This memorandum is intended to provide a quick reference guide to the key U.S. income tax issues that may be encountered by a hedge fund-of-funds and its investors by virtue of the investments in the underlying hedge funds. A typical structure (as depicted in the diagram) would have the U.S. tax-exempt investors, along with the non-U.S. investors, investing in a foreign “blocker” corporation (the Offshore Fund) that invests in a domestic fund-of-funds (FOF) partnership (the Hedge FOF). The U.S. taxable investors would typically invest directly in the Hedge FOF. The Hedge FOF then invests in the underlying hedge funds (the Underlying Hedge Funds), which may be either foreign or domestic and either corporate or partnership in form.

The key tax issues addressed herein are:

- Passive Foreign Investment Companies - PFICs
- Controlled Foreign Corporations - CFCs
- U.S. reporting obligations
- Effectively Connected Income - ECI
- Withholding tax
- Tax treaties
- Unrelated business taxable income - UBTI

These tax issues can arise at the level of the Underlying Hedge Funds, the Hedge FOF, the Offshore Fund, or at the investor level. Investors are divided into three categories – U.S. taxables, U.S. tax-exempts and non-U.S. Each has its own unique tax issues. It should be noted that while some of the tax rules discussed here may apply only to the Underlying Hedge Funds, the tax consequences of the application of those rules will be borne by the investors in the Hedge FOF or Offshore Fund due to their direct or indirect ownership of the Underlying Hedge Funds and their investments.

As indicated previously, Underlying Hedge Funds may be either domestic funds or foreign funds. There is typically no provision in a Hedge FOF’s documents that dictates what allocation the Hedge FOF must have to U.S. or foreign Underlying Hedge Funds. Domestic Underlying Hedge Funds are usually organized in partnership form, or are organized as companies that are treated as partnerships for U.S. tax purposes. Investing in a domestic Underlying Hedge Fund that is a corporation for U.S. tax purposes would have significant tax inefficiencies and should be avoided in the absence of very close scrutiny of the benefits to be obtained from that structure. Foreign Underlying Hedge Funds are generally organized as either foreign corporations or partnerships. Finally, domestic and foreign Underlying Hedge Funds may invest in securities issued by domestic or foreign issuers whose securities may be traded on domestic or foreign exchanges. In every case, each investment in an Underlying Hedge Fund must be closely reviewed for its tax consequences to the Hedge FOF’s investors.

In making this tax analysis, it is important to note that an entity may be classified as a corporation or a partnership for U.S. tax purposes without regard to the name of the entity. For example, a Cayman Island Exempt Limited Company can be taxed as either a corporation or a
corporate investments may be PFICs (see the discussion that an Underlying Hedge Fund itself or any of its foreign The most critical tax exposure for U.S. taxable investors is value of its gross assets are “passive.”

"passive income;" or (ii) at least 50 percent of the average rules, either (i) at least 75 percent of its gross income is “passive income;” or (ii) at least 50 percent of the average value of its gross assets are “passive.”

The most critical tax exposure for U.S. taxable investors is that an Underlying Hedge Fund itself or any of its foreign corporate investments may be PFICs! (see the discussion under “The Investors” below). For example, if a U.S.-taxable investor invests in the Hedge FOF, which in turn invests in a foreign corporate Underlying Hedge Fund, the investor will be considered for tax purposes to have invested directly in the foreign corporate fund. Because it is a foreign corporation, it is likely that the corporate Underlying Hedge Fund is a PFIC. In addition, if the foreign corporate Underlying Hedge Fund in turn invests in a foreign corporation, that foreign corporation may constitute a subsidiary PFIC and the U.S.-taxable investor will be treated as owning his pro rata share of the stock of that subsidiary PFIC. To the extent the Underlying Hedge Fund is a partnership, either foreign or domestic, which invests in a foreign corporation which is a PFIC, a taxable investor will be considered to own that PFIC stock directly.

Ownership of PFIC stock by the Hedge FOF or an Underlying Hedge Fund can result in an interest charge to U.S. taxable investors on any distributions from the PFIC; and gain on disposition of PFIC stock can be converted from capital gain to ordinary income by reason of the PFIC status. The making of a Qualified Electing Fund (QEF) election will avoid these adverse tax consequences, but each U.S.-taxable investor owning an interest (indirectly) in the PFIC will be required, if a QEF election is made, to include in income annually its share of the PFIC current income and gains (losses are not deductible). As result of a QEF election, a U.S.-taxable investor could recognize income subject to tax even though there may be no corresponding receipt of cash.

