

Slide 1



Golden Gate University
School of Taxation

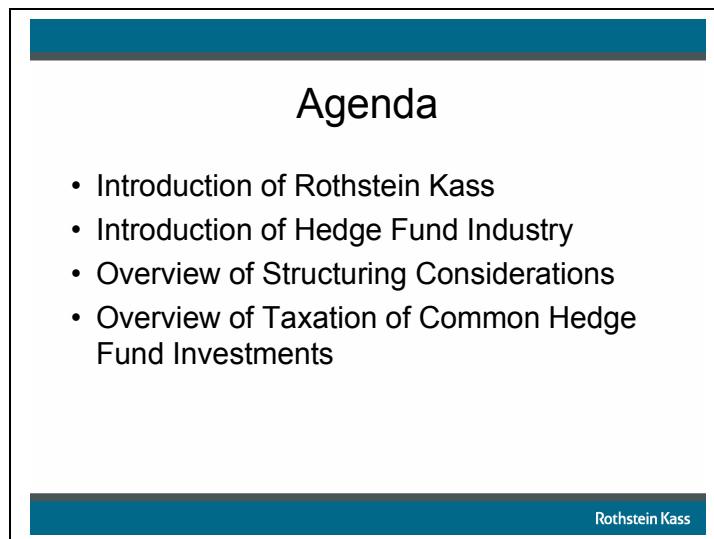
Expert Lecture: Hedge Funds and Taxation of
Investments

Presenters from Rothstein Kass & Company, LLP:
Paul T. Kangail
Navin Sethi
Seth Blackman

September 12, 2006

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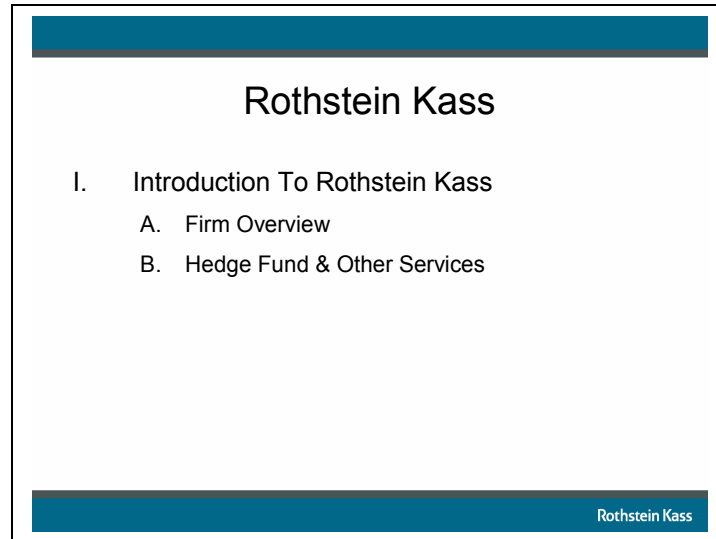


Agenda

- Introduction of Rothstein Kass
- Introduction of Hedge Fund Industry
- Overview of Structuring Considerations
- Overview of Taxation of Common Hedge Fund Investments

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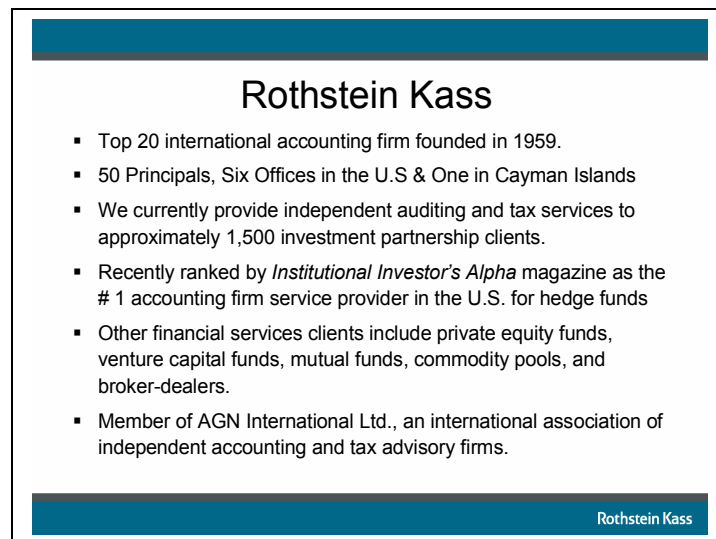
A presentation slide for Rothstein Kass. It features a dark blue header bar at the top and a dark blue footer bar at the bottom. The title "Rothstein Kass" is centered in the header. The main content is a bulleted list under the heading "I. Introduction To Rothstein Kass", with sub-points "A. Firm Overview" and "B. Hedge Fund & Other Services". The footer bar contains the text "Rothstein Kass" on the right side.

