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INVESTMENT FUNDS ALERT

IRS LIMITS DEDUCTIBILITY OF CERTAIN INVESTMENT FUND MANAGEMENT FEES

On July 3, 2008, the IRS released a new revenue ruling (Revenue Ruling 2008-39) that could adversely affect the U.S. federal income tax treatment of U.S. individual investors in a particular type of investment fund, the so-called “fund of hedge funds.” As described below, the ruling specifically relates to the deductibility of management fees incurred at the fund of hedge funds level.

BACKGROUND

In general, an individual who is a U.S. citizen or resident is entitled to a deduction for expenses that are either (i) incurred in connection with a trade or business, or (ii) incurred for the production of income. There is, however, a significant difference between the two types of expenses: expenses incurred for the production of income are only deductible to the extent that they, together with other “miscellaneous itemized deductions,” exceed two percent of a U.S. individual taxpayer’s adjusted gross income (commonly referred to as the “two percent floor”). No such limitation applies to trade or business deductions.

In the context of investment funds, a fund that is treated as an “investor” is not treated as engaged in a trade or business, so that expenses incurred by it would only be deductible by U.S. individual investors in such fund subject to the two percent floor. On the other hand, a “trader” is treated as engaged in a trade or business, so that expenses incurred in connection with that trade or business are deductible without limitation. In general, an investor invests for long-term profit, whereas a trader often has a much higher level of portfolio turnover and attempts to profit from short-term market fluctuations.

THE RULING

The ruling addresses the application of these rules to a scenario that is fairly common in the fund of hedge funds area, and that was previously the subject of some uncertainty. In the facts described in the ruling, a U.S. individual owns an interest in a partnership (referred to as the “upper tier partnership,” or “UTP”), which partnership in turn owns limited partnership interests in several lower tier partnerships (referred to as “LTP”). Each LTP in which the UTP invests is engaged in the business of trading in securities (i.e., it is a “trader”), but the UTP is not engaged in such a business. Instead, the UTP’s activities consist solely of acquiring, holding and disposing of interests in LTPs (i.e., it is an "investor" in respect of the LTPs). The UTP and each LTP pay annual management fees to their respective managers, which fee is computed as a specified percentage of the value of the net assets owned by the UTP and each LTP, respectively.

Not surprisingly, the IRS ruled that management fees paid by the LTPs are deductible as ordinary business expenses for U.S. federal income tax purposes. In the case of a fund of hedge funds, the management fees paid by the underlying funds in which the fund of hedge funds invests would, assuming these funds are traders, be deductible as ordinary business expenses against income indirectly allocated to U.S. individual investors from such funds through the fund of hedge funds.

More importantly, however, the IRS also ruled that the determination of whether management fees paid by the UTP were deductible as "investment expenses" or as ordinary business expenses is made solely on the basis of the activities of the UTP, without regard to the activities of the LTP. Since the UTP was an investor, fees incurred at that level were expenses for the production of income, and hence only deductible by U.S. individual investors subject to the two percent floor. In other words, according to the IRS, the trade or business activities of the LTP are not attributed to the UTP for purposes of characterizing the fees paid at the UTP level.

In the fund of hedge funds context, this generally means that a U.S. individual investor's share of any management fees paid by the fund of hedge funds directly to its manager will not necessarily be fully deductible against the fund's income, but instead will be a miscellaneous itemized deduction, the deductibility of which is subject to the two percent floor, unless the activities of the fund of hedge funds itself are sufficiently active to cause it to be a trader. Note, however, that the ruling by its terms does not affect the tax treatment of incentive compensation that is typically structured in the form of an allocation rather than a fee (assuming such allocation is respected for U.S. federal income tax purposes).

The principle of the ruling has application beyond the fund of hedge funds context. For example, a fund (including a private equity fund) may own an equity position in an operating company that is treated as a partnership for tax purposes. The ruling implies that the business of the operating company is not taken into account for purposes of determining the deductibility of management fees paid by the fund. Thus, unless the fund is itself a trader, such fees will be subject to the two percent floor in the case of U.S. individual investors.

In addition, a broad application of the principle of the ruling could conceivably apply to fees charged to a "feeder" partnership in a typical "master-feeder" investment fund structure, although strong arguments exist that the tax treatment of such fees are not adversely impacted by the ruling (i.e., because the arrangements in this context are factually and legally distinguishable from the fund of hedge fund fees addressed in the ruling). Moreover, it is possible that adjustments to a particular master-feeder fund's fee structure could be made to avoid application of the ruling.

There may be substantial arguments that the IRS' position is an incorrect interpretation of the law. (However, a taxpayer taking a position contrary to published IRS authority generally would be required to disclose such position to the IRS.) Furthermore, it may be possible to structure a particular fund of hedge funds in a manner that avoids the issues raised by this ruling. For example, in a fund of hedge funds, it may be possible for a U.S. individual investor to avoid the issues raised by this ruling by investing in such fund through a foreign corporation (although such an investment could raise other significant adverse tax issues for U.S. investors in certain funds).

CONTACT INFORMATION

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