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Prime Brokerage Spotlight: Partner Beth Wiener talks with Morgan Stanley Managing Director Joel Press

Beth M. Wiener, Partner-in-Charge of Marcum & Kliegman's Alternative Investment Group, met with Joel Press, Managing Director at Morgan Stanley, to discuss the role of prime brokers in the hedge fund industry.

Beth Wiener

Joel Press

Editor's Note- Joel's meeting with Beth occurred well before the current financial markets crisis. We all hope that Joel's views with respect to hedge fund industry growth will come to fruition despite current market conditions. Over the years we have witnessed other difficult periods for the hedge fund industry only to be followed by periods of explosive growth. As Joel stated, "the hedge fund industry's breadth and growth is unique." Adopting Joel's view, we too believe that the hedge fund industry will continue to grow.

We were thrilled that Joel accepted the invitation to speak with Beth. Joel Press is one of the most well know figures in the hedge fund industry and he has enjoyed a most amazing career beginning with Spicer & Oppenheim. Joel served as a member of the Management Committee of Spicer & Oppenheim, a firm that has supplied some of the most talented accountants in the financial services industry. Joel served as the head of the Global Hedge Fund Practice for Ernst & Young from 1989 through 2006. During this period, the hedge fund industry experienced explosive growth. Joel has just about done everything an accountant could possibly do in the hedge fund industry and more. He is the author of numerous articles pertaining to hedge funds. Joel knows virtually everyone in the industry and everyone knows Joel. He is a trustee of Long Island University where he also serves as Chancellor of the Brooklyn Campus. Active in several charitable organizations, most of us know Joel for his contributions to Hedge Funds Care, the hedge fund industry's most prominent charitable activity. Always a formidable competitor, we congratulate Joel on his move to Morgan Stanley and take a collective sigh of relief!

Wiener: *Joel, you've had a fabulous career at Ernst & Young and helped shape the hedge fund industry. After retiring from Ernst & Young, why did you choose prime brokerage and more specifically, Morgan Stanley?*

Press: I wanted to continue to work with asset managers, and I wanted to do it in a professional environment that was similar to the one I was leaving. Morgan Stanley is widely regarded as an industry leader in prime brokerage. I worked with many of the outstanding members of the Morgan Stanley team, and this was the place I wanted to be.

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Business Of Trading Securities Debunked By The U.S. Tax Court

By Maury Cartine, CPA

Hedge fund managers should take special note of a very recent decision of the United States Tax Court. William G. Holsinger and Joann Mickler vs. Commissioner, T.C. Memo. 2008-91, decided on August 11, 2008 examines the claims of the taxpayers that they were engaged in the business of trading securities. The benefits of being in the business of trading securities should be obvious to all hedge fund managers, but a quick refresher on the different income tax treatment for traders and investors may be helpful.

The expenses of a hedge fund engaged in the business of trading securities are deductible in arriving at adjusted gross income. Consequently, management fees, legal and accounting fees and administration fees are all fully deductible by the hedge fund's partners. In addition, a hedge fund that is engaged in a trade or business is eligible to make an election to mark to market all security positions at the end of the year and take into account the resulting gain or loss into taxable income. The mark to market election is attractive to hedge fund managers that want to match taxable income with book income. The mark to market election eliminates all wash sale loss deferrals and all straddle loss deferrals. However, the market to market election eliminates all the benefits of capital gain treatment. Gains and losses are treated as ordinary. Consequently, partners cannot benefit from the reduced tax rate applicable to net long-term capital gains and the partners cannot offset capital loss carryovers against the ordinary gains.

The expenses of a hedge fund merely investing in securities are treated by partners as investment expenses and these expenses are only deductible as itemized deductions. Therefore, these expenses are subject to the overall 3% limitation on itemized deductions, the 2% portfolio deduction limitation and the alternative minimum tax add-back. As if that wasn't bad enough, many states do not permit itemized deductions or limit itemized deductions (e.g. Connecticut and New York). Thus, investment expenses provide little or no state income tax benefits. Investment interest expense is also treated as an itemized deduction for partners of hedge funds that are merely investing securities and the benefits from this deduction will similarly be limited for state income tax purposes. Finally, a hedge fund engaged in investing in securities cannot make a mark to market election.