CFCs - Another anti-deferral provision in the Code potentially applicable to U.S. taxable investors relates to investments in controlled foreign corporations (CFCs). CFCs, by definition, require greater than 50 percent ownership by U.S. shareholders (the Hedge FOF is a shareholder for this purpose) each owning more than 10 percent of the voting stock of the foreign corporation. In the typical hedge fund, this is an unlikely (but not impossible) circumstance, at either the fund level or with regard to a fund investment. If the Hedge FOF or an Underlying Hedge Fund owns a CFC and the Hedge FOF owns directly or indirectly through an Underlying Hedge Fund that is a partnership for U.S. tax purposes, more than 10 percent of the CFC, U.S. taxable investors will be required to include in income the investor’s ratable share of the investment income of the underlying CFC, and on exit a portion of the gain may be converted from capital gain to ordinary income.²

U.S. Reporting Obligations - If the Hedge FOF acquires a 10 percent or greater interest in the stock of a foreign corporation, either directly or indirectly through an Underlying Hedge Fund that is a partnership for U.S. tax purposes, it is obligated to complete an IRS form 5471 for the corporation for each tax year that it owns the position. Completing the form requires significant information from the foreign corporation.

ECI - Individuals who are neither U.S. citizens nor residents of the U.S. for tax purposes (i.e. they are non-resident aliens) and entities treated as foreign corporations for U.S. tax purposes (which would include the Offshore Fund) are taxable on income that is effectively connected to the conduct of a U.S. trade or business (ECI). As a foreign corporation, the Offshore Fund will be subject to U.S. income tax if it is deemed to be engaged in the conduct of a trade or business in the United States (U.S. Business). The Offshore Fund will be treated as engaged in a U.S. Business if it is a partner in a partnership (i.e. the Hedge FOF) that is so engaged. The Hedge FOF will be deemed engaged in a trade or business if any of its Underlying Hedge Funds organized in partnership form is so engaged. Thus, if an Underlying Hedge Fund in partnership form (domestic or foreign) engages in a U.S. Business, the Offshore Fund, by virtue of its indirect investment in the Underlying Hedge Fund, will be deemed to be so engaged. In that case, the Offshore Fund will be
subject to U.S. tax at the regular corporate tax rate on its allocable share of income. In addition, the federal branch profits tax, levied at the rate of 30 percent (subject to reduction or elimination in an applicable U.S. treaty), will apply. If any Offshore Fund is considered to be engaged in a U.S. Business, it will be required to file U.S. federal income tax returns, whether or not it has any income allocated to it from the U.S. business. Failure to file a U.S. tax return within 18 months of its due date will cause the Offshore Fund to be taxed on its gross income connected to the U.S. Business without the benefit of any otherwise available deductions.

Although investing in or trading U.S. stocks, securities and commodities is generally not considered to be the conduct of a U.S. Business, certain activities or investments by an Underlying Hedge Fund formed as a partnership may give rise to it being engaged in a U.S. Business, including:

- investment in a U.S. pass-through entity (e.g. a U.S. LLC) that is engaged in an active operating U.S. Business
- loan origination activities
- certain types of mezzanine lending
- certain types of distressed debt investment
- certain investments in U.S. real property interests
- being a dealer in securities.

**Tax Withholding** - The U.S., along with most other countries, in order to insure collection of tax, imposes withholding tax on most items of investment income earned by non-resident investors (e.g. dividends, interest and, in some cases, capital gains). In the U.S., the statutory rate of withholding is 30 percent, subject to reduction or elimination by income tax treaty, if applicable, as described below. The U.S. withholding tax system operates on a self-certification basis (through the provision of Form W-8), which permits the U.S. entity that has the withholding obligation (i.e. the “withholding agent”) to distribute the item of income without withholding of tax if it has received the applicable W-8 form.³ In many other countries, the tax must be initially withheld and is then subject to the filing of a valid refund claim by the taxpayer.

In a tiered entity structure involving U.S. and foreign organizations, the obligation to withhold U.S. income tax on distributable income is generally imposed on the last U.S. entity in the distribution chain. For example, because the Offshore Fund is a foreign corporation, the Hedge FOF will have a withholding obligation on items of income distributable to the Offshore Fund that are subject to withholding tax.⁴

An Underlying Hedge Fund or an entity in which it has invested may also have to withhold non-U.S. taxes on income distributable by it to the Hedge FOF. The amount of tax an Underlying Hedge Fund must withhold will depend on the laws of the Underlying Hedge Fund’s jurisdiction of formation and/or operation. A domestic Underlying Hedge Fund, however, will not be obligated to withhold on distributions to a domestic Hedge FOF but may be required to withhold with respect to distributions to a foreign Hedge FOF.

