Comment: Cracks in the façade – risk management transactions of hedge fund managers

Selva Ozelli, an international tax attorney, certified public accountant and international tax editor with the Thomson Reuters Corporation in New York, examines the tax consequences of structured mortgage-backed assets held by foreign hedge funds.

The healthy facade of the US economy began cracking during the summer of 2007, when the deterioration in the US housing market rendered the valuations of securitised or structured mortgage-backed assets volatile. These assets had been valued dramatically bullish on inflated marks and misrepresented credit grades by brokers who earned substantial commissions by pushing the more than 600 different types of MBS onto hedge fund managers through repos[1] that were leveraged without regulatory bounds.

The resulting contracting demand for MBSs precipitated the tightening of unsecured term funding, leading to credit downgrades[2] and massive write-downs of MBS assets by financial institutions according to mark-to-market accounting rules and illiquidity. Losses mounted from forced liquidation of MBSs at low valuations triggered by redemption notices from hedge fund investors (some got out ahead of other investors based on side-letter agreements with preferential redemption terms) and margin calls from brokers trying to make up for the difference in the value of securities used as collateral on repos. The result was that most prominent veteran hedge funds were financially wounded and two of Bear Stearns's funds were bankrupted.

Many hedge fund managers were caught unprepared when the credit crisis hit during the summer of 2007. Only a few had short positions in credit derivatives that they initiated two years earlier, when these contracts were priced low, to profit from the deterioration in MBS values.[3] Some hedge fund managers transferred their poorly performing, illiquid MBS assets to side-pockets and valued them separately from the remainder of the fund's portfolio to immunise the fund's net asset value calculation from the performance of these hard-to-value assets, effectively freezing the illiquid, MBS-affected portion of the hedge fund's portfolio to avoid writing these investments down or selling them at a large loss.[4]

Other hedge fund managers who were not as astute (or not willing to absorb the losses on their risky, long, leveraged positions in MBS assets sitting in funds they managed) transferred their risky MBS assets – valued favourably with the help of their administrators, who were compensated based on a fee set as a percentage of the fund's performance[5] – not to a side-pocket, but to another fund, the MBS Loss Fund (MBSLF), and then floated the MBSLF publicly in stock exchanges in foreign jurisdictions (Transaction I).

Next, in a move straight out of the 2003 mutual fund scandal, in anticipation of the deterioration in overvalued MBS assets in MBSLF's portfolio, hedge fund managers purchased basket index credit swaps – a contract that simulated the credit of the MBSLF's portfolio holdings from a US broker dealer - that were constructed based on the hedge fund manager's non-publicly available knowledge of MBSLF's MBS portfolio holdings (credit swap)[6] held between two affiliated funds of the hedge fund manager, with MBSLF holding the risk side of the swap (Transaction II).

The credit crisis, which highlighted the various credit risk management techniques of hedge fund managers, struck a milestone in February 2008 when the MBS yield premiums widened to levels not seen in 15 years, bankrupting many hedge funds, including the prestigious USD22bn Carlyle Capital Corporation, a Dutch-listed, Guernsey-based MBS hedge fund, that was advised by the Carlyle Group, one of the world's largest private investment firms, which had a 15 percent interest in CCC.[7]

The Carlyle Group first floated CCC's shares at USD19 per share on the Euronext Amsterdam stock exchange in July 2007. The share price fell sharply to USD0.43 per share by the middle of March this year when CCC defaulted on nearly USD17bn of debt (borrowed from financial institutions including Bear Stearns, which also succumbed to the credit crisis because of excessive exposure to MBS assets and financing).[8]

Anticipating that CCC and Bear Stearns will not be the last victims of the credit crisis despite the Federal Reserve Bank's easing of interest rates[9] and offering favourable credit lines to financial institutions, the Securities and Exchange Commission and the Department of Justice, in partnership with the FBI and the IRS Criminal Investigation Division, have announced investigations of the USD2trn hedge fund industry for misvaluation of MBS assets, illicit transfers of capital by hedge fund managers between onshore and offshore funds, and inappropriately billed expenses to hedge funds.[10]

The credit-crisis-induced risk management transactions of hedge fund managers may also have unintended US tax consequences to the hedge fund, its investors, and its managers as outlined below.

