

Selected Tax Issues For Hedge Funds

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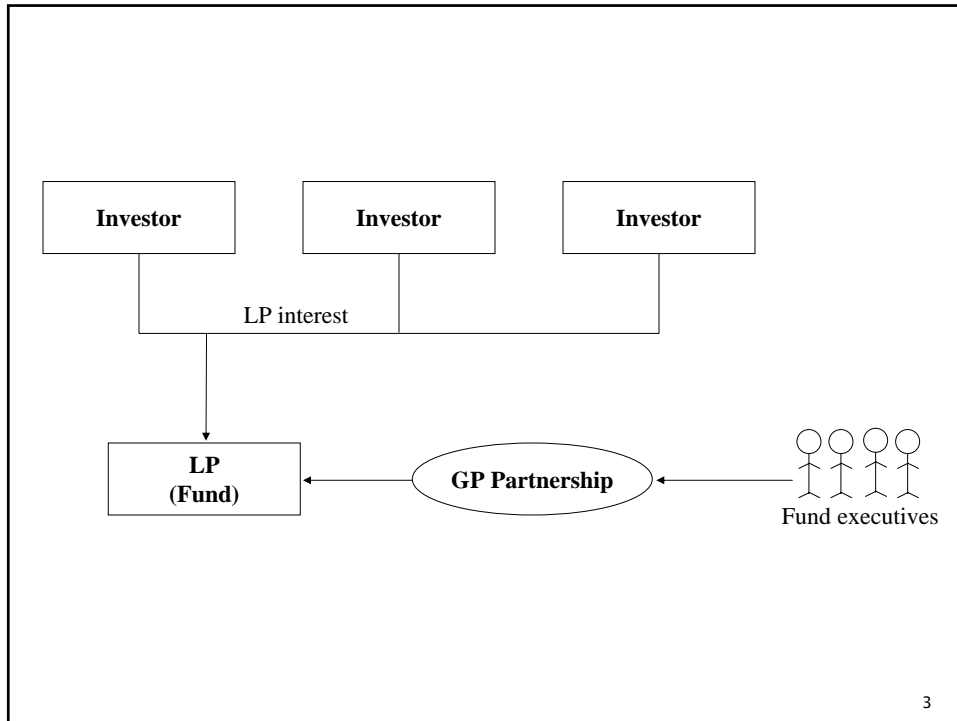
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Selected Tax Issues for Hedge Funds

- Carried interest of General Partner
 - Use of limited partnership with percentage of net profits allocated to general partner; may convert fees to capital gains
 - Proposed (?) U.S. legislation

Senate Finance Committee Minority Member, Chuck Grassley, is considering the reclassification of income of fund managers attributable to a carried interest as compensation. It is understood that Max Baucus, Finance Committee Chair, has no plans to introduce legislation addressing the taxation of private equity fund and hedge fund managers. Accordingly, as of the date of this writing, the prospects of legislation addressing the issue are unclear.



Tax Treatment in Canada

- Is a carried interest desirable from the perspective of a Canadian executive?
 - Yes, if treatment respected, capital gains and Canadian source dividends are taxed at favourable rates
 - Capital gains – 50% of the tax rate on ordinary income between 19.5% and 24.32% (depending on province)
 - Dividends from Canadian corporations are taxed at between approximately 19.1% and 29.7%

Grant of a Carried Interest as a Taxable Event?

Concerns:

- Is the granting of the carried interest a taxable event?
 - In Canada, as carried interest granted at inception of fund it is argued that there is no value
 - In the U.S., in Revenue Procedure 93-27, the IRS indicated that it would not attempt to tax transfers of carried/profits interests - a partnership interest that does not entitle the holder to a share of the proceeds if partnership assets were sold for their fair market value and the net sale proceeds distributed to the partners in liquidation of the partnership, all as of the time the profits interest is granted. An exception to the foregoing is provided if (i) the profits interest relates to a substantially certain and predictable stream of income, (ii) within two years of receipt, the partner disposes of the profits interest, or (iii) the profits interest is a limited partnership interest in a “publicly traded partnership.”

In May 2005, proposed regulations were published explicitly rejecting the theory that the grant of a partnership interest in connection with the performance of services is not a realization event. A service provider receiving a partnership profits interest would be protected from taxation only if the partnership and all of its partners affirmatively elect a “safe harbor” pursuant to which the FMV of the partnership interest is treated as being equal to its liquidation value. Special rules are provided treating profits interest that are not substantially vested.

