

# Tax Structuring for New and Emerging Managers

## Start-Up Boot Camp

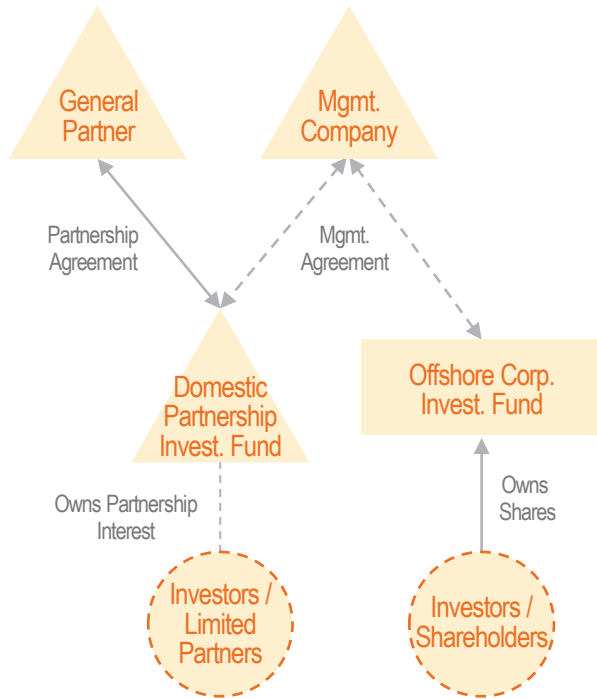


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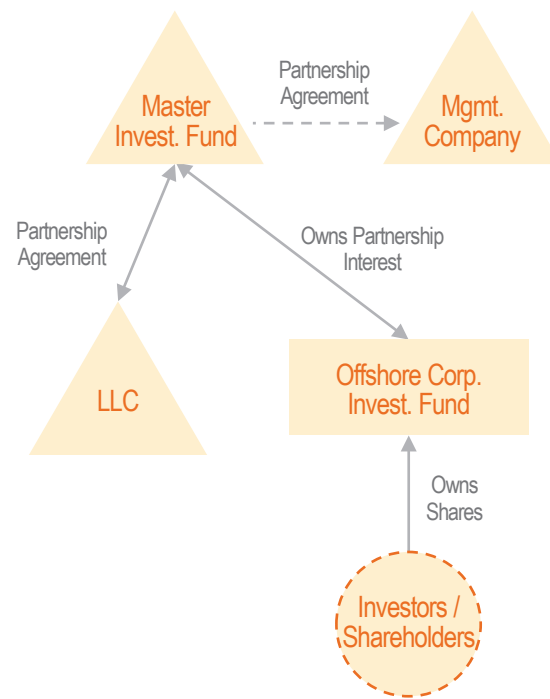


# Structuring a Stand Alone (Domestic or Offshore) vs Master Feeder (Full or Mini)

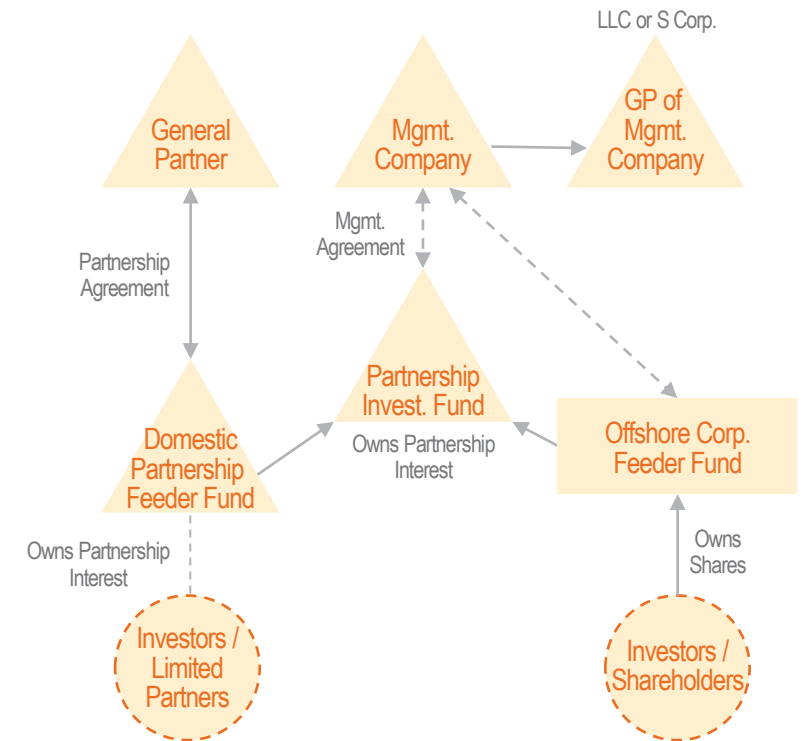
## Side-By-Side Fund Structure



## Mini-Master Fund Structure



## Master Fund Structure



# Which Structure Do You Choose?

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## Domestic...

