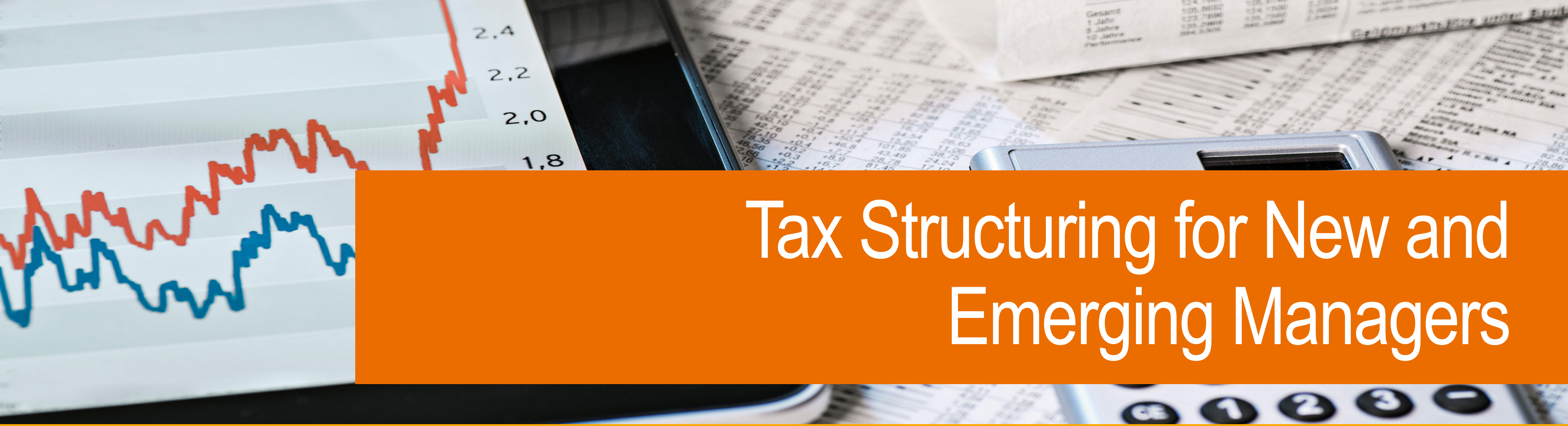
Tax Structuring for New and Emerging Managers

Assurance, Advisory & Tax



Tax Structuring for New and Emerging Managers

EFSI

i3 INVESTMENT PARTNERS

AKRAM
Assurance, Advisory & Tax

EARN CPE CREDIT

1. ANSWER POLLING QUESTIONS
2. PARTICIPATE IN THE CONVERSATION
3. FILL OUT CERTIFICATE THAT YOU RECIEVE AFTERWARDS

A Full-Service Accounting firm providing assurance, advisory, and tax services for hedge funds, private equity, venture capital, cryptocurrency funds, investors, traders, family offices and ultra high net-worth individuals.

Essential Fund Services helps both onshore and offshore hedge funds, private equity funds, venture capital funds, real estate funds and fund of funds with outsourced fund administration, capital introduction, M&A advisory and CFO/COO services.

i3 Investment Partners is a quantitative investment management company that seeks to provide investors with the consistent long-term growth of capital with diversified investments in U.S. stocks and global multi-asset class ETF's.

MEET OUR PANELISTS

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BUSINESS PLAN

Prepare a comprehensive business plan to build strong foundation

For emerging fund managers, a strong, comprehensive business plan can serve as a valuable tool to guide decisions and facilitate conversations in a range of key areas: **fund infrastructure, marketing, capital raising, operations, cash management, compliance, reporting**, and more.

Your business plan will be put to good use right away, during the initial phases of launching your fund, as you communicate your track record (if portable), objectives, and investment strategy to prospective stakeholders.

Although your business plan is mainly a strong tool for internal decision-making, seed investors, allocators, and service providers will also expect to see this information in writing.