I. The credit crisis

A. US tax implications to a foreign hedge fund

Depending on the locale and based on regulatory, tax, and investor considerations, foreign hedge funds are structured as limited liability partnerships, limited liability companies, unit investment trusts, corporations, insurance companies, or master-feeder funds that use a combination of offshore master partnerships with onshore and offshore feeder funds. Foreign hedge funds that trade in the US financial markets avoid US taxation on their trading income by relying on a trading safe harbour,[11] which renders the hedge fund manager's act of trading in securities – which includes an MBS[12] as well as a credit derivative[13] – for his or her own account in the secondary market not effectively connected income with a US trade or business.[14]

Foreign hedge funds nevertheless remain subject to withholding taxes[15] on their US-source fixed or determinable annual or periodic income[16] except for interest under the portfolio interest exemption,[17] which doesn't apply when the foreign lender is a controlled foreign corporation and the US borrower is a related person.[18]

1. Foreign hedge fund may be deemed a dealer

During the credit crisis, hedge fund managers – whose financial interests are aligned with their hedge fund investors as far as being averse to MBS asset loss absorption since they keep substantial assets of their own in a fund and earn most of their compensation from incentive fees set as a percentage of a fund's performance – may have entered into affiliated account trades between their US and foreign hedge funds, since funds established in the US or sold to US investors are prohibited from manipulating or otherwise misrepresenting the fund's NAV under the antifraud provisions of the federal securities laws.

Accordingly, hedge fund managers who manage several onshore hedge funds, foreign hedge funds, investment accounts, or MBSLFs may have bought or sold illiquid MBS's as described in Transaction I above or entered into credit swap transactions between affiliated funds as described in Transaction II above.

These types of risk management transactions initiated by a hedge fund manager among its affiliated offshore and US funds or accounts, based on all facts and circumstances,[19] may deem the hedge fund manager a dealer subject to the mark-to-market accounting rules.[20] A non-resident alien individual or a foreign corporation is considered to be engaged in a US trade or business if the partnership of which the non-resident alien or foreign corporation is a member is so engaged by virtue of the foreign partner's interest in the partnership, through the partnership's fixed place of business in the US.

Any member of a partnership, limited partners, general partners,[21] or offshore corporate feeders[22] that is deemed a dealer in stocks or securities, either in the US or abroad, is barred from relying on the trading safe harbour, and will be subject to net basis taxation in the US on ECI from a US trade or business[23] including three categories of foreign source income or loss or their economic equivalents, which include interest and dividend equivalents when the taxpayer has an office or other fixed place of business within the US.[24]

While all US-source income may be treated as ECI with a US trade or business,[25] only some foreign source income is so treated, and tax treaties may reduce the US tax on that foreign source income. Deductions attributable to ECI are allowed in computing the net amount subject to tax[26] with interest expense attributable to ECI with a US trade or business being determined under special rules.[27]

When a foreign hedge fund is deemed a dealer that is engaged in a US trade or business, the other US tax consequences that should be considered are:

a. The mark-to-market accounting's effect on illiquid MBS assets and credit swaps. If the foreign hedge fund is deemed a dealer, but has a valid mark-to-market election already in effect[28] (most hedge funds make a mark-to-market election), it should be able to exclude an illiquid MBS asset transferred to a side-pocket from mark-to-market accounting provided that the security is "clearly identified" as such.[29]

A side-pocket can be viewed as a separate sub-fund within the hedge fund that immunises the remainder of the fund's portfolio from the poor performance of the assets held in the side-pocket. When an illiquid MBS asset is transferred to a foreign hedge fund's side-pocket – either at cost or valued at the time of transfer with the help of committees, appraisers, fund administrators, investment bankers, or brokers – the fund investors at the time of the transfer are deemed to own their proportionate interest in that investment and later investors in the fund are not. Redeeming investors retain their proportionate interests in the side-pocket's investments until they are sold or otherwise transferred out of the side-pocket.

While the use of side-pockets artificially enhances a foreign hedge fund's NAV, boosting the fund's performance record and the incentive fees paid to the hedge fund manager, if a taxpayer fails to clearly identify the illiquid MBS asset transferred to a side-pocket, it will have to mark the illiquid MBS asset to market, write the relevant investment down, and report the resulting loss as ordinary. The mark-to-market accounting treatment will also apply to any notional principal contract (NPC) or any derivative security[30] transferred to a foreign hedge fund's side-pocket since the 'clearly identify' exemption is inapplicable to any NPC or derivative security that is held by a dealer in those securities.[31]

