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Tax

Key Hedge Fund Tax Developments in the U.K., the European Union, Ireland, Germany, Spain, Australia, India and Puerto Rico

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By Vincent Pitaro, *Hedge Fund Law Report*

Tax considerations have a powerful impact on hedge fund manager compensation and investor returns. Accordingly, tax considerations are front and center when managers select domiciles for their funds and management entities; structure funds and related entities; and enter and exit positions. Hedge fund taxation is inherently complicated and continuously changing; and the complexity is compounded for managers investing and operating globally.

To bring some clarity and coherence to this challenging subject, Rothstein Kass recently hosted a program examining recent or pending changes to relevant tax laws in the U.K. (including the "reporting fund" regime), the European Union (EU) (including the financial transaction tax), Germany, Ireland, Spain, Australia, India and Puerto Rico. Participants in the program provided detailed explanations of the current state of the tax law in each jurisdiction, how the law is likely to change and best practices for structuring and investing around current and anticipated tax law. This article memorializes the insights from the program, focusing in particular on practical consequences for hedge fund managers of tax law changes.

The speakers were Kari Campbell, a tax partner at U.K. financial services firm Smith & Williamson, LLP; Daniel M. Byrne, Principal at Rothstein Kass; Deirdre Joyce, International Tax Senior Manager at Rothstein Kass; and Steffen Gnutzmann, a lawyer and tax partner at WTS Group in Germany. For more on tax reporting considerations relevant to hedge fund managers, see "What Critical Issues Must Hedge Fund Managers Understand to Inform Their Preparation of Schedules K-1 for Distribution to Their Investors?," Hedge Fund Law Report, Vol. 6, No. 11 (Mar. 14, 2013).

U.K. "Reporting Fund" Regime

Campbell explained that, as of December 2009, the U.K. instituted a "reporting fund" regime under which hedge funds that opt into the regime are not required to distribute any of their income each year. Under the old "distributing fund" regime, registered funds were obligated to distribute at least 90% of their income to investors annually. See "Implications of the New U.K. Offshore Funds (Tax) Regulations for U.K. and Global Hedge Fund Managers and Investors," Hedge Fund Law Report, Vol. 2, No. 50 (Dec. 17, 2009).

The new regime created an incentive for funds to become reporting funds: Investors in a reporting fund pay taxes on any gains on the disposal of their fund investments at the

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preferential capital gains rate of 28% and are entitled to a £10,000 annual exclusion. In contrast, gains on disposition of fund securities by investors in non-reporting funds are taxed at the rate of 45%. However, investors in reporting funds still pay income taxes at the rate of 45% on all distributed and undistributed fund income. Corporate investors are not entitled to pay taxes at the preferential capital gains rate.

Campbell sees reporting fund status as an important selling point for funds that wish to market into the U.K. The main disadvantage of the regime is that investors are taxed on undistributed income, which may cause cash flow problems. In addition, the fund must file financial reports with the U.K. tax authority, HM Revenue & Customs (HMRC). The reports are not public, but reporting funds are listed on the HMRC's website.

The fund must file a financial report and a computation of reportable income for investors with HMRC within six months after the end of each fiscal year. The reports must be prepared in accordance with International Accounting Standards or the generally accepted accounting practice (with certain adjustments) specified in its application to become a reporting fund. Campbell observed that statements prepared pursuant to U.S. generally accepted accounting principles will require few, if any, adjustments. Investors are treated as having received the income shown on the fund's report 30 days after the end of the fund's fiscal year.

An existing fund may join the reporting fund regime. If so, an investor who invested prior to the change in status will continue to be taxed as if the fund were still a non-reporting fund. If the investor elects to change status, the investor will likely incur an immediate tax charge. The decision to elect reporting fund status may depend in large part on whether a fund expects to distribute sufficient income each year: If it does not, it might be less attractive to investors, who will nevertheless be taxed on that undistributed income. However, Campbell also observed that many U.K. investors insist that a fund be a reporting fund.