**Tax Treaties** - Tax treaties generally reduce the otherwise applicable withholding tax rate on items of investment income (e.g. interest, dividends and sometimes capital gains). In order to claim a treaty benefit, the investor generally must be the beneficial owner of the income, as well as a resident of the treaty country. It should be noted that the U.S. (as well as most other countries) does not have a tax treaty with tax havens such as the Cayman Islands, the jurisdiction of formation of many offshore funds and blocker corporations.

Where the Hedge FOF is a U.S. partnership, it will typically not be considered a U.S. resident for purposes of most U.S. treaties. Where the Offshore Fund, which is the investment vehicle for U.S. tax-exempt and non-U.S. investors, is a Cayman Island corporation, there will be no available treaty to reduce U.S. withholding obligations. U.S.-taxable investors, on the other hand, may be able to claim available U.S. treaty benefits in their own capacity, at least as to certain foreign investments made by an Underlying Hedge Fund formed as a partnership.
**UBTI** - U.S. tax-exempt investors are taxed on the receipt of any unrelated business taxable income (UBTI). UBTI is generally defined as income from a trade or business regularly carried on by a tax-exempt entity and does not generally include dividends, interest or capital gains. Since U.S. tax-exempt investors invest in the Offshore Fund, UBTI, which is otherwise generated by the Underlying Hedge Funds, is “blocked” from passing through to those investors. Therefore, whether an Underlying Hedge Fund generates UBTI is not a concern for the Hedge FOF structured with an Offshore Fund as a “blocker.”

**Use of Side Letters** - Although the Hedge FOF cannot ordinarily exercise control over the activities of the Underlying Hedge Funds in making their investments, the practice has grown in the marketplace to request a side letter from the Underlying Hedge Fund containing commitments relating to some or all of the various tax risks described in this memorandum. The level and exact nature of the commitment is subject to negotiation and varies widely. Sample “investor-friendly” side letter provisions are included in the appendix to this memorandum.

**THE INVESTORS**

The following paragraphs highlight the principal U.S. tax risk for each specific category of investors.

**U.S. Taxable Investors** - The principal tax risk for U.S. taxable investors is that they will be considered to own shares in a PFIC by attribution through the Hedge FOF from the Underlying Hedge Fund or its investments. The tax consequences for a U.S.-taxable investor owning a PFIC are that he will pay an interest charge on excess distributions on which taxes are deemed to have been deferred and will recognize ordinary income rather than long-term or short-term capital gain on disposition. The making of a QEF election will alleviate these adverse tax consequences, but such election requires the active participation of the PFIC itself, which must be separately negotiated for and is often not provided. It should also be noted that as a result of a QEF election, a U.S.-taxable investor may recognize income subject to tax even though there may be no corresponding receipt of cash by the investor. The U.S.-taxable investor may make an election to defer the payment of the tax that is due by virtue of the QEF election, but there is an interest charge on the deferral of the tax.

**U.S. Tax-Exempt Investors** - The principal tax exposure of a U.S. tax-exempt investor – namely the receipt of UBTI – is generally avoided by virtue of having those investors invest in the Offshore Fund, which acts as a “blocker” for any UBTI otherwise generated by the Underlying Hedge Funds. Income derived by a U.S. tax-exempt investor from an investment in a PFIC is generally not UBTI. Use of the blocker for U.S. tax-exempts is potentially tax inefficient for them when the income realized is of the type that is subject to withholding tax, principally U.S. source dividends, or is income that is ECI but is not otherwise classified as UBTI (e.g. capital gain on the sale of an LLC interest or a U.S. real property interest). If the Hedge FOF or an Underlying Hedge Fund invests in a U.S. corporation and that corporation pays a dividend, that portion of the dividend that is allocated to the Offshore Fund will be subject to a non-refundable U.S. withholding tax of 30 percent. If, on the other hand, the U.S. tax-exempt investor held the investment directly in the Hedge FOF, the income would not be subject to the 30 percent tax. If an Offshore Fund realizes ECI income, it will be taxed as described at “ECI,” above.