b. The withholding tax considerations of a foreign hedge fund deemed a dealer engaged in a US trade or business. If a foreign hedge fund is deemed a dealer that is engaged in a US trade or business, any outbound interest payments (including original issue discount)[32] relating to an MBS asset that would otherwise be exempt from the 30 percent withholding tax based on the portfolio interest exemption, or outbound credit swap payment that would not otherwise be subject to withholding tax, since these payments are sourced to the residence of the recipient if the hedge fund has no US office,[33] will be treated as US-source ECI, subject to net basis taxation.[34]

c. The deductibility of a foreign hedge fund's fees and expenses against its ECI from a US trade or business. If a foreign hedge fund is deemed engaged in a US trade or business, it is normally allowed deductions only if and to the extent that the fees and expenses are ECI with the conduct of a US trade or business. The allowable deductions under IRC 873(a) and IRC 882(c) are determined based on the taxpayer's status as a partnership, trust, or corporation, the character and source of its expenses determined under the regs or tax treaty provisions, the reasonableness of the hedge fund manager's compensation expenses, as well as the accounting method adopted by the taxpayer.

While a detailed discussion of the deductibility of expenses of a foreign hedge fund that is engaged in a US trade or business is beyond the scope of this article,[35] foreign hedge funds are not regulated regarding their fees and expenses and therefore have the ability to charge their investors asset-based management fees (1 percent to 5 percent based on the foreign hedge fund's assets) in addition to incentive fees (20 percent to 50 percent of the foreign hedge fund's profits).

Furthermore it is not uncommon for a foreign hedge fund to pay incentive fees to non-investment professionals at the hedge fund manager's discretion.[36] Nor is it uncommon for hedge fund managers to defer the receipt of all or a portion of their incentive fees in a segregated account or in an offshore rabbi trust,[37] reinvested in the master fund, where it continues to participate in the fund's future gains but not losses.

The IRS has discretion to redetermine a foreign hedge fund's compensation expenses that might have been calculated based on misvalued MBS assets. Compensation payments are deductible by a taxpayer only in an amount that is reasonable under all the circumstances[38] that "would ordinarily be paid for like services by like enterprises under like circumstances".[39]

In one case, the Tax Court disallowed a taxpayer's deductions for alleged salary and bonus payments to the owner-president-controlling shareholder and his relative. The owner was a small investment firm's principal manager and marketer, worked long hours, ensured its compliance with all relevant regulations, and closely supervised all of its investment and trading activities.

The court found the owner's compensation paid by the taxpayer unreasonable based on an independent investor analysis, which found unreasonable the taxpayer's practice of paying the controlling shareholder large bonuses in loss years as well as in profitable years. The court also found that the lack of any strong linkage between the taxpayer's performance in a given year and the shareholder's bonuses and compensation for that year rendered the taxpayer's compensation deductions unreasonable.

The Tax Court limited the taxpayer's bonus payments made to the owner to 20 percent of pre-tax earnings of the taxpayer, citing incentive fees paid to hedge fund managers as a comparable in determining the reasonableness of the owner's bonus payments. The Tax Court found the entire amount of compensation paid to the owner's relative unreasonable because the taxpayer presented no evidence, other than the owner's testimony, that the relative had performed any services for the taxpayer.[40]

The IRS also has the discretion to disallow deductions under IRC section 162(c)(1) for any incentive fee, management fee, other fee, expense reimbursement, kickback, rebate, surcharge, commission, derivative contract, or rent paid to non-investment professionals by the foreign hedge fund at the hedge fund manager's discretion when the payment falls within the scope of the US Foreign Corrupt Practices Act (FCPA).[41]

Foreign hedge funds pay premium brokerage commissions to their brokers that exceed the lowest rate available from other broker-dealers for basic execution services, or as is in the form of soft dollar brokerage commissions that are not limited to brokerage or research (including office space, clerical support, and marketing support). These excessive brokerage fees may taint the objectivity of a broker, which is part of the valuation process of a foreign hedge fund's MBS assets.[42] Foreign hedge funds also deduct organisation, operation, marketing, insurance, and some personal expenses of the fund manager, including extensive indemnification for the fund manager for liabilities incurred in managing the fund, except in the case of gross negligence or wilful misconduct.

However, to get the benefit of otherwise allowable deductions and credits for a tax year, a foreign hedge fund[43] must file (or cause to be filed) a true and accurate return.[44] The return must reflect the foreign hedge fund's income that is ECI, or treated as ECI, with the conduct of a US trade or business; and deductions and credits allowed a non-resident alien who elects under a tax treaty to be taxed on a net basis may be claimed by filing a return in the manner prescribed by the regs (if any) under the tax treaty or any other guidance issued by the IRS.[45] A foreign corporation that did not file returns (because it unsuccessfully took the position that it was an investment management business conducted through a US agent that did not cause it to be engaged in a US trade or business and that did not cause it to have ECI with a US trade or business) was unable to claim a deduction for the costs incurred in its business.[46]

2. Transfer Pricing Considerations

Hedge fund managers also may trigger the application of transfer pricing rules to a foreign hedge fund.