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- I. Introduction To Rothstein Kass
 - A. Firm Overview
 - B. Hedge Fund & Other Services

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A presentation slide for Rothstein Kass. It features a dark blue header bar at the top and a dark blue footer bar at the bottom. The title "Rothstein Kass" is centered in the header. The main content is a bulleted list of key facts about the firm. The footer bar contains the text "Rothstein Kass" on the right side.

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- Top 20 international accounting firm founded in 1959.
- 50 Principals, Six Offices in the U.S & One in Cayman Islands
- We currently provide independent auditing and tax services to approximately 1,500 investment partnership clients.
- Recently ranked by *Institutional Investor's Alpha* magazine as the # 1 accounting firm service provider in the U.S. for hedge funds
- Other financial services clients include private equity funds, venture capital funds, mutual funds, commodity pools, and broker-dealers.
- Member of AGN International Ltd., an international association of independent accounting and tax advisory firms.

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- **Annual Services**
 - Auditing
 - Tax compliance / Schedule K-1 Preparation
- **Structuring Advice**
 - Structuring advice for hedge funds in the start-up and expansion phases
 - Review of and commentary on offering documents and partnership agreements
- **Other Consulting Services**
 - Compliance services for registered investment advisors (Corporate Governance Group)
 - Tax planning and analysis related to complex financial instruments and transactions
 - International tax consulting
 - Executive search

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Did you know?????

The amount of money managed by funds passed the \$1.5 trillion mark during 2006...and that's still less than 2% of all global investments!!!

There are over 8,000 hedge funds worldwide ...and growing!!!

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What is a Hedge Fund?

- Private, unregistered investment vehicle
- Investors must be “accredited”
- Employ a wide range of strategies
- Investments include stocks, bonds, options, currencies, etc.
- Incentive Allocation – typically 20%
- Management fee – typically 1-2%

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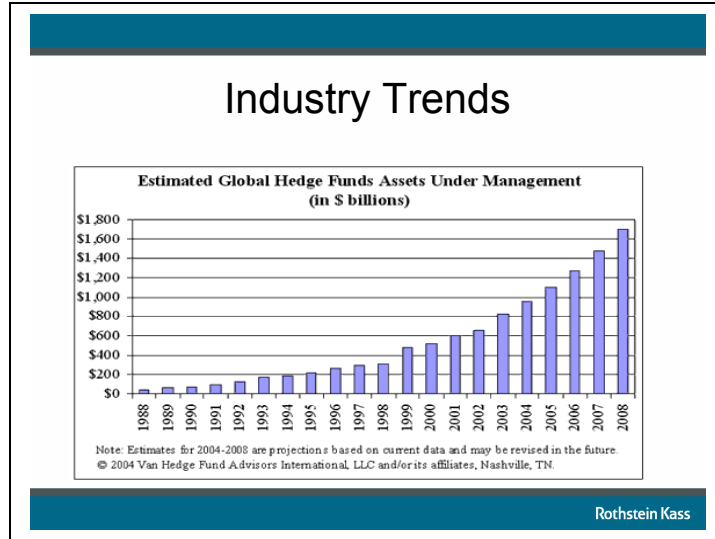
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Hedge Fund vs. Mutual Fund?

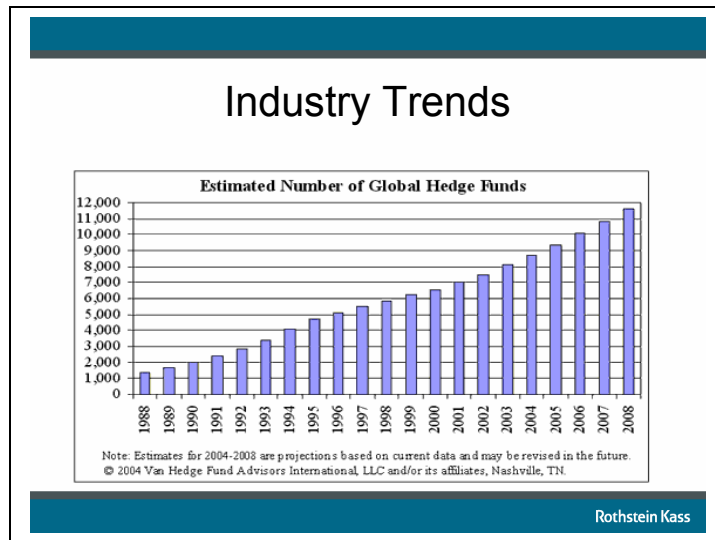
| | | |
|---------------------------|---|---|
| Type of Investment | Mainstream investment, launched in 1924 | Relatively new alternative asset class (1949) |
| Investment Mandate | Strict investment mandates | Fluid investment mandates and strategies |
| Reporting | Reporting standards & ratings services | No reporting standards |
| Knowledge | Widespread knowledge and common assumptions | Fragmented knowledge and assumptions |
| Fees | Management Fee | Management Fee & Incentive fees |
| Performance | Relative performance | Absolute performance |

