

LB&I Concept Unit

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General Overview

Hedge Fund Basics

Note: This Practice Unit was updated to remove references to resources that are no longer current or available and to correct minor typographical or formatting errors. It supersedes the 01/25/2017 Practice Unit of the same title.

Hedge funds are investment vehicles available to investors meeting certain net worth criteria.

A typical hedge fund structure includes one entity formed as a partnership for U.S. tax purposes that acts as the Investment Manager (IM). Another entity functions as the General Partner (GP) of the Master Fund. The IM receives a management fee (usually 2% of the underlying fund's net asset value) to manage the portfolio and to cover for operating and administering the fund (e.g., overhead, personnel compensation, office leases, and fixed asset costs). The GP receives an incentive compensation allocation based upon the performance of the master fund (usually 20% of the profits in excess of prior losses and net of management fees) in the form of an allocation of partnership profits.

Hedge funds are not private equity funds, mutual funds, ETFs, bond funds, regulated investment companies (RICs) or real estate investment trusts (REITS). Hedge funds' investments are more liquid than private equity funds. A hedge fund's investment time horizons are generally much shorter than a private equity fund's, which generally has investment horizons of 2 to 10 years. Unlike mutual funds, hedge funds are minimally regulated. Hedge funds are privately owned unlike ETFs, RICs, REITS, and bond funds which are publicly traded vehicles.

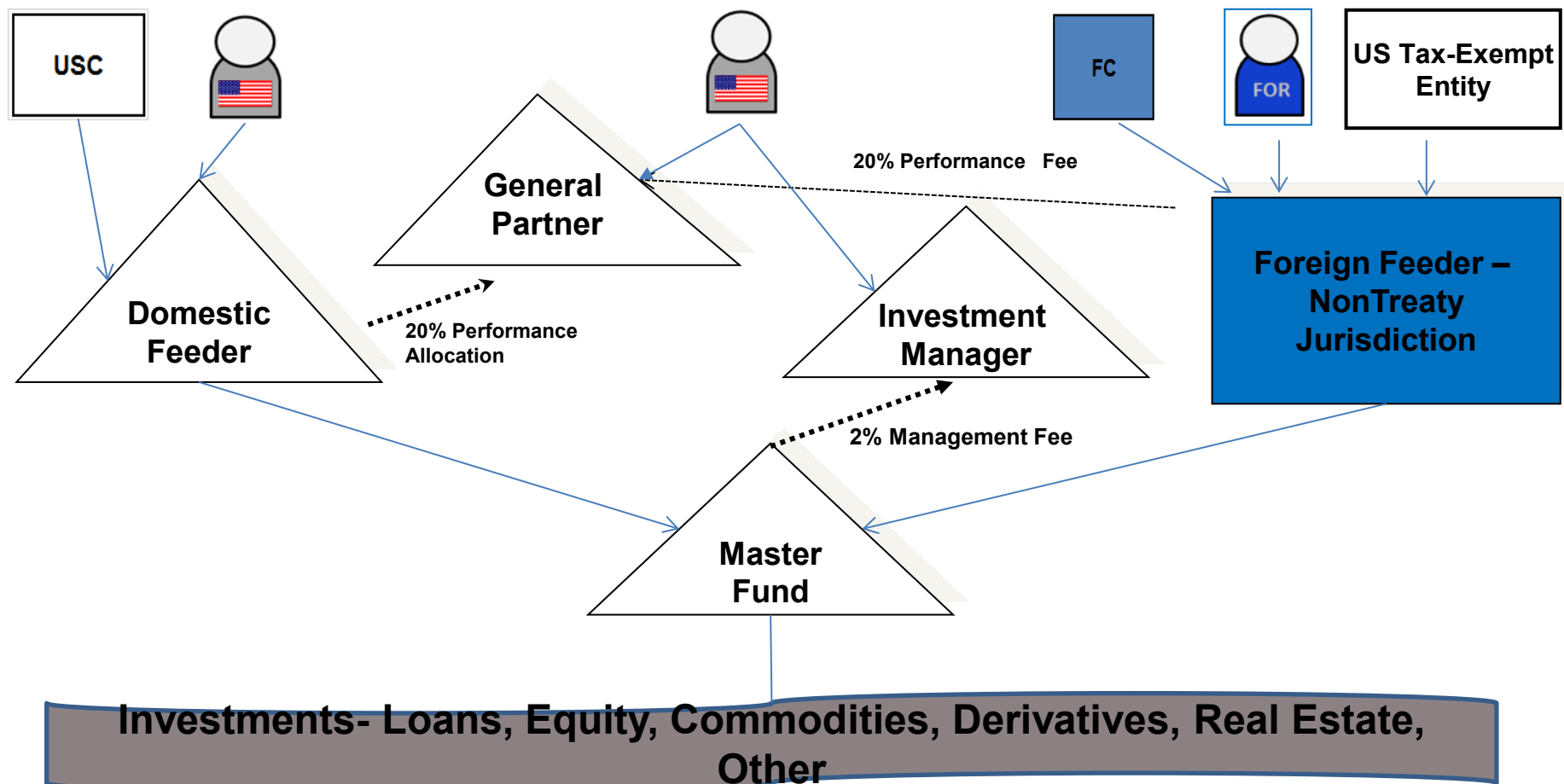
Most hedge funds use one of the following organization structures: 1) a single entity fund, 2) a master feeder fund, 3) a parallel fund, or 4) a fund of funds. For purposes of this LB&I Concept unit, we will be focusing on master feeder funds as they are more common in International tax examinations. The master feeder fund structure illustrated in the Diagram of Concept is a simple structure and taxpayers may be using more complicated structures.