- If a fund expects to have only U.S. investors, a domestic fund structure is sufficient.

## ...or Offshore?

- If a fund anticipates significant participation by offshore investors, an appropriate offshore fund in a tax neutral jurisdiction is needed to shield such investors from US tax liability.



# Domestic & Offshore Fund Structures

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## Domestic Fund Structure

Domestic-only (US Domiciled) fund structures are typically comprised of the following entities:

- A limited partnership (LLC) that acts as the fund entity.
  - The fund entity is formed in the state of Delaware.
- An LLC that acts as the investment manager (IM) and general partner (GP) of the fund (managing member in the case of an LLC).
  - These may be separate entities depending upon the tax jurisdiction of the GP and IM (ex: NYC).
- The IM/GP entity/entities are typically formed in the jurisdiction of the fund's IM.



# Domestic & Offshore Fund Structures (continued)

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## Offshore Fund Structure

The most widely-used options:

- Stand Alone
- Master-Feeder
- Mini Master

The two most common Offshore vehicles:

- Companies (LTD)
- Limited Partnership (LLC)



# Offshore Fund Structures | Vehicle Details

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## Companies (LTD)

- Companies are the most common offshore vehicle for both open-end and closed-end funds.
- Open-end funds do not have a fixed number of shares.
- The number of shares in the fund increases when investors add capital to the fund and decreases when current investors withdraw capital from the fund.
- Closed-end funds have a fixed number of shares in which existing investors sell shares to new investors and buy shares from leaving investors.



# Offshore Fund Structures | Vehicle Details (continued)

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## Limited Partnership (LLC)

- By dividing the functions of ownership and control, limited partnerships are very effective at protecting assets from seizure by creditors.
- Private equity funds with a limited number of investors will often make use of offshore limited partnerships.
- Regarding the Cayman Islands specifically, the offshore limited partnership vehicle is very popular among U.S. investors who tend to be familiar with Delaware limited partnerships, which the Cayman limited partnership structure is based on.



# Offshore Fund Structure Types

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## Offshore Stand Alone Structure

- Only one fund vehicle is used, and that fund vehicle is offshore
  - Normally in the Cayman Islands or the British Virgin Islands (BVI)
- Mainly used by managers who have no US presence
- Normally geared towards non-US investors, but may also benefit US based non-taxable investors who want to avoid unrelated business taxable income such as:
  - Pension funds
  - Charitable organizations
  - Endowments





# Offshore Fund Structure Types (continued)

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## Master Feeder Structure

- Normally used where there is a US presence and where a single manager is seeking investment from both US and non-US or tax-exempt US investors.
- The structure will comprise of:
  - A master fund (an offshore vehicle which is either a limited partnership or a corporate vehicle which elects to be treated as a partnership for US tax purposes), which conducts the trading
  - At least two feeder funds which invest all their assets into the master fund



# Offshore Fund Structure Types (continued)

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## Master Feeder Structure (continued)

- One feeder fund is typically a US limited partnership into which the US taxable investors will invest.
  - Using a limited partnership, which is a “pass through” entity for US tax purposes, means that the allocable master fund’s profits and losses are passed through to investors and taxed at investor level.
  - There is no entity tax at the master fund level in the offshore jurisdiction (either the Cayman Islands or the British Virgin Islands), thus avoiding double taxation.



# Offshore Fund Structure Types (continued)

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## Master Feeder Structure (continued)

- The second feeder (“offshore feeder”) will normally be an offshore company known as a “blocker corporation”.
  - It is into this offshore feeder that the non-US and US tax-exempt investors will invest.
  - Investment into a blocker corporation means that any US tax liability and any requirement to fill in a US tax return arises at the master/feeder fund level and does not affect the investors themselves.



# Offshore Fund Structure Types (continued)

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## Mini-Master Fund Structure

- A single offshore fund is established which is taxed as a corporation to benefit US tax-exempt investors and block UBTI and non-US investors.
- Needing to create only one new offshore vehicle saves costs, both on formation and in terms of upkeep. This is popular with startup and emerging managers.
  - The offshore fund invests directly into the existing US fund, which will then act as the master fund for the US non-taxable and foreign investors. It will also remain the fund into which the US taxable investors will continue to invest.