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Common Entities & Service Providers

- **General Partner**
 - Typically a separate LLC; Receives Incentive Allocation
- **Investment Advisor**
 - Typically a LP or LLC and maybe be structured with two entities; Receives Mngmt. Fee & Incentive Fee (Offshore)
- **Limited Partners or Shareholders**
 - U.S. Taxables, U.S. Tax-Exempts, and Foreign Investors
- **Other Service Providers:**
 - Prime Brokers and Custodians
 - Fund Administrators
 - Auditors and Tax Consultants
 - Attorneys

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**Hedge Fund Structuring
Considerations**

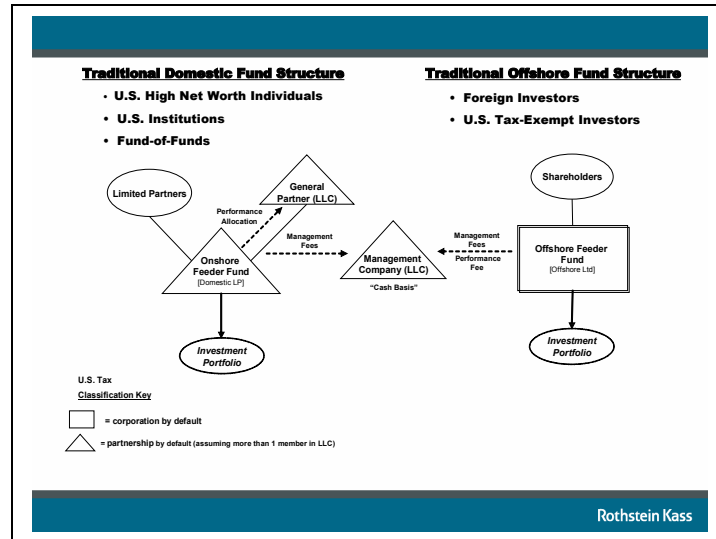
Common Hedge Fund Legal Structures

- A. “Side-By-Side” Structure
- B. Offshore Fund Considerations
- C. “Master-Feeder” Structure

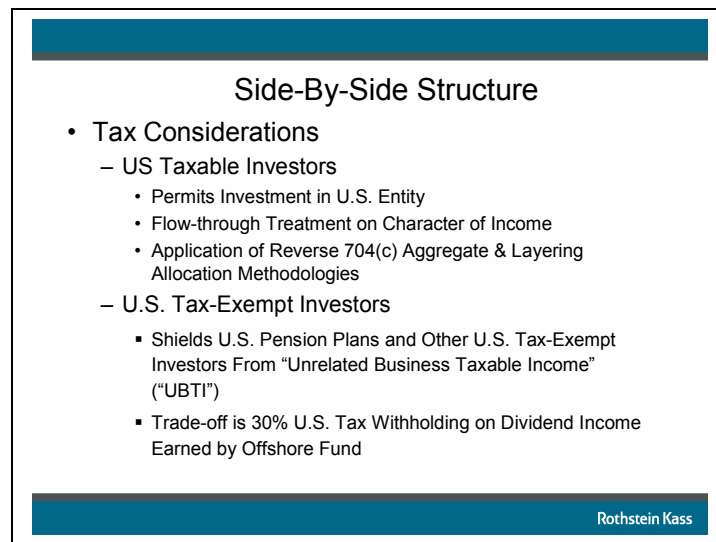
Fund of Funds Investment Strategy

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Side-By-Side Structure

- **Offshore Fund Considerations:**
 - Foreign Investors Historically More Comfortable Investing in an Offshore Fund
 - Allows Foreign Investors To Maintain Certain Degree of Anonymity
 - May Free Up Additional Investor “Space” In Onshore Fund (Side-By-Side) (Referring to SEC investor limits)
 - Additional Expense of Going Offshore
 - Popular Jurisdictions include Cayman Islands, BVI, and Bermuda