> Each hedge fund manager should consider how many days the hedge fund conducts trades and how long securities are held before sale.

Now back to our Tax Court case. The taxpayer, William Holsinger, retired in 1992 after a 30 year career with Eli Lilly & Co. In 1999 he married Joann and they began buying and selling stocks in 2000. They earned approximately $280,000 in 2000 and reported their gains on the purchase and sale of securities as capital gains. In April of 2001, the taxpayers formed a limited liability company (LLC) to conduct their security transactions and the LLC made a timely mark to market election. The LLC maintained two trading accounts with E-Trade, two with Options Xpress and one with Ameritrade-Comdisco. The taxpayers claimed ordinary losses from trading, depreciation and interest in the amount of $180,174 from the LLC on their 2001 tax return. The taxpayers also claimed a net loss of $80,100 as sole proprietors acting as agents for the LLC. In 2002, the taxpayers claimed an ordinary loss of $45,241 comprised of trading losses and related business expenses. The taxpayers operated from an office in their home. The office contained computers, internet access and four monitors because Mr. Holsinger wanted to be able to trade simultaneously.

In 2001, the taxpayers executed approximately 289 trades and traded on 63 days (less than 40 percent of the trading days from the time the taxpayers commenced their securities operations). In 2002 the taxpayers executed approximately 372 trades and traded on 110 days (less than 45% percent of the trading days in 2002). Mr. Holsinger testified that his goal in forming the LLC was to profit from short-term swings in the market. Mr. Holsinger also testified that he usually closed his account at the end of the day and tried to avoid holding stocks and options overnight.

The Court, taking into account the taxpayers testimony and weighing the facts presented, concluded that the documentary evidence was simply not consistent with the taxpayers story. The Court found that the taxpayers rarely bought and sold securities on the same day. In reviewing the tax payers' holding periods for securities, the Court noted that a significant amount of the securities were held for more than 31 days. Thus, the Court concluded that the taxpayers did not seek to capture the daily swings in the market and held that the taxpayers were not traders, but investors. Accordingly, the taxpayers business deductions were re-characterized as investment expenses and the mark to market election was inapplicable.

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Revenue Ruling 2008-31 – Opens The Door To U.S. Real Estate for Foreign Investors

By Maya Likar

Revenue Ruling 2008-31, issued on June 12, 2008 opens the door at least a crack, if not more, to foreign persons who are interested in investing in U.S. real estate to obtain exposure to U.S. real property performance. The Ruling provides foreign investors with the opportunity to invest in swaps and other financial instruments based on certain real estate indices without being subject to the income taxes imposed under the Foreign Investment in Real Property Tax Act (FIRPTA). This opportunity can be a vital step in opening up the U.S. real estate market to global investors.

The primary obstacle facing foreign persons who invest in U.S. real property is FIRPTA. Under FIRPTA, any gain recognized by a foreign person on the disposition of a U.S. real property interest (USRPI) is treated as effectively connected to a U.S. trade or business and therefore subject to U.S. income tax. FIRPTA requires the purchaser of such interest to withhold and remit to the Internal Revenue Service 10% of the proceeds due to the foreign person upon the sale of the USRPI to assure that the tax on the gain will be paid. By contrast, gains realized by foreign persons on the sale of U.S. securities that do not constitute a USRPI (e.g., the gain on the sale of IBM stock) are not subject to U.S. income tax.

A USRPI is generally defined as either an interest in real property located in the U.S. or the Virgin Islands. A USRPI includes stock of a U.S. corporation, if the company's USRPIs equal or exceed 50% of the total value of the company's real property interests and other business assets (a United States real property holding corporation). The term also includes any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property. Gain realized by a foreign investor from the sale or exchange of an interest in a partnership, trust, or estate will also be considered a gain from the sale or exchange of a USRPI to the extent the gain is attributable to a USRPI.