# Offshore Fund Structure Types (continued)

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## Mini-Master Fund Structure (continued)

Two additional benefits:

- Existing US-taxable investors do not need to be moved
- Existing assets of the domestic fund can remain where they are

Both factors vastly reduce the administration around the restructuring and subsequently reduce the cost. While there are some tax consequences to be discussed around the use of this structure, it has proved to be appealing to those looking to dip their toe in the waters of offshore vehicles.



# Cayman Islands vs. British Virgin Islands (BVI)

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## Cayman Islands

- Has a business-friendly structure, stable government and well-developed investment laws
- Is a tax-exempt jurisdiction, allowing offshore investors and US tax-exempt investors (that would otherwise be subject to UBTI taxes) to avoid paying US taxes on hedge fund gains
  - The Cayman Islands is the world leader as a jurisdiction for hedge funds.
- There are no direct taxes of any kind
- Exempted companies, the most common fund vehicle, can remain tax-free for 20 years
- Exempted limited partnerships can remain tax-free for 50 years.
  - These are popular with U.S. investors because they resemble the familiar Delaware limited partnerships.

## BVI

- Has recently gained the reputation as a cost-effective and convenient jurisdiction
- The regulatory structure creates a flexible jurisdiction with streamlined processes and strong legal certainty.
- Regulatory filing fees are considerably lower than those of the Cayman Islands.
- Investors, particularly in East Asia, have acknowledged the BVI's clout in the arena of offshore financial centers.



# Trader vs Investor Fund

## Considering the TCJA & MTM (475) Election

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### Trader Tax Status (TTS) and 475

- Business traders eligible for TTS are entitled to tax breaks, unlike Investor Fund Status entities.
- Sole proprietor (individual) TTS traders can deduct business expenses, startup costs, and home office expenses, and are entitled to elect Section 475 MTM ordinary gain or loss treatment.
  - *To deduct health insurance and retirement plan contributions, a TTS trader needs an S-Corp to create earned income with officer compensation.*
- Don't confuse TTS with the Section 475 election.
  - *Only qualified business traders may use Section 475 MTM; investors may not. Section 475 trades are also exempt from wash-sale loss adjustments.*
- The 20% deduction on QBI includes Section 475 ordinary income but excludes capital gains, interest, and dividend income. The QBI deduction for TTS/475 traders is subject to a taxable income threshold and cap.
- Business traders may only use Section 475 MTM if they filed an election on time, either by April 15 of the current year or within 75 days of inception of a new taxpayer (i.e., a new entity).



# Trader vs Investor Fund

## Considering the TCJA & MTM (475) Election (continued)

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### Investor Fund Status

- By default, the IRS lumps all traders into “investor tax status,” and investors get penalized in the tax code — more so with TCJA. Investors have restricted investment interest expense deductions, and investment fees and expenses are suspended.
- Investors have capital-loss limitations against ordinary income (\$3,000 per year), and wash-sale loss deferrals; they do not have the Section 475 MTM election option or health insurance and retirement plan deduction strategies.
- Investors benefit from lower long-term capital gains rates (0%, 15%, and 20%) on positions held for 12 months or more before sale. If active traders have segregated long-term investment positions, this is available to them as well.





# Tax Cuts and Jobs Act (TCJA)

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Since TCJA was enacted on December 22, 2017 (into effect in the 2018 tax year), traders eligible for trader tax status (TTS) have restructured their business to take advantage of TCJA.

Two changes:

- 20% deduction on qualified business income (QBI) in pass-through entities
- Suspended investment fees and expenses, making TTS even more crucial
  - TCJA continues to allow itemized deductions for investment-interest expenses.

No changes:

- Trader tax matters - including business expense treatment, Section 475 MTM ordinary gain or loss treatment, and wash-sale loss adjustments on securities
- TTS S-Corps' Solo 401(k) retirement contributions and health-insurance deductions
- TCJA also retains the lower Section 1256 60/40 capital gains tax rates; the Section 1256 loss carryback election; Section 988 for extraordinary gain or loss; and tax treatment on financial products including options, ETFs, ETNs, swaps, precious metals, and more.



# Tax Securities and Commodities Safe Harbor

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Funds which trade in U.S. capital markets are usually organized in offshore jurisdictions which do not impose income taxes on residents. Trades are planned and executed by portfolio managers and traders who sit in the United States. The portfolio managers and the traders are employed either by the fund, or by a portfolio manager that transacts on behalf of the fund. All profit-making activity occurs within the U.S..

How can gains from this activity not be subject to United States taxation?