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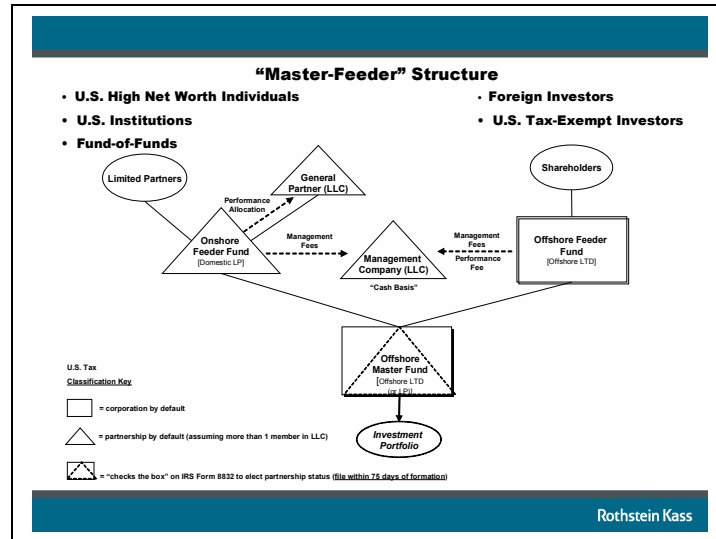
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Side-By-Side Structure

- **Other Considerations:**
 - Ability of Manager to Utilize Tax Efficiency Strategies for Benefit of US Taxable Investors
 - Ability to use Different Year-Ends so Incentive Fees are not Based Upon One Measurement Period
 - Need to Split Trade Tickets Between two Funds
 - Difficult to Keep Funds’ Portfolios Balanced

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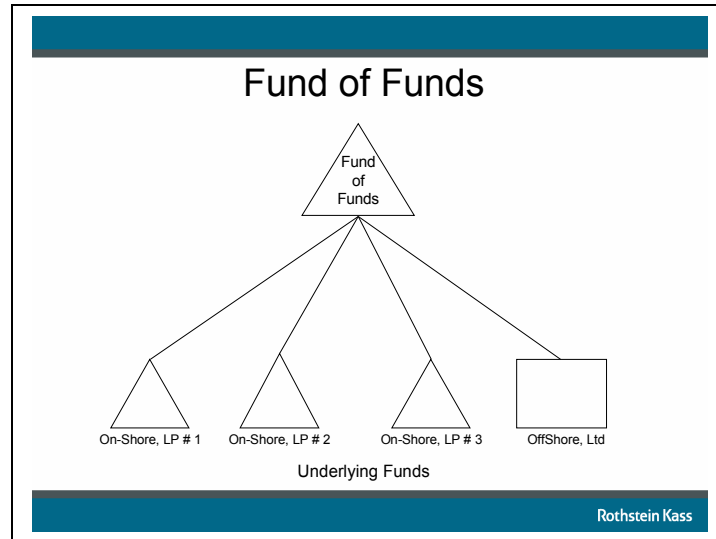
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- Master Feeder Considerations**
- **Advantages:**
 - Trading Costs Efficiencies
 - Matching of Returns of Separate Funds
 - Allows for Branding of Other Feeders
 - Has become a Commonly Used Structure
 - **Disadvantages:**
 - Tax Efficient Transactions for U.S. Investors may not be Beneficial for all Investors
 - Costs of Forming and Maintaining Three Entities
 - Complexities associated with U.S. Tax Withholding Procedures for Master
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- ### Fund of Funds Investment Strategy
- Tax Considerations:
 - Number & Timing of K-1s to be Received
 - Impacting Timing of Fund of HF's K-1s
 - Foreign Hedge Fund Investments – Treatment as PFICs or CFCs?
 - Generation of ECI from Underlying Funds
 - e.g. Loan Origination Income
 - Generation of State Sourced Income from Underlying Funds
 - Creating State Tax Return Filing Requirement for Fund and Potentially for Investors; State Estimated Tax Withholding Requirements
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Common Hedge Fund Investments

- U.S. Common & Preferred Equities
 - Long & Short Sale Positions
- Foreign Equities
- Flow-through Investments – LPs, LLCs
- U.S. & Foreign Debt
- Options, Swaps, Futures, Forwards, Commodities, etc.

