potentially inequitable result should be foreseeable, but because of the complexity of these transactions the unintended result can be overlooked. Suppose that the highly appreciated securities now held by the new fund are subsequently sold. **The taxable gain resulting from the sale of the highly appreciated securities will be allocated to the 3(c)(7) fund partners that never shared in the economic gain.** The more quickly the securities are sold, the more inequitable the result. The inequity will not be corrected until the partners that moved to the new 3(c)(7) fund completely withdraw their interests in the fund.

This bad result can be avoided by transferring all the securities headed to the new fund directly to the qualified purchasers moving to the new fund as a first step. The qualified purchasers would then contribute the securities to the new fund and the tax basis of the contributed securities would be stepped up to an amount equal to tax basis of the qualified purchasers' partnership interests and the unrealized gain on the highly appreciated securities would be eliminated. Unfortunately, this solution works only in isolated cases. Imagine formally transferring a very large portfolio of securities from the old fund to the separate brokerage accounts of many qualified purchasers as a first step and next having each qualified purchaser transfer the securities to the new fund. The paper shuffling and potential economic risk associated with this type of transfer will not likely be well received by the qualified purchasers transferring into the new fund.

Recent law changes cause the problems in the new 3(c)(7) fund to spill over into the old 3(c)(1) fund. If the old fund transfers out a disproportionately large amount of unrealized gain, the old fund will be required to reduce the tax basis of its remaining securities. Consequently, the unrealized appreciation transferred out to the new fund will also be taxed again to the partners in the old fund when the partnership sells its other securities in the ordinary course. The unfortunate partners in the old fund can thank the mandatory tax basis adjustment rules under American Jobs Creation Act of 2004 for this result. There appears to be no remedy for the resulting double taxation until an affected partner chooses to withdraw from either the old fund or the new fund. The last thing a hedge fund manager needs is a tax induced withdrawal from the fund!

Facing this situation, what should a hedge fund manager do?

He should consider equalizing the unrealized gain in the transferred securities to the unrealized gain in the capital accounts of the moving partners. He should also weigh the tax benefits of a non-pro-rata transfer of securities against his fiduciary obligation to the partners. The hedge fund manager may also consider choosing different lots of the same security to equalize the disparity in the unrealized gains between the partners remaining in the 3(c)(1) fund and the partners moving to the 3(c)(7) fund. The inequity will be mitigated by substantial capital contributions to the new 3(c)(7) fund from the long waiting list of qualified purchasers or by long holding periods for the transferred securities. The hedge fund manager might consider distributing cash to the qualified purchasers in exchange for their partnership interests in the old fund. The qualified purchasers would then contribute only cash to the new fund and the tax problems miraculously disappear! This solution seems simple enough until the hedge fund manager considers the ramifications. Will there be enough cash to make the required distributions without disrupting the securities portfolio? Will the distribution of cash to the qualified purchasers be a breach of the hedge fund manager's duties to the partners in the old fund? Will the market risk and cost to repurchase securities place an unfair burden on the partners in the new fund? Will the qualified purchasers simply take their money back? Finally, the hedge fund manager should consider whether certain qualified purchasers will substantially avoid adverse income tax consequences because of their tax-exempt status. For example a private foundation would have virtually no income tax worries provided that the hedge fund generates little or no unrelated business taxable income.

Transferring partners from a 3(c)(1) fund to a new 3(c)(7) fund can be a very effective way to increase assets under management. However, the transfer should be carefully planned beyond the moment of transfer when everything is tax-free. Things can go very wrong from a tax perspective and undo the goodwill created by the hedge fund manager's extraordinary performance. We always advise our readers to consult with counsel, but in this type of transfer you can't afford to leave your accountant out! MK

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Foreign Partners: Final Regulations Grant Limited Relief From Income Tax Withholding

By Joanna Wesolowski

AFTER ISSUING proposed regulations five years ago, the Internal Revenue Service recently issued final regulations addressing partnership requirements to withhold tax from foreign partners on effectively connected taxable income. The share of partnership income received by a foreign partner that is attributable to trade or business activities within the United States is effectively connected income. These final regulations will be effective for tax years beginning after December 31, 2007.

The final regulations permit a partnership to take into account certain deductions and losses of the foreign partner to reduce the amount of income tax to be withheld from the foreign partner's share of partnership income. The deductions and losses must be certified by the foreign partner under penalties of perjury by completing newly created Form 8804-C, Certificate of Partner Level Items to Reduce Section 1446 Withholding. Deductions and losses that may be taken into account include both separately stated items reported by the partnership on Schedule K-1 and deductions and losses from other sources that are properly allocated and apportioned to the effectively connected income. To be eligible to file Form 8804-C, a foreign partner must have filed U.S. income tax returns for the preceding three taxable years and paid all taxes reported on the income tax returns.