Under IRC section 482, the IRS has the discretion to “distribute, apportion, or allocate gross income, deductions, credits, or allowances” among two or more organisations, trades, or businesses that are under common control so as to prevent the evasion of taxes or to clearly reflect the separate incomes of the corporation and partnership income. For these purposes control is any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised that results in income or deductions being arbitrarily shifted.[47] This includes income and expenses between a corporation and a partnership that is treated as an entity separate from its partners (Cir. 1987).[48] While there is limited case law dealing with the application of transfer pricing rules to partnerships, the courts have applied transfer pricing rules when partners are related or are under common control.[49]

The standard to be applied for purposes of IRC section 482 would be whether the MBS asset valuations in Transaction I or the pricing of the credit swap in Transaction II were set at arm’s length with an uncontrolled taxpayer. If the illiquid MBS assets or credit swaps mentioned in Transaction I and Transaction II were not set at arm’s length but were favourably valued to accommodate the financial agenda of the hedge fund manager, his broker, or the foreign hedge fund’s administrator, they may trigger the application of a section 482 allocation.[50]

While a side-letter agreement is not likely to affect how the foreign hedge fund’s income or loss is computed (unless the foreign hedge fund is forced to liquidate its MBS assets at great losses to come up with the side-letter preferenced investor’s redemption proceeds), it will distort the partnership’s allocation provision, which is in substance a contract among the partners of the foreign hedge fund as to how they will share the partnership income or loss among the partners, and thereby may distort the income of the partners regarding each other, possibly triggering the application of an IRC section 482 allocation.[51]

3. ERISA Considerations

Many tax-exempt investors invest in hedge funds through an offshore corporate vehicle – either through a master-feeder fund’s foreign corporate feeder or a parallel foreign corporate fund, which may include an MBSLF to avoid IRC section 514 from recasting the leveraged investments of the hedge fund as a direct investment in debt-financed property subject to unrelated business taxable income on gains.[52]

A manager of a corporate foreign hedge fund that takes in capital from plans or funds subject to the Employee Retirement Income Security Act of 1974 avoids the ERISA plan asset look-through rules when the equity participation in the hedge fund by benefit plan investors is not “substantial” – less than 25 percent of any class of equity securities. For purposes of the 25 percent calculation, investments of the hedge fund manager and governmental and foreign plans are not taken into account.

The 25 percent asset test is applied on any date, immediately after the most recent acquisition, redemption, or intra-family transfer of any equity interest in the corporate foreign hedge fund. However, there is no regulatory oversight of the 25 percent asset test. Hedge fund managers – who enter into side-letter agreements and credit-crisis-induced risk management transactions with affiliates – have the responsibility of notifying their benefit plan investors when and if the plan’s fiduciary rules are triggered.

The losses from MBS assets induced by the credit crisis and the risk side of credit swaps, coupled with early redemption of investors with side-letter agreements, may leave benefit plan investors of a corporate foreign hedge fund with a more than 25 percent ownership interest in any class of equity securities of the corporate foreign hedge fund. If that happens, the underlying assets of the corporate foreign hedge fund may be treated as “plan assets” subject to ERISA, with one result being that transactions (including incentive fee arrangements) involving hedge fund assets deemed prohibited under ERISA’s party-in-interest and self-dealing rules, with prohibited transactions also being subject to taxation under IRC section 4975.

4. MBSLF’s US Tax Classification

An MBSLF set up by a hedge fund manager as indicated in Transaction I above may also elect, for US tax purposes, that the fund be classified as a qualified foreign company (QFC) that distributes qualified dividend income[53] to lure US investors, especially tax-exempt investors that prefer corporate foreign hedge fund investment structures for their hedge fund investments.

In IRS LTR 200752029 a publicly traded investment fund was an open-ended, limited purpose trust established under the laws of a foreign jurisdiction for investment purposes (an MBSLF), and held foreign country insurance company[54] stocks through a tiered partnership. For federal income tax purposes, the MBSLF was not a unit investment trust, but a foreign corporation because it was not simply an arrangement to protect or conserve property for its beneficiaries. The MBSLF was a device to carry on a profit-making business. Also, the trust document gave the MBSLF’s trustees broad power to vary its investments. This determination was made by looking at US tax laws rather than foreign tax laws.

