

# United States

## Taxation

HEDGE FUNDS 2009

### Hedge fund managers/advisors

#### Taxation

##### Tax rates applying to hedge fund managers/advisors

Most U.S. hedge fund managers/advisors are set up as either partnerships or limited liability companies which are flow-through entities for U.S. tax purposes; consequently, those entities are generally not subject to U.S. taxation. However, all income, deductions, gains, or losses from the hedge fund manager/advisor entities are passed on to the partners, who have the ultimate responsibility for paying tax on their distributive share of income, deduction, gains, or losses. For the 2008 tax year, the individual partners of these hedge fund managers/advisors filing as single or married filing jointly are taxed at federal graduated rates with a maximum rate of 35 percent for taxable income over USD 357,700. Long-term capital gains and certain dividends earned on stock that has a certain holding period (Qualified Dividend Income) will be taxed at a lower rate of 15 percent. State tax rates vary depending on residency of the partners.

##### The effective tax rate usually suffered by hedge fund managers/advisors

The effective tax rate applicable to hedge fund managers depends on a number of factors including entity type, filing status, and amount of taxable income. As indicated above, most hedge fund managers/advisors will pay tax on ordinary income at a federal tax rate of 35 percent and a state tax rate based on residency of partners on the distributive share of income recognized. Long-term capital gain and Qualified Dividend Income will be taxed at a rate of 15 percent.

##### Tax concessions, allowances, or exemptions specifically available to hedge fund managers/advisors

There are no specific tax concessions, allowances, or exemptions that are specifically available to hedge fund managers/advisors.

### Details of anti-avoidance tax rules that could bring the profits of an offshore hedge fund into tax

A hedge fund manager/advisor that operates from the United States is taxed on management fees and incentive fees received from the offshore fund. There are no anti-avoidance rules, though, that pull in offshore profits (aside from the incentive fee paid) of the offshore fund into taxable income of the hedge fund manager/advisor.

### Requirements to charge VAT (or equivalent sales tax) and the rate

The fund manager is not required to charge VAT on services provided to the fund. The United States does not have a VAT system.

## Hedge fund structures

### Taxation

#### Tax rates applying to the fund

Most U.S. hedge funds are set up as partnerships which are flow through entities for U.S. tax purposes; consequently, those entities are generally not subject to U.S. taxation. All income, deductions, gains, or losses from the hedge funds are passed on to the partners, who have the ultimate responsibility for paying tax on their distributive share of income, deduction, gains, or losses. The individual partners of these hedge funds are taxed on ordinary income at graduated rates with a maximum rate of 35 percent, and long-term capital gain and Qualified Dividend Income at a rate of 15 percent.

#### Access to double tax treaties

The fund will have access to a wide range of tax treaties to which the United States is a party.

#### Value-added tax registration and charging requirements

A U.S. fund is not required to register and charge VAT and there is no VAT system in the United States.

#### Withholding tax on dividends or interest payments

Hedge funds are required to withhold tax on U.S.-source dividend distributions to foreign (non-U.S) investors. The withholding is generally done at a flat rate of 30 percent, unless the foreign partner is a qualified resident of a country with which the United States has a tax treaty. In that case, the applicable tax rate in

the treaty applies. There is a specific exemption for withholding on portfolio interest; however, all applicable reporting is still required.

#### Tax return requirements

A U.S. fund that is structured as a partnership for U.S. tax purposes is required to file Form 1065, U.S. Return of Partnership Income, and an accompanying Schedule K-1, Partners Share of Income, Deductions, Credits, etc., for each investor. In addition, a fund may be required to file other forms as needed. Common examples are as follows:

- Forms 1042, 1042-S, and 1042-T: These forms are used to report the tax withheld on U.S.-source interest and dividends distributed to foreign (non-U.S.) investors.
- Form 8271: This form is required to report the registration number for a tax shelter that is required to be registered.
- Form 8865: This form should be used to report an interest in a foreign partnership if certain minimum ownership or contribution thresholds are met. Generally, this is required for a domestic feeder fund to file with respect to an offshore master fund.
- Forms 8886: This is filed to report and disclose information for certain reportable transactions, as defined by the Internal Revenue Service, in which the fund participated during the year.
- State and Local Returns: A hedge fund may be required to file certain state returns because of state nexus or resident partners. Such filing requirements are dependent on specific state and local law.

#### Investors

#### Taxation

##### Specific anti-avoidance tax legislation applying to an investor in an onshore fund

There is no anti-avoidance tax legislation applying to a U.S. investor in a U.S. hedge fund since most hedge funds are organized as flow-through entities and the partners or ultimate owners of these flow-through entities are required to pick up their distributive share of the income, deductions, gains, or losses currently.

### Specific anti-avoidance tax legislation applying to an investor in an offshore fund

A few anti-deferral rules are applicable to U.S. residents that invest in offshore funds organized as corporations. (All terms referred to below are as defined by the Internal Revenue Code of 1986, as amended.) Examples are as follows:

#### *Subpart F*

These rules are applicable to U.S. residents who invest in a Controlled Foreign Corporation (CFC). In general, a CFC is a foreign corporation that is more than 50 percent owned by U.S. persons. A U.S. person is defined as an individual or entity who owns at least a 10 percent interest in such foreign corporation. These rules require the 10 percent owners to pick up subpart F income currently, regardless of whether such income has been distributed. Subpart F income generally includes the type of income generated by typical hedge funds.

#### *Passive Foreign Investment Company (PFIC)*

The PFIC anti-deferral rules apply to U.S. residents who invest in a foreign corporation, if at least 75 percent of the gross income of such corporation is passive income, or at least 50 percent of the average assets held by such corporation are the type that produce passive income. Passive income for purposes of these rules generally includes the type of income generated by typical hedge funds. In general, should the PFIC rules apply, the investor must either pay a significant interest charge on the deferral of such income or elect to be taxed on net income (but not net losses) currently.

When both the PFIC and subpart F anti-deferral rules apply, the subpart F rules supersede the PFIC rules. However if an investor does not own more than 10 percent of the Fund, the CFC rules will not apply.

### Tax information needs of investors

Such reporting depends on the structure of the offshore fund. If such entity is set up as a foreign partnership, a Schedule K-1 or substitute Schedule K-1 with the investor's distributive share of income, deductions, gains, and losses must be provided to each U.S. investor.

If the entity is a foreign corporation, either the PFIC rules or CFC rules apply, as discussed above. If the fund is deemed to be a PFIC, the offshore fund must provide the U.S. investors with Annual PFIC Statements that provide the investors with their pro-rata share of income (distributed or undistributed) earned by the fund.

If the investor owns at least 10 percent of a CFC, the offshore fund must provide the U.S. residents enough information to enable them to compute their deemed share of subpart F income.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.