POLLING QUESTION #1

Tell us about yourself?

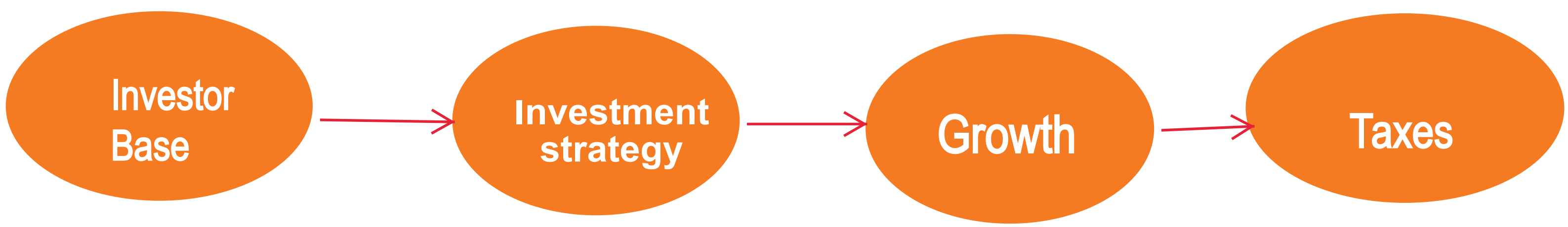
A- Fund Manager, Investment Advisor
B- Service Providers (Accountants, Banker, Lawyer, etc.)
C- Day Trader
D- Other

FUNDS STRUCTURES - Align fund structure with investment strategy and investor profile

There are several factors that should inform your decisions about the structure of your fund:

Anticipated investor base (i.e., U.S.-based or foreign investors), investment strategy, growth objectives, and tax considerations. Emerging managers often choose to start with a domestic fund to keep operations simpler and save the additional costs involved in supporting an offshore fund.

The anticipated size of the fund (in assets under management, or AUM) will naturally attract a specific group of investors. Whether you plan to market your fund to institutional investors with relatively large minimum investment requirements, or you envision your investor base as a mix of family, friends, and smaller allocators, you'll need to structure the size and type of your fund accordingly.



FUND STRUCTURES (Continued)

Additional considerations include:

Fund domicile preferences	Typically, taxable U.S. investors only invest in domestic funds, whereas international and nontaxable entities may only invest in offshore funds.
Investment strategy	Consider who your strategy should be marketed to, as different types of investors may have different return and risk expectations. They also may already have sufficient allocations to your strategy.
Allocation of investments	some investors spread their money across several fund types and strategies according to specifically written guidelines (e.g., 35% private equity, 20% hedge, 35% real estate, and 10% debt).
Open-end or closed-end	With an open-end fund, money can be added or withdrawn in accordance with the Private Placement Memorandum. Closed-end funds don't allow investors to withdraw funds as easily, if at all. And there are also hybrid funds, which are a mix of the two.

Which Structure Do You Choose? Fund Structures (Continued)

Domestic…

- If a fund expects to have only U.S. investors, a domestic fund structure is sufficient.

…or Offshore?

- If a fund anticipates significant participation by offshore investors, an appropriate offshore fund in a tax neutral jurisdiction is needed to shield such investors from US tax liability.

Domestic & Offshore Fund Structures (Continued)

Domestic Fund Structure

Domestic-only (US Domiciled) fund structures are typically comprised of the following entities:

- A limited partnership (LLC) that acts as the fund entity.
    - The fund entity is formed in the state of Delaware.
- An LLC that acts as the investment manager (IM) and general partner (GP) of the fund (managing member in the case of an LLC).
    - These may be separate entities depending upon the tax jurisdiction of the GP and IM (ex: NYC).
- The IM/GP entity/entities are typically formed in the jurisdiction of the fund's IM.