This LB&I Concept Unit will focus on tax issues related to a master fund.

Diagram of Concept

Hedge Fund Basics

Master-Feeder Structure



Facts of Concept

Hedge Fund Basics

Facts of Concept

Who is the taxpayer?

1. Master Fund - The Master Fund is generally a foreign entity or U.S. limited partnership or LLC (treated as a partnership for U.S. tax purposes). The Master Fund invests the capital of both the foreign feeder and domestic feeder according to the Fund's investment strategy. Investments may include stocks, bonds, securities and other financial instruments. Generally, the Master Fund files Form 1065, U.S. Return of Partnership Income.
2. Investment Manager - The Investment Manager generally is a U.S. partnership or LLC whose partners include an individual investment advisor(s) and other individuals or entities. The Investment Manager manages the portfolio of the Master Fund on behalf of the investors. As consideration for managing the portfolio, the Master Fund enters into a Management Agreement including provisions to pay the Investment Manager a management fee equal to a fixed percentage (generally 2%) of the fair market value (or net asset value) of the underlying portfolio of investments.
3. General Partner - The General Partner is a U.S. partnership owned by the same or similar partners or members of the Investment Manager. It usually holds a small general percentage interest (1% or more) in the Master Fund and/or feeder funds. The general partner participates in the economic performance of the Master Fund through the "carried interest." The Master Fund will issue the General Partner a profits interest (generally 20% of the annual master fund profit that exceeds a specified amount) that is treated as a partnership interest as opposed to a fee for services rendered.

Facts of Concept (cont'd)

Hedge Fund Basics

Facts of Concept

Who is the taxpayer? (cont'd)

4. Domestic Feeder (DF)- The domestic feeder is generally a U.S. limited partnership or LLC (treated as a partnership for U.S. tax purposes). The DF is a passthrough entity almost always comprised of US individual investors, U.S. C corporations, or other U.S. taxable entities. Generally, all income that is allocated from the Master Fund to DF would be subject to US taxation at the partner level.
5. Foreign Feeder (FF)- The foreign feeder is typically formed as a foreign corporation. For US tax purposes, the FF is treated as a corporation (there may be a Form 8832 election made). The place of formation is generally a low or no tax jurisdiction (Cayman Islands, Bermuda, etc). The US tax-exempt investors (pension funds, 401k funds, governmental entities, etc.) and foreign investors (foreign corporations, non-resident aliens, etc.) make their investments in the Master Fund through the FF. Any distributions from the FF to its foreign investors are treated as dividends for US tax purposes.

