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INVESTMENT FUNDS TAX ALERT

IRS INQUIRY INTO TAX-ADVANTAGED DERIVATIVE TRANSACTIONS ENTERED INTO BY HEDGE FUNDS AND OTHER FOREIGN INVESTORS MOVES FORWARD

It has been widely known that an IRS task force has been investigating the use of certain derivative transactions by hedge funds and other foreign investors to avoid U.S. withholding tax on U.S. source dividends and certain other types of income. Based on recent news reports regarding formal IRS information requests received by a couple of large U.S. financial institutions regarding certain derivative trades, as well as information we have received directly from several financial institutions, it is likely that the investigation has progressed. The IRS investigation seems to be focused on so-called "dividend enhancement" trades such as total returns swaps over U.S. publicly traded stock, but it is likely that the investigators will also consider similar trades involving certain types of securities loans over publicly traded shares as well as notional principal contracts referenced to U.S. publicly traded partnership interests and certain U.S. non-publicly traded securities. The IRS investigation is likely to focus on (i) the business purpose of the tax-advantaged derivative transactions from the perspective of the hedge fund or other foreign investor, (ii) the similarity between the derivatives transactions and certain securities lending transactions that are the subject of existing regulations designed to deny the same type of tax benefit achieved through the use of the tax-advantaged derivative contracts, and (iii) the possibility that certain derivative transactions may in substance constitute margin accounts of the foreign counterparties to the derivative transactions. Although the scope of the investigation is unclear, it seems likely that at least certain tax-advantaged derivatives transactions will not be called into question.

One possible consequence of this investigation is that certain financial institutions that enter into tax-advantaged transactions tighten their internal guidelines relating to the types and quantity of derivative transactions into which they will enter. In particular, it is possible that certain financial institutions will (i) restrict further the direct or indirect acquisition or sale of reference securities between the financial institution and the derivative counterparty, (ii) limit the use of derivative transactions entered into close to a dividend record date or entered into over shares of companies that have announced an extraordinary dividend, (iii) limit the use of derivative transactions over large blocks of securities of a particular issuer, (iv) alter provisions in the relevant derivatives contracts relating to the determination of the value of the underlying securities at the inception and unwind of the transactions, and/or (v) require that the fund counterparty to the derivatives transaction post less collateral (i.e., increase the effective leverage obtained in connection with the trade).

It remains to be seen if the current investigation could lead to tax audits of particular foreign funds that have entered into tax-advantaged derivative transactions, and whether potential tax liabilities from any trades that do not pass muster would ultimately be borne by the financial institution or hedge fund counterparty. However, even if such widespread investigations of funds do not materialize, the current investigation could have a material adverse impact on certain funds if the investigation induces fund auditors to demand that funds establish a tax reserve in connection with certain derivatives transactions. In certain cases, it is possible for funds that utilize tax-advantaged derivatives transactions to significantly reduce tax risk from such transactions. Risk mitigation techniques typically involve restructuring of certain derivatives transactions, negotiation of tax indemnity rights against financial institution counterparties, and the use of alternative fund structures that reduce or eliminate the need for tax advantaged derivatives transactions.

CONTACT INFORMATION

If you have questions relating to the IRS investigation or any particular derivatives transactions, please contact :

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