Even though not every recognised business entity can elect its tax classification (and the letter ruling did not mention MBSLF’s entity form in the foreign jurisdiction to ascertain whether it was mandatorily classified as a corporation for US tax purposes[55]) the MBSLF for its highest tier entity elected to be treated as a QFC, based on the taxpayer’s representation that the MBSLF did not qualify as a passive foreign investment company.[56] The letter ruling did not address the US federal tax elections of the tiered partnerships that held stocks of foreign insurance companies. Furthermore, the letter ruling expressed no opinion as to whether the MBSLF was a resident of a foreign country for purposes of a tax treaty, nor whether the MBSLF satisfied the requirements of the limitation on benefits article of a tax treaty, whereas the MBSLF will not make a QFC election without being eligible for benefits of a comprehensive income tax treaty with the US under IRC section 1(h)(11)(C)(i).

5. Tax Treaty Considerations
A hedge fund's US tax classification or the US taxation of a foreign hedge fund's activities may be subject to different rules under US tax treaty provisions, which should be considered if a foreign hedge fund or MBSLF is claiming US tax treaty benefits.

For example, an MBSLF's QFC classification under US tax law may be challenged under the Ireland-US treaty since companies holding shares through fiscally transparent entities such as partnerships or trusts are subject to a look-through approach and are considered to hold their proportionate interest in the shares held by the intermediate entity. This limits the treaty benefits in some circumstances for companies holding shares through these entities.[57]

6. Tax Shelter Transaction Considerations
The credit-crisis-induced cross-border affiliated transactions of a hedge fund manager between US and offshore funds may be scrutinised for distressed asset and debt (DAD) transactions entered into for the purposes of shifting economic losses from a tax-indifferent party to a US taxpayer.[58] The IRS has indicated that DAD transactions may be challenged on the basis of the judicial doctrines, including substance over form, lack of economic substance,[59] the economic effect and business[60] test as well as step transaction, and in the case of distressed debt, that the distressed debt was worthless under IRC section 166.[61]

7. RICO Considerations
If a foreign hedge fund is found to have deprived a foreign government of tax revenue, either for being a dealer and engaged in a foreign trade or business, or for transfer pricing or withholding tax or tax treaty adjustments arising from the hedge fund manager's credit-crisis-induced cross-border affiliated transactions, then it may be subject to penalties under the Racketeer Influenced and Corrupt Organizations Act, since RICO applies to taxpayers that deprive a foreign government of tax revenue.[62]

B. US Tax Implications for Hedge Fund Investors

1. Investors of a Foreign Hedge Fund Deemed Engaged in a US Trade or Business
When a foreign hedge fund is deemed engaged in a US trade or business, any investor in the fund – in the US or abroad – is barred from relying on the trading safe harbour and is subject to net basis taxation in the US on ECI from a US trade or business.

If a foreign partner disposes its interest in an MBS loss foreign hedge fund deemed engaged in a US trade or business, the foreign partner's gain or loss from the disposition of its interest in a foreign or domestic partnership that conducts business in the US through a fixed place of business is not realised directly from the active conduct of the US trade or business. However, the gain or loss is US-sourced if it is attributable to the foreign partner's fixed place of business in the US. Also, US tax treaties may require the activities of the partnership to rise to the level of a permanent establishment in the US.[63]

The character of the gain or loss is determined under the asset use test by applying a look-through approach and is treated as a disposition of an aggregate interest in the partnership's underlying property for purposes of determining the source and the effectively connected character of the gain or loss.[64]

2. Tax-exempt investors in an MBSLF

US investors in an MBSLF with a QFC election should evaluate the fund annually for the PFIC classification to avoid being subject to its anti-deferral rules, since a foreign corporation's PFIC status is determined on a year-to-year basis.[65] The PFIC classification of the MBSLF will affect the US federal tax liability of its US shareholders because a QFC doesn't include any foreign corporation which for the tax year of the corporation in which the dividend was paid, or the preceding tax year, is a PFIC.[66] However, controlled foreign corporations[67] are not excluded from the definition of QFC so long as they are not also a PFIC.[68] Accordingly, US investors of the MBSLF may be well-served by making a prophylactic qualified electing fund election.[69]

US tax-exempt investors of an MBSLF should also evaluate the fund for the application of CFC provisions because under a look-through rule, some tax-exempt investors' subpart F insurance income is recharacterised for unrelated business income tax purposes.[70] The CFC classification of the MBSLF will also allow US shareholders of the CFC[71] to use the subpart F tax provisions of the Internal Revenue Code and the US tax treaties to access an MBSLF's accounting and tax records and bring it within the reach of the US federal legal system.[72]

C. US tax implications for the hedge fund manager

1. Incentive fees deferred offshore in a rabbi trust

A hedge fund manager's incentive fees that are deferred offshore in a rabbi trust may not result in the deferral of income, because incentive fees directly or indirectly set aside in a trust for purposes of paying deferred compensation to a hedge fund manager under a nonqualified deferred compensation (NQDC) plan are treated, for purposes of IRC section 83, as property transferred in connection with the performance of services.