Domestic & Offshore Fund Structures (continued)

Fund Structures

The most widely-used options:

- Standalone Domestic (USA)
- Standalone Offshore
- Master-Feeder
- Mini Master
- Side by Side

Fund Structure Types (continued)

Offshore Stand Alone Structure

- Only one fund vehicle is used, and that fund vehicle is offshore
    - Normally in the Cayman Islands or the British Virgin Islands (BVI)
- Mainly used by managers who have no US presence
- Normally geared towards non-US investors, but may also benefit US based non-taxable investors who want to avoid unrelated business taxable income such as:
    - Pension funds
    - Charitable organizations
    - Endowments

Fund Structure Types (continued)

Master Feeder Structure

- Normally used where there is a US presence and where a single manager is seeking investment from both US and non-US or tax-exempt US investors.
- The structure will comprise of:
  - A master fund (an offshore vehicle which is either a limited partnership or a corporate vehicle which elects to be treated as a partnership for US tax purposes), which conducts the trading
  - At least two feeder funds which invest all their assets into the master fund

Fund Structure Types (continued)

Master Feeder Structure (continued)

- One feeder fund is typically a US limited partnership into which the US taxable investors will invest.
    - Using a limited partnership, which is a “pass through” entity for US tax purposes, means that the allocable master fund’s profits and losses are passed through to investors and taxed at investor level.
    - There is no entity tax at the master fund level in the offshore jurisdiction (either the Cayman Islands or the British Virgin Islands), thus avoiding double taxation.

Fund Structure Types (continued)

Master Feeder Structure (continued)

- The second feeder (“offshore feeder”) will normally be an offshore company known as a “blocker corporation”.
  - It is into this offshore feeder that the non-US and US tax-exempt investors will invest.
  - Investment into a blocker corporation means that any US tax liability and any requirement to fill in a US tax return arises at the master/feeder fund level and does not affect the investors themselves.

Fund Structure Types (continued)

Mini-Master Fund Structure

- A single offshore fund is established which is taxed as a corporation to benefit US tax-exempt investors and block UBTI and non-US investors.
- Needing to create only one new offshore vehicle saves costs, both on formation and in terms of upkeep. This is popular with startup and emerging managers.
  - The offshore fund invests directly into the existing US fund, which will then act as the master fund for the US non-taxable and foreign investors. It will also remain the fund into which the US taxable investors will continue to invest.

Fund Structure Types (continued)

Mini-Master Fund Structure (continued)

Two additional benefits:

- Existing US-taxable investors do not need to be moved
- Existing assets of the domestic fund can remain where they are

Both factors vastly reduce the administration around the restructuring and subsequently reduce the cost. While there are some tax consequences to be discussed around the use of this structure, it has proved to be appealing to those looking to dip their toe in the waters of offshore vehicles.

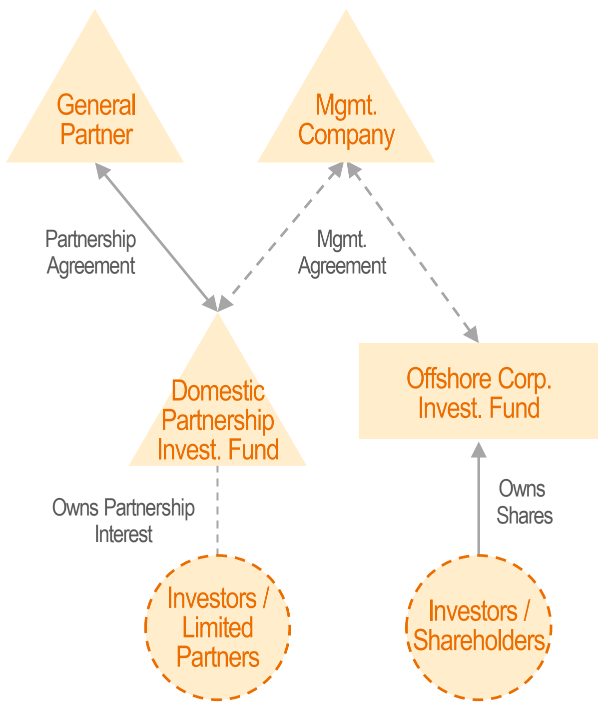
FUNDS STRUCTURES (continued)