**Non-U.S. Investors** - A non-U.S. investor’s principal tax concern relates to the possibility of being considered to be engaged in a U.S. Business by virtue of the activities or investments of the Underlying Hedge Funds. Since the non-U.S. investors invest through the Offshore Fund, the ECI exposure is “blocked,” with the result that all tax costs and compliance obligations are incurred at the Offshore Fund level, as discussed above. Non-U.S. investors are unaffected by investments in PFICs.

**KEY QUESTIONS**

Below in question form is a listing of information relating to investments by the Hedge FOF in the Underlying Hedge Funds necessary in order to properly analyze the numerous tax issues described above.

**Questions to Ask Underlying Hedge Fund Managers**

- Is the Underlying Hedge Fund a domestic or foreign entity?
- Is the Underlying Hedge Fund a corporation or a pass-through entity for U.S. tax purposes?
- If foreign, in which jurisdiction is the Underlying Hedge Fund organized?
• Does the Underlying Hedge Fund intend to invest in domestic or foreign entities, or both?
• Has the Underlying Hedge Fund invested, or does it intend to invest, in pass-through entities (e.g. U.S. LLCs)?
• Do the activities to be engaged in by the Underlying Hedge Fund constitute engaging in U.S. trade or business? Is this issue discussed in the Underlying Hedge Fund’s offering materials?
• Does the Underlying Hedge Fund intend to invest in U.S. real property interests, including U.S. corporations that hold significant U.S. real property?
• Does the Underlying Hedge Fund intend to use leverage in the making of its investments?
• Does the Underlying Hedge Fund anticipate claiming U.S. treaty benefits with regard to any of its investments?
• Does the Underlying Hedge Fund permit investments in PFICs? Do the Underlying Hedge Fund’s offering materials discuss whether information will be provided to enable an investor to make a QEF election?
• Does the Underlying Hedge Fund provide assurances that its investments will not cause any of its investors to be required to file tax returns in jurisdictions other than in their place of residence?
• Does the Underlying Hedge Fund allow for side pocket (illiquid) investments?

Foreign Corporate Underlying Hedge Fund Investing In U.S. Entities
• foreign corporate Underlying Hedge Fund itself may be a PFIC as to U.S.-taxable investors.

Foreign Corporate Underlying Hedge Fund Investing In Foreign Entities
• foreign Underlying Hedge Fund may be a PFIC
• investment in a foreign corporation may give rise to subsidiary PFIC issues.

Foreign Partnership Underlying Hedge Fund Investing In Domestic Entities
• possible ECI exposure to Offshore Fund (see Domestic Underlying Hedge Fund investing in domestic entities, above).

Foreign Partnership Underlying Hedge Fund Investing In Foreign Entities
• investment in a foreign corporation may give rise to PFIC issues.

SUMMARY OF KEY CONCERNS

The following highlights the key U.S. tax concerns arising in a variety of potential investment scenarios.

Domestic Underlying Hedge Fund Investing In Domestic Entities

• ECI exposure for Offshore Fund
• nature of Underlying Hedge Fund’s activities (e.g. loan origination) or investments (e.g. U.S. real property interests, LLCs).

Domestic Underlying Hedge Fund Investing In Foreign Entities

• PFIC and CFC exposure for U.S.-taxable investors
• possible treaty benefits for U.S.-taxable investors.

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Endnotes

1 While the Offshore Fund itself will likely be classified as a PFIC, no U.S. taxable investors are anticipated to invest in the Offshore Fund.

2 If an investment is both a CFC and a PFIC, only the CFC rules will apply so long as the Hedge FOF owns more than 10 percent of the CFC.

3 Provision of these forms is generally required in a fund's subscription package.

4 It should be noted, however, that subject to the discussion of ECI, above, most U.S.-source investment income is not taxable to the Offshore Fund and, therefore, not subject to withholding.

5 Note, however, that if a U.S. tax-exempt investor’s acquisition of its interest in an Offshore Fund is debt-financed, all or a portion of the income attributed to such interest would be included in UBTI and taxable to the investor, regardless of whether such income would otherwise be excluded as dividends, interest, capital gains or similar income.

6 The tax issues associated with investment by domestic or foreign entities in U.S. real property interests are beyond the scope of this memorandum. If significant U.S. real property interests are involved, special tax planning may be required.