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Treatment of Income As From Employment

- Does the carried interest produce income from employment?
 - In Canada, the carried interest does not produce income from employment and arguably there is no value at time it is granted
 - In the U.S., although as a general matter, for federal income tax purposes, the carried interest does not produce income from employment, the individuals rendering services on behalf of the Fund may be subject to self-employment tax

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Calculation and Character of Fund Income

- No special regime
- How is the income of the partnership calculated from a Canadian perspective?
 - Income is calculated as if the partnership were a separate person resident in Canada
 - Separately calculate income or loss from each source
 - Income will retain its character in the hands of the partner
- Similar rules apply for purposes of U.S. taxation

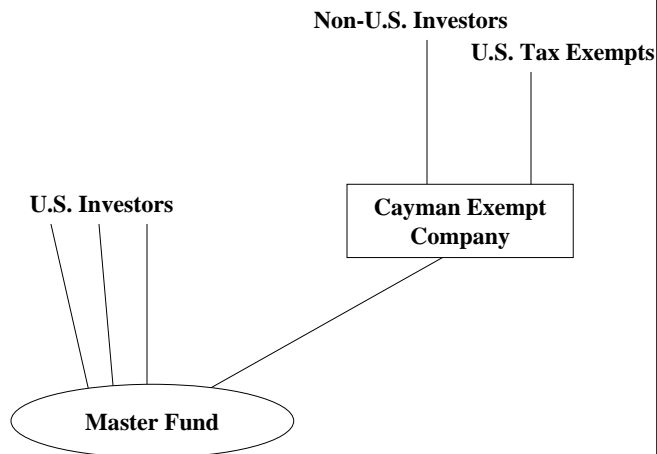
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- Gains and losses from short sales
 - In Canada, if trader or dealer in securities or carry on business of trading taxable on income account; if hold securities to earn investment income, capital gains, CRA permits partners to elect under s. 39(4) ITA to deem gains on capital account; gain or loss on short sale of shares generally on income account unless s. 39(4) election
 - In U.S. no similar issue for the foreign investor (IRC Section 864(b))
- Lending Activity
 - In Canada, lending activities are on income account as form is generally respected in Canada, Repo transactions will not be recharacterized in Canada
 - In the U.S., whereas trading in stocks or securities by a foreign person for its own account is not treated as the engagement in a trade or business under the safe harbor of IRC Section 864(b), such safe harbor does not extend to lending activity; for this purpose, the U.S. characterizes repo transactions as secured loans

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Master / Feeder Structure



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- Master Fund vs. Foreign Corporate Feeder
 - Preference by Canadian pensions to invest in the Master Fund to avoid withholding tax on dividends
 - Canadian taxable investors have likewise begun investing through the Master Fund in the Master/Feeder structure in order to access reduced rate of withholding on dividends
 - Both with respect to Canadian pensions and Canadian taxable investors, regard must be given to the provisions of IRC Section 894(c), treating investments through hybrid entities
 - Foreign investment entity reporting in Canada - either imputed income based on prescribed rate times designated cost or mark-to-market; applies to investment in offshore corporation
 - U.S. tax exempts generally choose to invest through the foreign corporate feeder, regard being given to UBIT issues; this can be of special concern to charitable remainder trusts, given that such trusts can lose their tax exempt status in the event that they have even a single dollar of UBIT
 - Place of organization of the feeder, U.S. or foreign, regard being given to disparate reporting requirements and the potential application of the U.S. controlled foreign corporation regime to foreign equities acquired by the fund

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- Total Equity Swaps
 - Used to avoid Canadian withholding tax on dividends or distributions from income trusts
 - No Canadian withholding tax on compensation payments

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- Carrying on Business - Manager in U.S./Canada, Fund in Cayman
 - Protection in Canada provided conditions met; non-residents NOT considered to be carrying on business in Canada if designated investment services provided by a Canadian service provider (s. 115.2 ITA)
 - Protection in the United States provided under the safe harbor rule of IRC Section 864(b) for trading (but not dealing) in stocks and securities for the taxpayer's own account; for this purpose, the term "securities" is defined broadly to include notes, debentures and other evidence of indebtedness or any evidence of an interest in a right to subscribe to or purchase any of the foregoing; under the proposed regulations, the safe harbor is extended to trading in derivatives, including swaps, derivative financial instruments in commodities, currency, equities, partnership or beneficial ownership interests in a widely held or publicly traded partnership or trust, indebtedness or swaps; special rules, however, apply to shares of USRPHCs, as to which gain is treated as effectively-connected with a U.S. trade or business subject to an exception for stock regularly traded on an established securities market where the foreign investor holds 5% or less of the class of stock and shares of domestically controlled REITs

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