Five main types of fund structure:

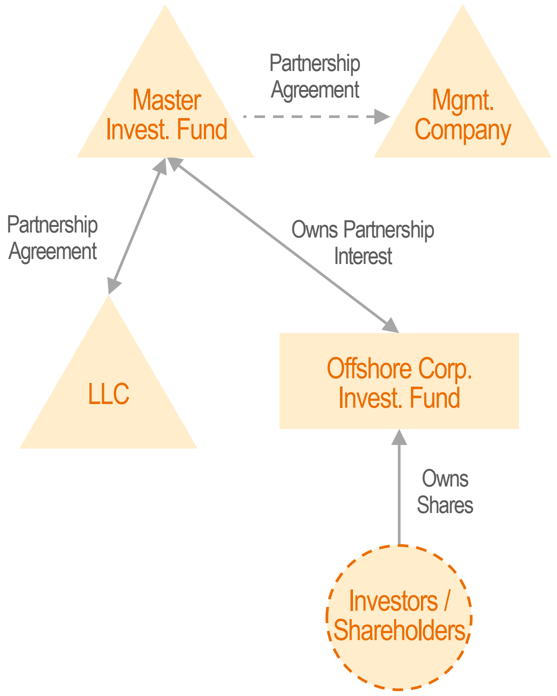
Standalone domestic	Standalone offshore	Master-feeder	Mini-master	Side-by-side
The standalone domestic structure is used by U.S. managers who expect capital allocations from U.S. investors or U.S. taxable investors. When compared to other structures, the standalone domestic structure is the least complex and most economical to support, making it most common. This fund structure contains 1) the fund, 2) the general partner, and 3) the investment manager. The general partner is an owner in the fund and receives an incentive allocation, while the investment manager does not have ownership and receives a management fee.	**The standalone offshore structure** is used by offshore managers who expect capital allocations from non-U.S. investors or U.S. tax-exempt investors.	**Master-feeder structures** are generally used when the investor base is composed of tax-exempt, offshore, and U.S. taxable investors. Tax-exempt and offshore investors will invest into the offshore feeder, resulting in various tax benefits. This structure is used more often than the mini-master structure because offshore investors typically prefer investing solely in offshore funds. The offshore investors' capital flows to the master fund, which is typically a Cayman entity, instead of to a U.S. master entity, which is used typically in the mini-master structure.	**The mini-master fund structure** includes a U.S. master trading entity and an offshore feeder. The offshore feeder is a partner in the domestic fund. The offshore entity is taxed as a corporation, thus benefiting U.S. tax-exempt entities and non-U.S. investors. The pros of a mini-master structure are that there's one fewer entity to manage, one fewer audit and tax return, one fewer administrator fee, and less in foreign jurisdiction fees than you would find in a master-feeder structure.	**The side-by-side structure** includes a domestic and offshore fund, which make direct investments based on the agreed-upon investment strategy. The former is usually a limited partnership or LLC, while the latter is organized outside of the U.S. The onshore and offshore fund each do their own trading. This type of fund structure creates unique challenges, such as trading at least two accounts and potential differences in performance, but also offers the advantage of allowing the funds to trade differently when tax considerations that may benefit the U.S. investors become available.