The deductions and losses that may be taken into account are subject to a number of limitations. The foreign partner can only claim deductions and losses that will be reported on a U.S. income tax return for a taxable year ending before the due date of the income tax to be withheld. For example, a foreign partner's taxable year ends on December 31. The due date of the income tax to be withheld is the following April 15th.The foreign partner cannot take into account any deductions or losses that occur after December 31 and before April 15th. This limitation precludes the use of guesstimates by the foreign partner. Certain deductions and losses cannot be taken into account or are limited due to the complexities of determining the actual deduction on the foreign partner's income tax return. For example, deductions for charitable contributions are not permitted to be taken into account and deductions for state income local income taxes withheld by the partnership are limited to 90% of the income taxes actually withheld. Deductions for domestic production activities under Section 199 may not be taken into account again due to the complexities in determining the deduction on the partner's income tax return.

While foreign partners might enjoy the relief provided by the final regulations, it is not likely that general partners will be jumping for joy. If the foreign partner's certification is defective, the partnership remains liable for the unpaid withholding tax and interest. If the partnership has reasonably relied upon the foreign partner's certification, the partnership should be relieved of any penalties. A partnership may reject the foreign partner's submission of Form 8804-C in whole or in part. Since the adverse consequences of a defective certification are significant, general partners should review Form 8804-C very carefully and act cautiously before reducing the income tax to be withheld from the foreign partner.

If you have further questions related to these new US withholding rules, contact your M&K Tax Professional. MK

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The IRS Focuses on Investment Partnership Pass-Through Dedcutions

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Portfolio deductions are itemized deductions subject to the 2% limitation applicable to investment expenses, the overall 3% limitation on itemized deductions and the alternative minimum tax add back. Finally, characterization of the management fees as itemized deductions will increase the state and local income tax liability for those limited partners who are unlucky enough to live in a state or city that does not permit itemized deductions or significantly limits the benefits of itemized deductions. Prior to the issuance of Revenue Ruling 2008-39, many professionals believed that the management fees could be allocated pro-rata between business expenses and portfolio deductions based upon the nature of the activities of the underlying partnerships (i.e. trader or investor).

Revenue Ruling 2008-39 is bad news for fund of fund investors who are individuals subject to itemized deduction limitations. The Ruling is silent with respect to the treatment of the fund of fund's own legal and accounting fees. Based on the reasoning expressed in Revenue Ruling 2008-39, it would appear likely that the fund of fund's own expenses for legal and accounting services would also be treated as itemized deductions. MK

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Building An Internal Tax Department Into Your Hedge Fund

By Philip F. Strassler, CPA

Factors To Take Into Account In Beginning a Tax Function

1. Structural Complexity – Number of Moving Parts
2. Investment Strategy Complexity
3. Number of U.S. Reporting Entities
4. Legacy Investments/ Family Office Needs (e.g., Airplane, Household Help, Bill Paying, Financing Alternatives)
5. Need for More Proactive/Timely Tax Advice
6. Offshore Office(s)
7. Need to Specifically Tailor Tax Reporting for Specific Investor Needs or Pursuant to Side Letter Agreements
8. Need for More Tax Engagement Continuity (Reduce the Annual Learning Curve)
9. Size of Fund – Affordability of Internal Tax Professionals
10. Need to Provide K-1s as Early as Possible – Reduce LP Unhappiness and Restlessness
11. Confidentiality of Information – Investors and GP Information

Layers of Tax Compliance

1. Domestic Fund U.S. Partnership and State Tax Returns and K-1s
2. Pass Through U.S. Partnership Tax Returns for Offshore Entity Master
3. Year End Tax Estimates for Domestic Fund
4. Blocker Tax Returns
5. Management Company – LLC, LP or S- Corporation Tax returns –U. S., Foreign, State and Local – i.e. NYC UBT
6. General Partner – LLC or LP Tax Returns
7. Tax Returns for Entities created for Estate and Charitable Planning Purposes – Family Partnerships, Family Trusts, Private Foundations, Charitable Remainder Trusts and Charitable Lead Trusts
8. Personal Tax Returns and Estimates
9. Required Disclosures – IRC Sec. 6694 / Tax Shelter Reporting
10. FIN 48 Compliance
11. Miscellaneous Tax Filings – Sales and Use , Commercial Rent, Foreign Bank Account Reporting, Forms 1099, Forms to Report U.S., State and Foreign Withholding Taxes

Tax Function Models

1. Outsource Entire Tax Functionality – Tax Return Preparation, Review and Tax Planning and Ideas – Rely on CPA Firm/ Administrator/ Law Firm
2. Senior Tax Professional with CPA – Background with Specialization in Hedge Fund Tax Preparation and Review – Outsource All Tax Return Preparation to CPA Firm or Administrator – Rely on this Professional for Proactive Planning and Advice Coordinated with Lawyers and CPA Firm
3. Senior Tax Professional and Tax Professional Staff – Outsource as Little as Possible – Personal Tax Returns, Management Company and General Partner Tax Returns and Planning under Auspices of CPA Firm – Rely on Professionals for Proactive Planning and Advice Coordinated with CPA Firm and Lawyers
4. Full Family Office – All Tax Return preparation is Completed Internally