The choice of the corporate form may also lead to the FF being classified as a passive foreign investment company" ("PFIC") under IRC 1297. A foreign corporation is a PFIC if either a) 75 percent or more of its gross income for the tax year is passive income (passive income test), or b) on average 50 percent or more of its assets produce passive income or are held for the production of passive income (passive asset test). An asset is generally characterized as passive if it generates, or is reasonably expected to generate, in the reasonably foreseeable future, passive income as defined in IRC 1297(b). The FF is commonly referred to as a blocker entity because it prevents income flow through treatment to the investors in the FF.

Detailed Explanation of the Concept

Hedge Fund Basics

Key Documents in Hedge Fund Identification

Analysis	Resources
Identifying a Master/Feeder Structure	- Global Tax Organizational Chart - Form 1065- NAICS code (i.e., 523900); Business Activity / Product Description (i.e., Investments) - On Form 1065 of Master Fund, only Schedule K investment type income is being reported (little or no ordinary income/losses reported on page 1.) - On Form 1120-F filed by the foreign partner, which may report little or no income/expenses on Section II, Income Effectively Connected with the Conduct of a Trade or Business in the United States. - The filing of a Protective Form 1120-F Return by the Foreign Feeder showing no income or expenses or checking the box that they are not engaged in a U.S. trade or business. - Certain words in the Taxpayer Name (i.e., US Feeder, Master Fund, Secondary Fund, Co-Investment, etc.)

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

Key Documents in Hedge Fund Identification (Continued)

Analysis	Resources
Identifying a Master/Feeder Structure	- Disclosure of an Agent location in the U.S. for the Foreign Feeder on Form 1120-F Page 1, Question E - On the foreign feeder Form 1120-F, there may be limited assets reported on Balance Sheet (i.e. only asset is an investment in another partnership) Schedule L - On Form 1120-F, Schedule M-1 or M-3 may have a large adjustment for Net Income which is not reported for tax purposes on Schedule M-3 column 3 "Other Permanent Differences for Allocations to Non-ECI and ECI"

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

U.S. Trade or Business Issues

Analysis	Resources
1. Is the Master Fund engaged in a U.S. trade or business ("USTB")? ▪ The Code/Regulations do not have a comprehensive definition of USTB. ▪ The term USTB includes the performance of certain personal services within the United States at any time within the taxable year. ▪ Whether a person engages in a trade or business within the United States is based on the facts and circumstances of each case. The Master Fund will be considered engaged in a trade or business within the United States if its trade or business activities are considerable, continuous and regular. ▪ The activities undertaken by any agents acting on behalf of the person are taken into account. Thus, activities performed by the Investment Manager could be deemed performed on behalf of the Master Fund.	▪ IRC 864(b) ▪ Treas. Reg. 1.864-2(e) ▪ USTB Cases cited on Index of Related Issues

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

U.S. Trade or Business Issues

Analysis	Resources
2. Activities that do not constitute a trade or business within the U.S. by a Master Fund ▪ Investing ▪ The conduct of activities in the United States that are ministerial and ancillary to a business conducted outside the United States are not sufficient to give rise to a trade or business in the United States. 3. A nonresident alien individual or foreign corporation is treated as engaged in a trade or business within the United States if the partnership of which it is a member is so engaged.	▪ Higgins v. Commissioner, 61 S.Ct. 475 (1941) ▪ Scottish American Investment Co. v. Commissioner, 12 T.C. 49 (1949) ▪ IRC 875(1)

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

Trading Safe Harbors to U.S. Trade/Business Classification

Analysis	Resources
Exceptions to the Master Fund being engaged in a U.S. trade or business 1. Trading in Stocks, Securities, and Commodities: the term “trade or business in the United States” does not include trading activities that satisfy one of the following safe harbors: ▪ Safe Harbor No.1: Trading in stocks, securities, or commodities through a resident broker, commission agent, custodian, or other independent agent, but only if the foreign person does not have an office or other fixed place of business in the United States through which the transactions in stocks or securities, or in commodities are effected. A foreign person that is a dealer can use this exception to avoid US trade or business status. ▪ Safe Harbor No.2: Trading in stocks, securities, or commodities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. This safe harbor is not available to a dealer in stocks, securities, or commodities.	▪ IRC 864(b)(2)(A)-(C)