The fund must register by the later of the last day of the fund's fiscal year or 3 months after it offers securities to U.K. investors. Late applications are not accepted. The fund application must declare which GAAP and which equalization method it will use, if any. The equalization method chosen will depend on the type of income the fund expects and the number of subscriptions and redemptions it expects. There are five acceptable methods, one of which is not to use equalization.

Developments in the European Union

European Union Financial Transaction Tax

Joyce discussed the implementation of the EU's new Financial Transaction Tax (FTT). The EU has permitted 11 countries – Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain (FTT zone) – to proceed with a single tax. The FTT is a transaction tax imposed on (i) all financial transactions involving shares, bonds and derivatives issued in the FTT zone, whether effected on an exchange or over the counter, and (ii) transactions by financial institutions located in the FTT zone. The tax applies even if counterparties are located outside the FTT zone. Joyce explained that the goal of the FTT is to reduce volatility and curb high-frequency trading. The FTT rate is applied to (i) the price paid for shares or bonds or, if higher, their current market value, and (ii) the notional amount of derivatives. It is not expected that the FFT will come into effect until mid-2014 at the earliest. The proposed rates are "no less than" 0.1% for shares and bonds and "no less than" 0.01% for derivatives. France and Italy have already

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adopted their own local individual FTTs, with rates ranging from 0.1% to 0.22%. These local FTTs must be repealed upon the adoption of the FTT by the FTT zone.

German Implementation of AIFMD and the Elimination of Deferral on Capital Gains Tax

Gnutzmann observed that Germany is on the verge of implementing the EU's Alternative Investment Fund Manager's Directive. He noted that Germany's proposed implementing legislation goes beyond manager regulation and also encompasses product and tax regulation. See "Application of the AIFMD to Non-EU Alternative Investment Fund Managers (Part Two of Two)," Hedge Fund Law Report, Vol. 6, No. 24 (Jun. 13, 2013). The final implementing legislation has not yet been adopted. He explained that, presently, Germany has a very liberal private placement regime that does not limit hedge funds to selling to "accredited" or sophisticated investors. For a discussion of analogous regulation in the U.S., see "How Can Hedge Fund Managers Identify and Navigate Pitfalls Associated with the JOBS Act's Rollback of the Ban on General Solicitation and Advertising?," Hedge Fund Law Report, Vol. 6, No. 10 (Mar. 7, 2013). Consequently, it is not difficult for hedge funds and funds of funds to take in German investors. However, the current regime will remain in effect only until July 2014. At that point, it will become more difficult for non-German funds to market to German investors, especially individuals.

The current tax regime in Germany gives hedge funds and other alternative investment funds (AIFs) a "privileged" tax status: Tax on a fund's capital gains is deferred as long as the gains are not distributed to investors and as long as investors do not sell or redeem their fund securities. The proposed regime will treat various AIFs differently: There will be a privileged regime for funds organized under the EU's Undertakings for Collective Investment in Transferable Securities and certain AIFs, primarily long-only funds. As an example, he said a fund with more than 30% leverage would not qualify for privileged tax treatment. He believes that most hedge funds and private equity funds will not qualify for the privileged treatment. There will be separate regimes for partnerships; for passive foreign investment companies and controlled foreign corporations; and for "opaque" corporations. In effect, the tax law will be used for "product regulation, even for professional investors."

He pointed out that funds in existence as of July 21, 2013, will be grandfathered in and will continue to be taxed under the current privileged regime, even if they would not qualify as a tax-privileged fund under the new regime. Investors in new classes of fund shares first issued by existing funds after July 21, 2013, will also be entitled to the benefits of the old regime. He added, however, that there is already discussion about putting a time limit on the grandfathering, perhaps after July 2016.

A hedge fund manager contemplating marketing funds into Germany should understand how a fund fits into the German regulatory and tax regimes and consider whether a private placement exemption is available or, if not, whether a non-German feeder fund or managed account might be appropriate. Finally, the manager should consider the tax reporting requirements of the prospective German investors.