Responsibilities of Internal Tax Function

Reporting

1. Distribution of K-1 s on a Timely Basis
2. Fielding LP Questions Concerning K-1s
3. Review and Filing of Tax returns
4. PFIC Reporting
5. Responsibility for Check the Box Elections
6. Coordination of Owners' Tax Return Preparation and Estimated Tax Payments
7. Responding to Federal, State and Foreign Tax Notices
8. Coordination with CFO for Proper Accounting Treatment of Side-Pocket Investments
9. Management Company Record Keeping for Travel & Entertainment

Tax Analysis

1. Keeping Current on What is Happening in the "Hedge Fund" World of Taxes and Integrating Changes Into Owners' Income and Estate Tax Planning
2. FIN 48
3. Coordination with Investment Team as to Tax Consequences Related to Strategies and Investments – i.e. FIRPTA, Effectively Connected Income, Swaps, Withholding Taxes on Dividends and Interest
4. Deferred Compensation – Understanding Rules and Maintaining Appropriate Records
5. Wash Sales – Awareness of Rules and Developing Methodology to Insure that there are No Surprises
6. Appropriate Application of Fill Up Stuffing Allocations
7. Appropriate Determination Of UBTI
8. Application of OID and Market Discount Rules to Distressed Securities
9. Straddle and Constructive Sale Analysis
10. Trader vs. Investor Determination
11. 475(f) – Mark to Market
12. Foreign Currency Rules / 988
13. 1256 Rules / 60-40 treatment
14. Specific Identification of Securities Sold to Maximize Tax Efficiency
15. Developing Methodology of Tax Efficient Ownership – i.e. Profits Interests, Phantom Incentive Compensation Plans, Buy/Sell Agreements
16. Involvement in Developing Permanent Capital Strategies
17. Transfer Pricing
18. Distribution of Securities to LP and GP
19. Tax Consequences of Investing in Bankruptcy or Reorganization Related Securities
20. Use of Retirement Plans
21. Fringe Benefit Planning

Structure

1. Issues on Conversion of Offshore Parallel Fund to Mini – Master – Tax Implications related to Built in Gain or Loss on Contributed Securities, Stuffing with Partial Withdrawals and Tax Basis and Holding Period for Contributed Securities or Use of Intermediary Pass Through Entity with Offshore Feeder
2. Choice of Investment Vehicle Structure
3. Tax Structure of Side Pocket Investments and Blocker Corporations

K-1 Preparation Software

1. HedgeTek
2. Advent Partner
3. Libris K-1 – Electronic Collation of Federal and State
4. FC Office – Fund Count LLC
5. Investall – KPMG
6. K-1 Suite – Ernst & Young

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The IRS Focuses on Investment Partnership Pass-Through Deductions

Two New Critical Revenue Rulings

By Maury Cartine, CPA

THE INTERNAL REVENUE SERVICE recently issued two Revenue Rulings that directly affect hedge fund investors. The first Revenue Ruling, 2008-38, issued on July 3, 2008, is generally favorable to hedge fund investors. The Ruling examines how the deduction for interest expense should be treated by limited partners that do not materially participate in the hedge fund's operations. The hedge fund described in the Ruling is engaged in the business of trading securities. Citing Revenue Ruling 2008-12, issued earlier in the year, the Internal Revenue Service reaffirms that interest expense must be separately allocated to non-materially participating limited partners since the interest expense is subject to the investment interest limitation. Consequently, the deduction for interest expense is limited to the non-materially participating limited partner's net investment income.

More importantly, Revenue Ruling 2008-38 holds that the interest expense is nevertheless a business deduction in arriving at adjusted gross income and not an itemized deduction. Many states do not permit itemized deductions or significantly limit the benefits of itemized deductions. Although this Ruling is no surprise to most accountants servicing hedge funds, it is comforting for non-materially participating limited partners to know that their state income tax burdens will not be increased as a result of an adverse ruling by the Internal Revenue Service.

Unfortunately, the second Revenue Ruling, 2008-39, also issued on July 3, 2008 is not hedge fund investor friendly. This Ruling creates additional itemized deductions for both federal and state income tax purposes. Revenue Ruling 2008-39 reviews the treatment of management fees paid by a fund of funds partnership that only invests in underlying hedge fund partnerships that are engaged in the business of trading securities. The Ruling holds that a fund of funds is not itself engaged in a trade or business even though all of the underlying hedge fund partnerships are engaged in the business of trading securities. Therefore, the Ruling holds that the management fees paid by the fund of funds partnership are not a business expenses, but rather portfolio deductions or expenses incurred in the production of income.

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