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

Trading Safe Harbors to U.S. Trade/Business Classification

Analysis	Resources
▪ The term “securities” means any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing; and the effecting of transactions in stocks or securities including buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer. ▪ The phrase “effecting of transactions in stocks or securities” includes buying, selling, shorting or trading stocks, securities, or options or contracts to buy or sell stocks or securities for the account and risk of the taxpayer, and any other activities closely related to those activities, such as obtaining credit. ▪ An NRA individual or foreign corporation is not engaged in a trade or business within the U.S. solely because it is a member of a partnership that effects transactions in securities for the partnership’s own account.	▪ Treas. Reg. 1.864-2(c)(2)(i) ▪ Treas. Reg. 1.864-2(c)(2)(ii)

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

Trading Safe Harbors to U.S. Trade/Business Classification

Analysis	Resources
2. Trading in Derivatives: ▪ If a foreign person is not a dealer, the term engaged in trade or business within the United States does not include effecting transactions in derivatives for the taxpayer's own account, including hedging transactions. 3. A Dealer in Stocks or Securities may be eligible for Safe Harbor No.1 but may not rely on Safe Harbor No.2. A dealer in stocks or securities is generally: ▪ A merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom. Dealer exclusion - Persons who buy and sell, or hold, stocks or securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations, members of partnerships, or fiduciaries, who in their individual capacities buy and sell, or hold, stocks or securities for investment or speculation are not dealers in stocks or securities.	▪ Prop. Treas. Reg. 1.864(b)-1 ▪ Treas. Reg. 1.864-2(c)(2)(iv)(a) ▪ Treas. Reg. 1.864-2(c)(2)(iv)(a)

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

US Source Income that is Effectively Connected Income With a US Trade or Business

Analysis	Resources
If the Master Fund is engaged in a US trade or business, what US source income could be Effectively Connected Income: ▪ Whether FDAP income (including U.S. source interest and dividends) and U.S. source gain or loss from the sale or exchange of capital assets is effectively connected is based on the Asset Use test or Business Activities test – Asset Use test - the income, gain or loss is derived from assets used in or held for use in the conduct of such trade or business. – Business Activities test - the activities of such trade or business were a material factor in the realization of the income, gain or loss. – As an example, if a Hedge Fund is a continuous lender of funds and records such loans and interest income on its U.S. books, it is likely the asset use or business activities test has been met. ▪ U.S. source income, other than FDAP and gain or loss from the sale of capital assets, is Effectively Connected Income.	▪ IRC 881(a) ▪ IRC 864(c)(2)(A) ▪ IRC 864(c)(2)(B) ▪ IRC 864(c)(3)

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

US Source Income that is Effectively Connected Income With a US Trade or Business

Analysis	Resources
If the Master Fund is engaged in the active conduct of a banking, financing or similar business in the US, through any of the following activities then the income (interest income, fee income, etc) will be considered effectively connected notwithstanding the Asset Use and Business Activities tests previously discussed: Activities including: ▪ Receiving deposits of funds from the public, ▪ Making personal, mortgage, industrial, or other loans to the public, ▪ Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness, ▪ Issuing letters of credit to the public and negotiating drafts drawn thereunder, ▪ Providing trust services for the public, or ▪ Financing foreign exchange transactions for the public.	▪ Treas. Reg. 1.864-4(c)(5)(i)

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

Foreign Source Income that is Effectively Connected Income With a US Trade or Business

Analysis	Resources
When the Master Fund is engaged in a US trade or business: certain foreign source income earned by the Master Fund may be effectively connected if i. Income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or a foreign corporation if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable and such income, gain, or loss and ii. Consists of dividends, interest, or amounts received for the provision of guarantees of indebtedness, and either is derived in the active conduct of a banking, financing, or similar business within the United States or is received by a corporation the principal business of which is trading in stocks or securities for its own account.	▪ IRC 864(c)(4)(B)(ii)

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

US Source Income That is Effectively Connected Income With a US Trade or Business

Analysis	Resources
If the Master Fund is investing in U.S. real estate, what is the tax treatment: ▪ Per the provisions of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), gain or loss of a foreign corporation from the disposition of a United States real property interest shall be taken into account as if the taxpayer were engaged in a trade or business within the United States during the taxable year and such gain or loss were effectively connected with such trade or business. ▪ A United States real property interest includes a) an interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the Virgin Islands, and b) any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that such corporation was at no time a United States real property holding corporation.	▪ IRC 882(a)(1) ▪ IRC 897(a)(B) ▪ IRC 897(c)(1)(A)(i-ii)