It doesn't matter whether the assets are technically available to satisfy claims of general creditors if:[73] (1) at the time set aside, the assets (or trust or other arrangement) are located outside of the US;[74] or (2) at the time transferred, the assets (or trust or other arrangement) are later transferred outside of the US.[75] Thus, offshore rabbi trusts (that in effect protect assets from creditors) are treated as funded arrangements that do not result in the deferral of income for a hedge fund manager.[76]

Accordingly, a hedge fund manager with an NQDC plan may be required to include amounts in income because of the application to the plan (or to any trust or assets associated with the plan) of IRC section 83, IRC section 451, the economic benefit doctrine, or other applicable law, even though the plan, trust, or assets comply with IRC section 409A(b) or Notice 2006-33.[77]

II. Conclusion

With the International Monetary Fund estimating that the credit crisis will continue to spread worldwide with losses approaching USD1 trillion, and more hedge funds rumoured to be in trouble because of their leveraged MBS asset investments, the credit-crisis-induced risk management transactions of hedge fund managers hidden in the shadows of hedge fund accounting improprieties should be closely scrutinised for their US tax, foreign tax, US tax treaty, ERISA, RICO, as well as FCPA consequences for the hedge fund, its manager, and its investors.

This article was first published in Tax Analyst

FOOTNOTES

1 A repurchase agreement (repo) is economically similar to a secured loan, in which the borrower (seller/cash receiver) sells securities for cash to a lender (buyer/cash provider) and agrees to repurchase those securities at a later date for more cash. The buyer receives securities as collateral to protect against default. The legal title to the securities passes from the seller to the buyer. Coupons (instalment payments that are payable to the owner of the securities) that are paid while the repo buyer owns the securities are usually passed directly onto the repo seller. This might seem counterintuitive, because the ownership of the collateral technically rests with the buyer during the repo agreement.

2 *Securities Law Daily*, “Credit Ratings: S&P May Downgrade Subprime Securities, Also Plans Review of Affected CDO Portfolios,” July 11, 2007, pp. 1-2.

3 Kate Kelly, “Goldman’s Subprime-Bet Star Is Leaving,” *The Wall Street Journal*, Apr. 26, 2008, p. 1.

4 Gregory Zuckerman, “Vranos May Try to Reopen Ellington Credit Fund,” *The Wall Street Journal*, Dec. 7, 2007, p. 1; Simon Hildrey, “Multiple Challenges Make Tricky Work,” *Financial Times*, Nov. 5, 2007, p. 1; Sophia Grene, “Side-Pocket Solution to Illiquidity,” *Financial Times*, Jan. 20, 2008, p. 1; and Miles Costello, “Shareholders Will Demand Investigation Into Absolute Funds Strategy,” *Times* (UK), Oct. 29, 2007, p. 13.

5 *Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, LLC*, (S.D.N.Y., 2007), Slip Copy, p. 8 of 16; Nicholas P.B. Bollen and Veronika K. Pool, “Do Hedge Fund Managers Misreport Returns? Evidence from the Pooled Distribution,” Oct. 1, 2007, pp. 1-5.

6 Such a derivative contract - similar to ones used during the mutual fund scandal to economically short equity mutual fund shares and profit during the 2000-2003 equity bear market - would not meet the definition of a notional principal contract (NPC) under reg. sections 1.446-3(c)(2) and (4) and therefore will not fall under the trading safe harbour.

7 The Carlyle Group, Hoover’s Basic Company Records, Apr. 16, 2008, p. 1.

8 “Carlyle Capital on the Brink of Collapse, Fund Now Expects Banks to Seize Some USD16 Billion in Assets,” Associated Press, Mar. 13, 2008, p. 1; Greg Robb, “Bear Stearns Bailout Called a Huge Blunder,” MarketWatch, Apr. 29, 2008, p. 1.