Revenue Ruling 2008-31 examines a transaction in which a foreign corporation enters into a derivative contract that qualifies as notional principal contract with a counterparty that is a domestic corporation. The payments to be received are tied to the performance of a broad-based real estate index. The Revenue Ruling holds that the notional principal contract does not represent a direct or indirect right to share in the appreciation in the value of the real property and as a result is not a USRPI. Accordingly, the Revenue Ruling concludes that any gain on the transaction

would not be subject to the tax imposed by FIRPTA. This conclusion is based on the fact that the real estate index covers a large geographic area where the population exceeds one million and the counterparty domestic corporation does not, directly or indirectly, own or lease a material percentage of the real property, the values of which are reflected in the index. The Revenue Ruling indicates that the indices

(1)cover a large geographic area such as a large metropolitan area and
(2) are calculated by reference to sales prices obtained from public records, appraisals and reported income or similar objective financial information, each with respect to a broad range of real property holdings of unrelated owners.

The Revenue Ruling only discusses an interest in a notional principal contract. Nonetheless, the Revenue Ruling gives certainty to a foreign holder that any gain upon disposition of the swap of U.S. real estate performance, including the receipt of payments on the swap, will not be subject to U.S. income tax under FIRPTA provided that the swap covers a broad-based real estate index and the counterparty does not taint the transaction with its own real estate holdings.

The U.S. income tax law makes it difficult, if not impossible for a foreign person to invest in U.S. real estate without incurring U.S. income tax liability on any income or gains attributable to the investment. Revenue Ruling 2008-31 opens the door for foreign investors seeking broad based U.S. real estate investment opportunities through the use of swaps and other financial instruments over certain real estate indices. In the Revenue Ruling, the Internal Revenue Service emphasized the broad-based nature of the index as the reason for its holding that the notional principal contract was not a USRPI. Thus, because the Revenue Ruling is based only upon the "broad-based nature" of the index, it should be possible to have the rationale apply to other financial instruments, the payments on which are determined by reference to similar broad-based U.S. real estate indices. In time, newly designed financial instruments following the holding of Revenue Ruling 2008-31 should provide opportunities for global investors to obtain exposure to U.S. real property performance without being exposed to FIRPTA taxes. MK

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Prime Brokerage Spotlight: Partner Beth Wiener talks with Morgan Stanley Managing Director Joel Press.

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Wiener: *What is your role at Morgan Stanley?*

Press: As you might expect, my focus is client service. I will continue to advise hedge fund managers on the various developments in the hedge fund industry. I want to make sure our clients are aware of new financial instruments and products. I want them to understand the regulatory and tax consequences of their trading operations, and I want them to use me as a sounding board and draw on my experiences over the last 40 years. I want our clients to provide the best possible returns to their investors, and in that regard, I will point out best practices to improve efficiency in operations and trading. I work with start-ups as well as established funds and help our clients think through the issues of running a business and growing a business. Helping clients evaluate their fund documents, choose the best structure and select the most appropriate compensation programs and equity programs for their staff is all part of what I do at Morgan Stanley. In looking back, my role is in some ways very similar to what I did at Ernst & Young.

> " Prime brokerage changes with the marketplace. Wall Street is always developing new financial products and new transactions".
> *- Joel Press, Morgan Stanley Managing Director*

Wiener: *How has prime brokerage evolved during your career?*

Press: Prime brokerage changes with the marketplace. Wall Street is always developing new financial products and new transactions. For example, credit default swaps didn't exist six or seven years ago. Prime brokers must respond in real time to meet the expectations of their clients and the marketplace. The continued expansion of the derivatives markets and continued growth of the equity markets demand creative financing solutions, greater technology and reporting tools to support the continuously evolving trading activity.