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Tax Rules Applicable to Common Hedge Fund Investments

- List of Tax Rules to be Discussed:
 - Short Sales
 - Wash Sales
 - Constructive Sales
 - Straddles

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**Tax Rules Applicable to Common
Hedge Fund Investments**

- List of Additional Common Tax Rules not to be Discussed:
 - Dividends – QDI & Extraordinary
 - Debt Obligations:
 - OID, Market Discount, & Premium Accretion/Amortization
 - Section 1256 Contracts
 - Foreign Investments:
 - PFICs, CFCs, Sec. 988
 - Worthless Securities
 - PTPs
 - Swaps and Notional Principle Contracts

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Short Sale Rules - §1233

- Sales of Securities that the Seller does not Own; Seller uses a Broker who borrows the Security from Another Client's Account
- Seller Expects the Value of the Security to Decrease in the Future.
- Short Against the Box – Short Selling a Security the Taxpayer Holds Long

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Short Sale Rules - §1233

- Key Tax Provisions
 - In general, Recognition occurs on Settlement Date of Transaction Used to Close Short Sale
 - Loss Recognized on Date When Stock is Delivered (i.e., Settlement Date)
 - Gain Recognized on Trade Date of the Stock that is Delivered (Application of §1259)
 - Character & Holding Period Determined based upon Asset Used to Close the Transaction
 - G/L will be Short-term Unless Long used to Close Short was Held Long-term before Short Sale was Entered Into
 - Closed Short Sale Transactions are subject to the Wash Sale Rules

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Short Sale Rules - §1233

- In Lieu of Dividend Payment Rule –
 - If Taxpayer Closes a Short Sale within 45 days, any in Lieu of dividend payments are not currently deductible but rather are added to the basis of the Short Sale.

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Wash Sale Rules- §1091

- Taxpayer Sells stock or Security at a Loss and within 30 days before or after the date of the Sale the Taxpayer Buys (or enters into an Option to Buy) "Substantially Identical Stock or Securities"
- Holding Period of W/S Securities is Tacked onto Newly Acquired Shares
- Deferred Loss is Added to Tax Basis of Newly Acquired Shares
- Typically Hedge Funds enter into significant Wash Sales; Need for Wash Sale Reporting System
 - Need to Understand Systems Ability to Properly Account from Basis Adjustment on Subsequent Disposition of Newly Acquired Shares

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Constructive Sales Rules - §1259

- A Constructive Sale Occurs when –
 - A Taxpayer holds an "Appreciated Financial Position" and then enters into a Short Sale, an Offsetting Notional Principal Contract, or a Futures or Forward Contract on the Same or Substantially Identical Property
- Tax Consequences –
 - Taxpayer Recognizes Gain as if AFP was Sold at its FMV on Date of the Constructive Sale
 - Basis Adjustment for Gain Recognized
 - Holding Period is Restarted

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Constructive Sales Rules - §1259

- Rules Also Apply to a Short Sale that is an AFP
- Exception –
 - Constructive Rules will not apply to a Transactions that would Otherwise be Subject to these Rules if (1) such Transaction is Closed on or before the period ending 30-Days after the Close of the Tax Year and (2) the Taxpayer Continues to Hold the AFP, in a Naked Position, During the 60-Day Period beginning on the date such Transaction is Closed

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Straddle Rules - §1092

- A Brief Discussion on these Complex Tax Rules
- Straddle Defined
 - The Holding of an Offsetting Positions with Respect to Personal Property
 - Offsetting if there is a Substantial Diminution of the Taxpayer's Risk of Loss
 - Position means an interest including a Futures or Forward Contract or Option in Personal Property
 - Personal Property means any personal property of a type that is actively traded
 - With Changes Made By 2004 Tax Act, Personal Property now includes Stock

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Straddle Rules - §1092

- **Examples of Offsetting Positions:**
 - Short Against the Box
 - Put vs. Long (Short Put vs. Short)
 - Call vs. Short (Short Call vs. Long)
 - Offsetting positions of stock and a convertible debt security of the same corporation
 - Holding an index and a portfolio of stocks whose performance mimics the performance of an index may be a straddle

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Straddle Rules - §1092

- **Certain Tax Consequences of Straddle Rules**
 - Loss Deferral Provisions – A Taxpayer that Realizes a Loss on the Disposition of one or more Offsetting Positions can Deduct such Losses only to the Extent that such Realized Losses Exceed the Unrealized Gain, if any, in the Offsetting Position
 - Deferred Loss is Carried Forward to Succeeding Years until Unrealized Gain is Smaller than Deferred Loss

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Straddle Rules - §1092

- Holding Period Suspension Rules
 - The Holding Period of a Position Subject to the Straddle Rules does not Begin Until the Offsetting Position is Closed
- Inclusion of Stock as Personal Property has greatly Impacted Merger-Arbitrage Transactions
- Straddle Identification Rules are a Crucial Tax Planning Tool for Taxpayers that Enter into Offsetting Positions