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CFC/PFIC. The General Partner acknowledges that some investors in the Hedge FOF may be taxable individuals or corporations for U.S. federal income tax purposes and that an investment by the Underlying Hedge Fund, directly or indirectly, in a non-United States Portfolio Company may give rise to taxability to those investors under either the controlled foreign corporation (CFC) or passive foreign investment company (PFIC) provisions of the Code. Accordingly, in the event that the Underlying Hedge Fund invests in a foreign Portfolio Company, the General Partner will provide the Hedge FOF with an analysis of whether such Portfolio Company is a CFC or PFIC. The PFIC analysis will be done on an annual basis for each foreign Portfolio Company.

If it is determined that the Portfolio Company is a CFC, the General Partner will, and will cause the Portfolio Company to, provide sufficient information for the Hedge FOF to comply with any and all reporting obligations imposed by the Code or any other applicable statute or regulation, including, but not limited to (i) the inclusion of any subpart F income required under Section 951(a) of the Code; and (ii) the information reporting required under Section 6038 of the Code, including the filing of Form 5471 “Information Return of U.S. Person With Respect To Certain Foreign Corporations.”

If it is determined that the Portfolio Company is a PFIC, the General Partner will, and will cause such Portfolio Company to, if required, provide upon its request, within 90 days following the end of each Fiscal Year of the Underlying Hedge Fund, the information necessary for the Hedge FOF (or its direct and indirect members, if applicable) to timely make and maintain a “qualified electing fund” election within the meaning of Section 1295 of the Code with respect to any Portfolio Company that the General Partner has determined is such a PFIC. To the extent necessary or required, the Underlying Hedge Fund will, upon request by the Hedge FOF, make a qualified electing fund election for the benefit of the Hedge FOF.

The General Partner and/or the Portfolio Company will provide the above information annually for so long as the Portfolio Company retains its PFIC status. The General Partner hereby acknowledges the Hedge FOF’s request that it receives the information referenced in the immediately preceding sentence with respect to each Portfolio Company the General Partner has determined is a PFIC. Upon the request of the Hedge FOF, the General Partner shall provide the Hedge FOF with the information specified in Treasury Regulation Section 1.1295-3(c)(1)(iii) not otherwise in the Hedge FOF’s possession in order to enable the Hedge FOF to timely file a “protective statement” within the meaning of Treasury Regulation Section 1.1295-3(c) with respect to any Portfolio Company.

TREATY BENEFITS. The General Partner agrees that it will cause the Underlying Hedge Fund to take any and all actions necessary or appropriate, including filing all necessary forms, to obtain the benefit of any treaty provision, including the reduction of withholding or other tax rates, that may be available under any applicable tax treaty between the United States and the jurisdiction of the Portfolio Company or the jurisdiction of one or more holding companies, if any, utilized to hold the stock of the Portfolio Company. In addition, the General Partner agrees to take any and all actions necessary or appropriate to permit the Hedge FOF or its U.S. limited partners to claim any treaty benefits, including reduced rates of tax that may be available to the Hedge FOF as a Limited Partner of the Underlying Hedge Fund.

U.S. TRADE OR BUSINESS. The General Partner agrees that it shall use its [best efforts] [reasonable best efforts] [commercially reasonable best efforts] to conduct the affairs of the Underlying Hedge Fund in a manner that does not cause the Hedge FOF (or a Limited Partner of the Hedge FOF that is not a “United States Person” as that term is defined in Section 7701 of the Code) to be deemed to be engaged in the “conduct of a trade or business within the United States” within the meaning of Sections 871.
and 881 of the Code solely as the result of its investment in the Underlying Hedge Fund. In addition, the General Partner represents that it is not presently a dealer in stocks, securities or commodities as that term is used for purposes of Section 864(b)(2)(A)(ii) and (B)(ii) of the Code, and that it shall use its [best efforts] [reasonable best efforts] [commercially reasonable best efforts] to avoid being so characterized in the future.

CLAIMS FOR REFUND. The General Partner agrees that it will cause the Underlying Hedge Fund to take any and all actions necessary or appropriate, including filing all necessary forms, to obtain the refund of any taxes withheld on payments made to the Underlying Hedge Fund as to which such refund is otherwise available and/or to assist the Hedge FOF (or any Limited Partner of the Hedge FOF) to make any claims available to the Hedge FOF (or any Limited Partner of the Hedge FOF) for refund of any taxes withheld on payments to either the Underlying Hedge Fund or to the Hedge FOF (or any Limited Partner of the Hedge FOF) as to which such refund is otherwise available.