Wiener: *Clients make choices in selecting prime brokers, but prime brokers also make choices in accepting clients. What does Morgan Stanley look for in a new client?*

Press: Just like an accounting firm and, for that matter, all service providers in the hedge fund industry, we will only work with people we trust. You wouldn't do an audit for a client you can't trust and trust is the cornerstone of our industry. We do full due diligence on prospective clients. We talk to people about who they are and we check out who they are. We also look at their trading strategy and make sure we are a good match. We match their needs to our skills and if we have a fit we move forward. We have no prescribed size limits that are etched in stone. We have worked with $50 million dollar start-ups and we've worked with multi-billion dollar start-ups. We look carefully at a fund manager's qualifications and plan. If we like what we see, we will invest the time and effort necessary to help that fund manager grow assets under management.

Wiener: *Does Morgan Stanley offer capital introduction services to hedge fund clients?*

Press: We are very direct with our approach to capital introduction. We don't promise anything we can't do. Everybody wants to raise money, but raising money is more for some than for others. We never misrepresent what we will be able to do on the introduction. New start-ups have more difficulty raising money than ever before. The likelihood of capital introduction should never be the primary reason to choose a prime broker.

Wiener: *What factors should a fund manger consider in evaluating the performance of their prime broker and when should the manager make a change?*

Press: Fund managers make changes for many different reasons including some that may be obvious, but many more that may be subtle. They may be dissatisfied with the menu of services available to them. At Morgan Stanley, we provide a consulting service to address technology needs, office space, internal accounting, and we provide capital introduction when appropriate. All prime brokers do not provide these services equally and Fund managers may look to any of these reasons and others in choosing to change prime brokers. Often overlooked is the human element. How does the prime broker's service team match-up with the hedge fund's personnel? Have they developed a rapport? Do they work well together? Do they trust each other? Sometimes it comes down to the service team. The fund manager may have the right prime broker, but the wrong service team. We look carefully at our service teams. We have a great team at Morgan Stanley, and if we need to make changes to better service a fund manager's needs, it is an easy thing to do. We are confident that we have many talented people in many different areas that can step in to satisfy a fund manager's needs.

Wiener: *The SEC has focused attention on soft dollar arrangements many times during your career. Does Morgan Stanley still provide soft dollars and if you do, are soft dollars limited to Section 28(e)?*

Press: Soft dollar arrangements remain a part of the hedge fund industry. Morgan Stanley limits the use of soft dollars to brokerage and research services in accordance with the safe harbor under Section 28(e). Soft dollars used for purposes outside the safe harbor continue within the industry. However, the disclosure and compliance requirements are greater. We have limited the use of soft dollars to brokerage and research to reduce the amount of compliance that would otherwise be necessary.

Wiener: *Does Morgan Stanley get involved in the valuation of securities for prime brokerage clients and if so, to what extent?*

Press: We lend money so we obviously have to be involved with valuation. For securities traded on exchanges our valuation would be in accordance with GAAP as these securities would constitute Level I investments under the Fair Value Measurement standards set forth in FAS 157. For all other securities and derivative instruments our valuation is proprietary for our own needs. Therefore, auditors would have to look to other sources to document the hedge fund's valuation for those instruments.

Wiener: *Billion dollar funds have become commonplace and the hedge fund industry has become more institutionalized. Is there any room for the smaller start-ups?*

Press: There is still potential for the smaller hedge funds, but the investment managers must remain focused on their performance and not be distracted by capital raising efforts. These smaller funds can survive and flourish, but the real growth may take several years. For now investment managers must find ways to retain key personnel. The big funds have the ability to attract top talent because they can pay more and they potentially have more staying power. The smaller funds will have to be more entrepreneurial in finding ways to reward their key personnel if they want to keep talent and grow.