Use of Tax Treaty Companies in Ireland and Other Jurisdictions

Byrne explained that a U.S. tax treaty with Ireland provides favorable tax treatment for income earned in Ireland. Similar treaties exist with other nations, including Luxembourg and Cyprus. If

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a fund does enough trading in one of those jurisdictions, setting up a treaty company to minimize local taxation may be more cost effective than trading through derivatives. Use of "treaty companies" is more common for private equity funds, but may also be attractive to some hedge funds. For instance, they are used for funds engaging in loan origination, aircraft leasing and life settlement investing. See "Implications of Recent IRS Memorandum on Loan Origination Activities for Offshore Hedge Funds that Invest in U.S. Debt," Hedge Fund Law Report, Vol. 2, No. 41 (Oct. 15, 2009).

Byrne commented that the goal is to create a special purpose vehicle that qualifies for the benefits of a tax treaty and that incurs "little or no tax leakage" in the jurisdiction where that vehicle is formed. He discussed, as an example, use of an Irish "Section 110" company to provide benefits to a U.S. feeder hedge fund. The company must be a resident of Ireland and cannot have a permanent establishment in the U.S. All of its administrators and outside service providers must be based in Ireland, or at least outside the U.S. In addition, the ultimate U.S. investors must own at least 50% of the company indirectly. The Section 110 company can be structured, using "profit participating notes," so that it pays little or no tax in Ireland. The company's profits flow to an Irish qualified investor fund (QIF), which is not subject to taxation on income, gains or distributions. The QIF then distributes its profits to a Cayman or other offshore master fund in which the U.S. feeder fund invests. For more on QIFs, see "Considerations for Launching Qualified Investor Funds in Ireland: An Interview with Pat Lardner, Chief Executive of the Irish Funds Industry Association," Hedge Fund Law Report, Vol. 5, No. 31 (Aug. 9, 2012). For more on Ireland as a desirable site for offshore funds, see "Redomiciling Offshore Investment Funds to Ireland, the European Gateway," Hedge Fund Law Report, Vol. 4, No. 8 (Mar. 4, 2011).

U.S.-Spain Tax Treaty Change May Result in Double Taxation of U.S. Fund Investors

Byrne explained that Spain imposes a capital gains tax on non-residents and a withholding tax on dividend income from Spanish entities paid to non-residents. Under the existing tax treaty, a U.S. feeder fund that invested in Spain through an offshore master fund that was taxed as a U.S. partnership would be exempt from the capital gains tax on Spanish transactions and might be subject to dividend withholding at a lower rate. However, in January 2013, the U.S. and Spain signed a tax protocol that, when ratified, will eliminate the ability to "look through" the offshore master fund. Only partnerships organized in either Spain or the U.S. will be entitled to the benefit of the treaty. Byrne said that, as a result, U.S. investors in a U.S. feeder in a master-feeder fund structure will be subject to double taxation on Spanish-source income. See "Hedge Fund Managers Using 'Mini-Master Funds' to Retain Favorable Tax Treatment of Performance-Based Revenue from Offshore Funds," Hedge Fund Law Report, Vol. 2, No. 22 (Jun. 3, 2009). He suggested that, going forward, it may be preferable for funds to gain exposure to Spain through swaps and other derivatives. See "Department of Labor Advisory Opinion Facilitates Continued Access to the Swaps Market by Plan Asset Hedge Funds," Hedge Fund Law Report, Vol. 6, No. 9 (Feb. 28, 2013).

Australian Investment Manager Regime

Joyce discussed the progress on the implementation of the Australian Investment Manager Regime (IMR), which is intended to provide greater tax certainty and flexibility to foreign-managed funds. Under the IMR, a foreign fund may retain Australian brokers and other financial services intermediaries without becoming subject to taxation in Australia. Its first two elements

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were enacted in 2012. They addressed the Australian intermediary issue and exempted foreign funds from tax in Australia on passive portfolio income. Under the third element of the IMR, a foreign fund will not be subject to tax on Australian-source capital gains on passive portfolio investments.