- It is exempted by a statutory safe harbor. Generally, U.S. nonresidents who are not engaged in a U.S. trade or business are subject to a 30 percent U.S. gross withholding tax on fixed, determinable, annual, or periodic payments from U.S. sources (FDAP), subject to reduction in certain cases under treaties or domestic law.
- FDAP includes items generally thought of by non-tax specialists as fixed, determinable, or periodic, such as dividends, interest, rents, and royalties, but it has been expanded to include almost any income other than gain from the disposition of property.
- U.S. nonresidents engaged in a U.S. trade or business are subject to U.S. federal income tax on a net basis on all income that is effectively connected with their U.S. trade or business (their ECI).



# Tax Securities and Commodities Safe Harbor (continued)

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- There is no statutory or regulatory definition of a U.S. trade or business. However, the Internal Revenue Code (the “Code”) includes two statutory safe harbors. Proposed treasury regulations include one more:
  - Under Code section 864(b)(2), trading in stocks, securities, or commodities by a U.S. nonresident through a domestic broker or other independent agent does not constitute a U.S. trade or business. This exemption applies to U.S. nonresidents who are dealers in stocks, securities, and commodities, as well as to nondealers.
- Under the same Code section, trading in stocks, securities, or commodities by a U.S. nonresident who is not a dealer in stocks, securities, or commodities is not a U.S. trade or business even if it is done by an employee or agent with discretionary authority located in the U.S.. This safe-harbor exempts a broader category of activities (i.e., trading through brokers and independent agents in the U.S. as well as trading through employees or dependent agents in the U.S.) from U.S. trade or business status for a narrower group of taxpayers (i.e., U.S. nonresidents who are not dealers in stocks, securities, or commodities).
- Under current proposed regulations, trading in derivatives on stocks, securities, and commodities in the U.S. by a U.S. nonresident that is not a dealer in stocks, securities, commodities, or derivatives does not constitute a United States trade or business.



# Tax Efficient Hedge Fund Strategies

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1. Plan for changes to the taxation of carried interests. Consider changing the carried interest allocation to a fee or the management fee to an allocation.
2. When to recognize gains and losses; Loss harvesting
  - Consider your current year tax situation and your projected tax situation for next year to determine in which year it would be preferable to recognize gains and losses for tax purposes.
3. Miscellaneous itemized deductions
  - Under the TCJA, individuals can no longer deduct miscellaneous itemized deductions for 2018 through 2025
  - Evaluate whether your fund is a trader or an investor and whether that may change. Alternatively, it might be possible to see if such expenses can be capitalized, otherwise recharacterized or paid in a different manner.
4. Consider making a Section 475(f) mark-to-market election.
  - A Section 475 election may offer significant tax benefits, including for built-in gains or losses.



# Tax Efficient Hedge Fund Strategies (continued)

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5. Consider the use of stock-settled stock appreciation rights.
  - If a substantial portion of the carried interest will now be taxable as short-term capital gains, consider the use of stock appreciation rights (“SARs”). SARs allow the deferral of income but there is a built-in clawback, they are very complex and no, or very few, funds have implemented SARs. Since there are several issues regarding the use of SARs, it might take a significant amount of time to implement a SARs plan.
  
6. Private Placement Life Insurance / Insurance Dedicated Funds
  - Hedge fund managers should consider offering insurance dedicated funds (“IDFs”) as a way for investors to invest in their fund strategy in a more tax-efficient manner. Conversely, investors should consider whether investing in a fund via private placement life insurance or private placement variable annuities is potentially a more tax-efficient way to invest. Investing in an IDF can eliminate income and estate taxes if done properly.



# Tax Efficient Hedge Fund Strategies (continued)

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## 7. Opportunity Zones

- If you have recognized capital gains, consider whether it makes sense to reinvest some or all of your capital gains in opportunity zone funds. Opportunity zone provisions were enacted in the TCJA and offer significant tax benefits including deferral of income tax and potential elimination of income tax on future appreciation.

## 8. Section 1256 Contracts

- IRC section 1256 (b)(1) –The term “section 1256 contract” means
  - 1256(b)(1)(A) any Regulated Futures Contracts
  - 1256(b)(1)(B) any foreign currency contract
  - 1256(b)(1)(C) any nonequity option
  - 1256(b)(1)(D) any dealer equity options
  - 1256(b)(1)(E) any dealer securities futures contract



# Tax Efficient Hedge Fund Strategies (continued)

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## 8. Section 1256 Contracts (continued)

- IRC section 1256 Tax Treatment

- Mark to market – Each §1256 Contract held at the close of the taxable year should be treated as sold for its FMV. Basis in the contract is adjusted for any mark inclusion.
- 60/40 Treatment – Any gain or loss attributable to a §1256 contract will be treated as 40% short term and 60% long term capital gain or loss.
- Exception - Foreign Currency Contract – Mark to Market as ordinary treatment unless election is made.



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