9 Greg Ip, “Fed Cuts Rate, Signals Pause Ahead,” *The Wall Street Journal*, Apr. 30, 2008, p. 1.

10 Federal Bureau of Investigation, San Diego Division, press release, “Hedge Fund Manager Sentenced to 72 Months in Prison,” Apr. 7, 2008, *available at* http://sandiego.fbi.gov/pressrel/2008/sd040708.htm.

11 IRC section 864(b); Treas. reg. section 1.864-2(c)(2)(i); Treas. reg. section 1.864-2(d)(2).

12 Based on the manner in which payments are made and the form of the entity issuing the security, an MBS may be classified for tax purposes either as debt or equity under IRC section 385(b).

13 Prop. reg. section 1.864(b)-1(b) expanded the scope of the trading safe harbour to permit transactions in derivatives that meet the definition of an NPC for the taxpayer’s own account, provided that the taxpayer qualifies as an “eligible non-dealer.” The proposed regulations would be effective for tax years beginning 30 days after the date final regs are issued, but taxpayers may take any reasonable position regarding the application of the securities and commodities safe harbours to derivative transactions before the final regs are issued. Positions consistent with the proposed regs are considered reasonable. [Preamble to prop. regs 6/12/98.] For these purposes, credit swaps (defined above) are not likely to meet the definition of an NPC under the trading safe harbour rules.

14 IRC section 871(b) and 882.

15 IRC section 1441.

16 IRC section 871(a), 881.

17 IRC section 871(h)(1).

18 IRC section 881(c)(3)(C).

19 Reg. 1.475(c)-1(a).

20 IRC section 475(c)(1); Lee A. Sheppard, “News Analysis: US Officials Preview Guidance for Financial Intermediaries and Hedge Funds,” *Tax Notes Int’l*, Jan. 31, 2005, p. 354, *Doc 2005-1157* [**PDF**], or *2005 WTD 21-7* ; Needham & Brause, 736 T.M., Hedge Funds, BNA Portfolio 736: Hedge Funds, Sec.(F) Investments in Debt Securities.

21 Vitale, Alberto, (1979) 72 TC 386.

22 IRC section 875(1).

23 IRC section 871(b)(1); IRC section 882(a)(1); Treas. regs. 1.864-2(c)(2)(ii) and 1.864-2(c)(2)(iv)(a).

24 IRC section 864(c)(4); Rev. Rul. 2004-3, 2004-7 IRB 486.

25 IRC section 864(c)(3); Treas. reg. section 1.864-4(b).

26 IRC section 873; IRC section 882(c)(1).

27 Treas. reg. section 1.882-5T(a)(1)(i).

28 IRC section 475(f).

29 IRC section 475(f)(1)(B).

30 Defined in IRC section 475(c)(2)(D) or IRC 475(c)(2)(E). A credit swap, as defined above, or other credit derivative contract may meet the definition in IRC section 475(c)(2)(E) giving rise to mark-to-market accounting of a side-pocket that contains credit swap or other credit derivatives of a foreign hedge fund that is deemed a dealer in these derivatives since the clearly identified exception is inapplicable.

31 IRC section 475(b)(4).

32 IRC section 871(a)(1)(C)(ii).

33 Treas. reg. section 1.863-7(b)(1).

34 Treas. reg. section 1.863-7(b)(3).

35 Federal Tax Coordinator, Volume 19A, O (part 2), Decks O-10500 thru O-10600, Research Institute of America; Needham & Brause, 736 T.M., Hedge Funds, BNA Portfolio 736: Hedge Funds.

36 John R. Emshwiller, “Bill Clinton May Get Payout of USD20 Million,” *The Wall Street Journal*, Jan. 22, 2008, p. 1.

37 A rabbi trust is an unfunded and unsecured nonqualified deferred compensation arrangement under which an employer places assets in a fund or trust to be used to provide deferred compensation benefits to employees. A rabbi trust creates an agency relationship (rather than a trust) since the assets and income of the fund or trust are subject to claims of the employer’s creditors if the employer becomes insolvent, the employees receive no beneficial ownership or preferred claims on the assets, and the fund administrator or trustee does not have discretionary authority to invest fund assets or to make payments to employees and their beneficiaries. For further information, *see* IRS LTR 9015008 or IRS LTR 8936082.

38 *Miller Mfg. Co. v. Comm’r*, 149 F.2d 421 (4th Cir. 1945), 33 AFTR 1383, 45-1 USTC para. 9293.