Joyce explained that, to qualify for favorable capital gains treatment, the fund must not be resident in Australia; cannot own or control an Australian trading business; must be resident in a country, such as the Cayman Islands, that has an Exchange of Information Agreement with Australia; must file an annual information statement within 3 months after the end of the fund's fiscal year; must be "widely held"; and may not be "closely held". A fund will be deemed to be widely held if its shares are traded on an approved exchange or if it has more than 25 beneficial owners. A fund will be deemed to be closely held if 10 or fewer investors own more than 50% of the fund's securities or if a single investor owns more than 10% of the fund's securities. Exceptions to those rules enable a fund to qualify even during start-up and wind-down. Managed accounts are not included under the IMR. Many funds have been gaining exposure to Australia through swaps in order to avoid raising the capital gains tax issues that should be reduced or eliminated by the IMR.

India Tightens Rules on Tax Treaty Companies

Byrne indicated that, due to a favorable tax treaty with India, 40% of foreign investment in India passes through Mauritius: Companies with a certificate of residency in Mauritius are generally exempt from capital gains tax in India. See "Hedging into Africa through Cayman and Mauritius," Hedge Fund Law Report, Vol. 4, No. 7 (Feb. 25, 2011). In 2012, India adopted anti-avoidance rules to make it more difficult to use shell companies in jurisdictions like Mauritius and Singapore to take advantage of such tax treaties. When the rules take effect, a Mauritius company will only be exempt from Indian capital gains tax if it has "commercial substance": The Mauritius company will have to have an office in Mauritius, employ local residents and have a key person with "meaningful decision-making authority" resident in the Mauritius office. The rules will take effect in April 2016. Companies in existence prior to September 2010 will be grandfathered. He indicated that it may be more practical to establish a company in Singapore with commercial substance than it is in Mauritius. On regulatory considerations for Singapore-based hedge fund managers, see "Structuring, Regulatory and Tax Guidance for Asia-Based Hedge Fund Managers Seeking to Raise Capital from U.S. Investors (Part One of Two)," Hedge Fund Law Report, Vol. 5, No. 31 (Aug. 9, 2012).

U.S. "Effectively Connected Income"

Foreign investors are taxed on "effectively connected income" (ECI), which is income earned by a non-U.S. person who is engaged in a trade or business in the U.S. ECI is subject to U.S. taxation. Byrne observed that, contrary to the views of many practitioners, since 1991 the U.S. Internal Revenue Service (IRS) has taken the position that when a non-resident entity, such as an offshore fund, sells an interest in a partnership that is engaged in a trade or business in the U.S., such as a master limited partnership, the gain on that sale constitutes ECI "to the extent that the sale of the partnership's underlying assets would generate ECI." He said that an official of the U.S. Department of the Treasury recently mentioned that the IRS is working on new regulations to address this issue and that the issue is on the radar of the Obama administration. Even so, he

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noted that tax disclosures in recent prospectuses still state that gains on sales of such partnership interests will be deemed to constitute ECI.

Puerto Rico Provides Favorable Tax Treatment for U.S. Fund Managers

Byrne noted that some hedge fund managers have considered moving from the U.S. to a more tax-friendly jurisdiction. When they do so, they must generally establish residence in the other jurisdiction; move a substantial portion of their operations out of the U.S.; relinquish their U.S. citizenship; and pay an exit tax based on the current market value of their assets. Byrne indicated that a manager who relocates to Puerto Rico may secure favorable tax treatment without giving up U.S. citizenship or being subject to the exit tax. A U.S. citizen who establishes bona fide residence in Puerto Rico may be able to avoid federal, state and Puerto Rico capital gains taxes until 2035 and may be eligible for a 4% tax rate on “management and performance fee income attributable to services rendered in Puerto Rico.” He or she may also avoid state income taxes entirely, but will remain subject to U.S. federal income taxation on other income. To qualify, a “significant portion of the funds operations [must] be relocated to Puerto Rico.”

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