Wiener: *Joel, you have been involved with hedge funds from the very beginning. As you look forward, where do you see the hedge fund industry going?*

Press: I have always said the hedge fund industry's breadth and growth is unique, and I firmly believe the industry will continue to grow. I think we can expect significant growth in the next two to three years. Growth will bring with it new challenges. The business of running a hedge fund will become more complex. More hedge funds will have chief operating officers, presidents and strategic initiatives. Hedge fund businesses will continue to find opportunities to go public. The industry will grow in many different ways as new investment opportunities present themselves. Fund managers will be able to grow assets under management and smart investors will still have the opportunity to realize the enhanced returns that are often identified with the hedge fund industry. MK

Congress Eliminates A Grand Old Tax Deferral Opportunity for Hedge Fund Managers

By Maury Cartine, CPA

Fund managers have enjoyed the benefits of deferring income tax on offshore fund performance and management fees for several decades. The nonqualified deferred compensation arrangement between the offshore fund and a U.S. fund manager is almost as old as the hedge fund itself. Early in 2007, Congress noted that arrangements between offshore funds and fund managers to defer the receipt of performance fees and/or management fees provided a one-sided tax benefit to U.S. taxpayers. By contrast, a domestic hedge fund offering a deferral arrangement to a fund manager would have to pay the price of foregoing a deduction until the deferred performance fees and management fees were actually paid. Since the offshore fund pays no U.S. income tax and needs no deductions, the tax deferral opportunity for the fund manager is in effect, priceless!

Congress took exception to this priceless opportunity and introduced several bills to eliminate the one-sided tax deferral. The most recent bill, H.R. 6049, introduced by Representative Charles Rangel, was included as part of the Bailout legislation, H.R. 1424, the Emergency Economic Stabilization Act of 2008 signed by the President on October 3, 2008 as P.L.110-343.

The new law eliminates the tax deferral of performance fees and/or management fees for services rendered after December 31, 2008. The new law permits the continued deferral of performance fees and/or management fees for services performed before January 1, 2009 until the earlier of the date that such deferrals are payable or the last taxable year of the fund manager beginning before 2018. This means that existing deferrals could continue until December 31, 2017 for most fund managers since the taxable year for most fund managers is a calendar year. If an existing deferral is payable after December 31, 2017, the new law provides the parties with a limited period of time to amend the deferred compensation arrangement to accelerate the payment of the deferred amount to coincide with the taxable year that such deferred amount must be included in income. The time period must be established through guidance issued by the Secretary of the Treasury within 120 days after the date of enactment of the new law. Congress has estimated that the new law eliminating the tax deferral for performance fees and/or management fees will increase revenue by 25.1 billion dollars over the next ten years. Some long time observers of the hedge fund industry might argue that the revenue raising potential of the new law is substantially understated. However, fund managers facing the current financial crisis might now be inclined to think – if only I didn't defer… No matter which view you choose, a grand old tax deferral tool for fund managers has been eliminated forever. MK

Business Of Trading Securities Debunked By The U.S. Tax Court

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Hedge fund managers should carefully review the activities of the hedge funds they manage in determining if the hedge fund is engaged in the business of trading securities or merely investing in securities. Each hedge fund manager should consider how many days the hedge fund conducts trades and how long securities are held before sale. Holsinger and Mickler vs. Commissioner, Supra, demonstrate that a good story or a long memo is simply not enough to convince the Internal Revenue Service or the Courts that a hedge fund is engaged in the business of trading securities.

An incorrect determination that a hedge fund is engaged in the business of trading securities can have far reaching effects. One of those effects is the loss of the mark to market election. Accountants and lawyers servicing hedge funds have always been concerned about this possibility and these concerns are now reality for at least William Holsinger and Joann Mickler.

The good news is that hedge funds must determine their trader and investor status each year. Hedge funds do not make an irrevocable election to be treated as a trader or investor. The facts in each particular taxable year control the determination. It is possible that changing market conditions or changing investment objectives may turn a trader into an investor or vice versa. And it is also possible for a hedge fund manager to take a fresh look at the same recurring facts and choose the appropriate status for that taxable year and all future taxable years.

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