39 Treas. reg. section 1.162-7(b)(3).

40 *Wechsler & Co. Inc. v. Comm’r*, T.C. Memo. 2006-173, RIA TC Memo para. 2006-173.

41 **Selva Ozelli**, “Is This Bribe Deductible? Tax Implications of the US Foreign Corrupt Practices Act,” *Tax Notes Int’l*, Dec. 17, 2007, p. 1171, *Doc 2007-25721* [**PDF**], or *2007 WTD 245-8* .

42 Kira Nickerson, “High Fees Could Lessen the Impact of Hedge Funds’ Foray Into Retail Market,” *Financial News Online US*, Jan. 23, 2008.

43 For these purposes, a nongrantor foreign trust, which is taxed as a non-resident alien individual, may, in rare circumstances, be subject to tax under IRC section 871(b) on its undistributed income that is effectively connected with a US trade or business under IRC section 875(2). If that foreign trust files a delinquent US federal income tax return, it is likely that the IRS would disallow deductions and credits under IRC section 874(a).

44 IRC section 874(a).

45 Treas. reg. section 1.874-1(a).

46 *Inverworld Inc. v. Comm'r* (1996), T.C. Memo. 1996-301, RIA T.C. Memo. para. 96301, 71 CCH TCM 3231.

47 Treas. reg. section 1.482-1(a)(3).

48 *US v. Basye*, 410 U.S. 441 (1973); *Dolese v. Comm'r*, 811 F.2d 543, 547-548 (10

49 *Rodebaugh v. Comm'r*, 33 TCM 169 (1974), *aff'd per curiam*, 518 F.2d 73 (6th Cir. 1975); *Dolese v. Comm'r*, 811 F.2d 543 (10th Cir. 1987).

50 Treas. reg. section 1.704-1(b)(1)(iii); TAM 9319003 (Jan. 28, 1991).

51 *Id.*

52 IRC section 512.

53 IRC section 1(h)(11).

54 Hedge funds may be structured as insurance companies; *see* Needham & Brause, 736 T.M., Hedge Funds, BNA Portfolio 736: Hedge Funds, Sec (D) Hedge Funds Disguised as Insurance Companies.

55 Reg. section 301.7701-2(b)(8)(i).

56 IRC section 1(h)(11)(C)(iii).

57 Treas. Tech Expl. p. 33.

58 Coordinated issue paper, (Distressed Assets Tax Shelters), April 18, 2007.

59 *Long Term Capital Holdings v. U.S.*, 330 F.Supp 2d 122 (D.Conn. 2004), *aff'd* 2005 U.S. App. LEXIS 20988 (2d Cir. 2005).

60 *Supra* note 52.

61 Notice 2008-34, 2008-12 IRB.

62 *Pasquantino v. US*, 541 U.S. 972 (2004); Guy Chazan, "Hermitage Capital Management Runs Into Trouble in Russia - U.K. Fund Accuses Authorities of Trying To Steal Its Assets," *The Wall Street Journal*, Apr. 4, 2008, p. 1; "Moscow Court Postpones Bank of New York Case," *The Wall Street Journal*, Apr. 8, 2008, p. 1; PR Newswire, "The Bank of New York Mellon Provides Update on Russian Court Case," Apr. 7, 2008, p. 1.

63 South Africa-US treaty, art. 13(3); Thailand-US treaty, art. 13(1), Treas. Tech. Expl., pp. 43-44.

64 Rev. Rul. 91-32, 1991-1 CB 107, as corrected by Announcement 91-86, 1991-24 IRB 120.

65 Federal Tax Coordinator, Vol. 19, O (part 1), Deck O-2200, Research Institute of America.

66 IRC section 1(h)(11)(C)(iii).

67 Federal Tax Coordinator, Volume 19, O (part 1), Deck O-2300 thru O-2700, Research Institute of America.

68 Notice 2004-70, Sec. 4.01, 2004-44 IRB 724.

69 LTR 90204086.

70 IRC section 512(b)(17).

71 CFCs are subject to US accounting and corporate governance rules; Treas. reg. section 1.952-2(b)(1).

72 **Selva Ozelli**, "Shareholder Leverage in the Face of Corporate Inversions," *Tax Notes Int'l*, Feb. 17, 2003, p. 661, *Doc 2003-4192* [**PDF**], or *2003 WTD 32-13* .

73 IRC section 409A(b)(1).

74 IRC section 409A(b)(1)(A).

75 IRC section 409A(b)(1)(B).

76 H.R. 108-548 (PL 108-357), p. 343.

77 IRC section 409A(b)(1)(A).