Detailed Explanation of the Concept (cont'd)

Hedge Fund Basics

US Source Income That is NOT Effectively Connected Income With a US Trade or Business and Subject to US Tax

Analysis	Resources
If the Master Fund is engaged in a U.S. trade or business, what is the tax treatment of certain Non-Effectively Connected Income: - Foreign persons are liable for taxes whether they derive the income directly or through a partnership. - The Code imposes a 30% U.S. tax on amounts of FDAP that is U.S. source and not effectively connected with a U.S. trade or business unless the foreign person is eligible to claim a reduced rate of withholding under an income tax treaty. - This tax is generally collected by withholding at the source by the payer of the income. - If organized as a U.S. entity, the Master Fund is a withholding agent. - If the Master Fund receives interest income that is characterized as Portfolio Interest, there is no withholding required by the Master Fund and the recipient is not subject to U.S. tax on such interest income.	- IRC 702(b) - IRC 871(a) - IRC 881(a) - IRC 1441(a) - IRC 1442(a) - IRC 1441(b) - IRC 881(c) (2)

Index of Referenced Resources

Hedge Fund Basics

USTB Cases cited on [Index of Related Issues](#)

Form 1065

Form 1120-F

IRC 702

IRC 864

IRC 871

IRC 875

IRC 881

IRC 882

IRC 897

IRC 1296

IRC 1441

IRC 1442

Treas. Reg. 1.864-2

Treas. Reg. 1.864-4

Prop. Treas. Reg. 1.864(b)-1

Training and Additional Resources

Hedge Fund Basics	
Type of Resource	References
Reference Materials	▪ Hedge Funds BNA Portfolio - BNA Tax Management Portfolio 736

Glossary of Terms and Acronyms

Term/Acronym	Definition
ECI	Effectively Connected Income
FC	Foreign Corporation
FDAP	Fixed Determinable Annual or Periodical
FIRPTA	IRC 897(a) provides that a foreign person must report gain or loss on the disposition of a “ United States real property interest” as Effectively Connected Income.
MF	Management Fees received by the investment advisor typically based on the net asset value of assets under management. The typical fee percentage will usually range from 1.5% to 2% of the net asset value of the portfolio per annum.
PFIC	Passive Foreign Investment Company
REIT	Real Estate Investment Trust

Index of Related Issues

Issue	Associated UIL(s)	References
USTB cases	9421.01 - Identification of a U.S. trade or business or permanent establishment (PE)	- Pinchot v. Commissioner, 113 F.2d 718, 719 (Fed 2d Cir. 1940). - Inverworld Ltd. v. Commissioner, 979 F.2d 868 (CA DC.1992) - De Amodio, 34 T.C. 906 (1960) - Handfield v. Commissioner, 23 T.C. 633 (1955) - Lewenhaupt v. Commissioner, 20 T.C. 151 (1953)
Exceptions to USTB- cases	9421.01 - Identification of a U.S. trade or business or permanent establishment (PE)	- Higgins v. Commissioner, 61 S.Ct. 475 (1941) - Scottish American Investment Co. v. Commissioner, 12 T.C. 49 (1949). - Estate of Yaeger v. Commissioner, 889 F.2d 29 (Fed 2d Cir. 1989)
Chief Counsel Advisory for U.S. Trade or Business status for lending and underwriting activities	9421.01 - Identification of a U.S. trade or business or permanent establishment (PE)	CCA 201501013
Chief Counsel Advisory for Dealer Status	9421.01 - Identification of a U.S. trade or business or permanent establishment (PE)	CCA 201238025
Hedge Fund Lending case	9421.01 - Identification of a U.S. trade or business or permanent establishment (PE)	IRS AM 2009-010 – Hedge Fund GLAM – Lending case

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9421	Interest Expense of a US Branch of a Foreign Bank Non-Treaty
9421	Gross Effectively Connected Income (ECI) of a Foreign Corporation (Non-Treaty)