Fund Structures Diagram (Continued)

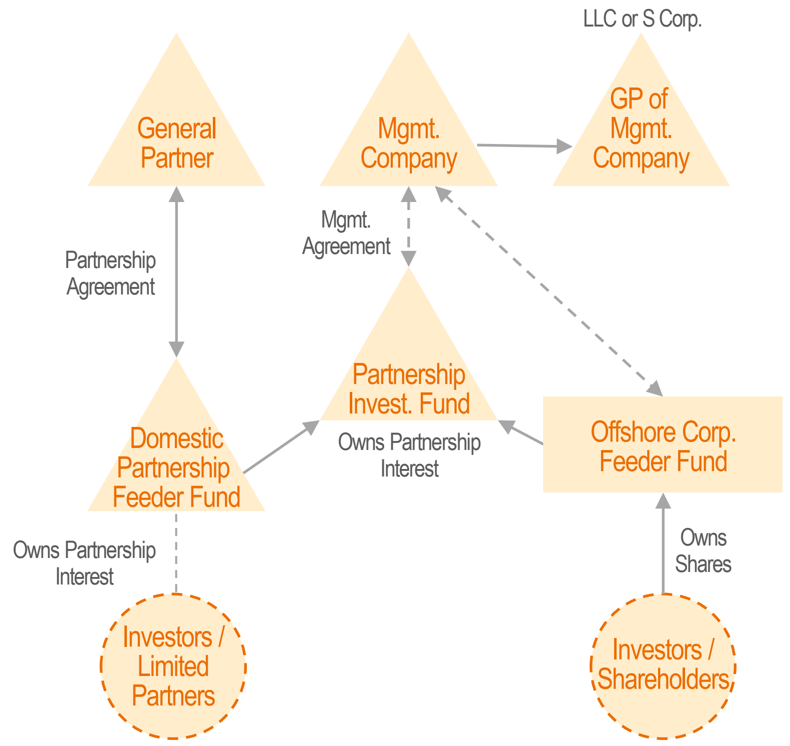
Side-By-Side Fund Structure



Mini-Master Fund Structure



Master Fund Structure



POLLING QUESTION #2

Foreign Investor should invest in an offshore Fund only?

- ✓ Yes
- ✗ No

Which Offshore Jurisdiction is best for Emerging Managers?

The Cayman Islands vs. British Virgin Islands

Cayman Islands vs. British Virgin Islands (BVI)

Cayman Islands

- Has a business-friendly structure, stable government and well-developed investment laws
- Is a tax-exempt jurisdiction, allowing offshore investors and US tax-exempt investors (that would otherwise be subject to UBTI taxes) to avoid paying US taxes on hedge fund gains
    - The Cayman Islands is the world leader as a jurisdiction for hedge funds.
- There are no direct taxes of any kind
- Exempted companies, the most common fund vehicle, can remain tax-free for 20 years
- Exempted limited partnerships can remain tax-free for 50 years.
    - These are popular with U.S. investors because they resemble the familiar Delaware limited partnerships.

BVI

- Has recently gained the reputation as a cost-effective and convenient jurisdiction
- The regulatory structure creates a flexible jurisdiction with streamlined processes and strong legal certainty.
- Regulatory filing fees are considerably lower than those of the Cayman Islands.
- Investors, particularly in East Asia, have acknowledged the BVI’s clout in the arena of offshore financial centers.

POLLING QUESTION #3

Which offshore jurisdiction is preferred by you ?

A-Cayman Islands
B- British Virgin Islands
C- Jersey and Guernsey
D- Bermuda
E-Other

Difference Between Investor vs. Trader Fund?

Investor Fund…

- Investor funds usually buy and hold investments for long term... generate long term capital gain (loss) and Qualified Dividends. Portfolio turnover is very low

Trader Fund...?

- Trader Funds capture short term fluctuations in the financial market and generate short term capital gain /(loss) in addition to ordinary dividends. Portfolio turnover is quiet high

Trader vs Investor Fund (continued)
Considering the TCJA & MTM (475) Election

Trader Tax Status (TTS) and 475

- Business traders eligible for TTS are entitled to tax breaks, unlike Investor Fund Status entities.
- Sole proprietor (individual) TTS traders can deduct business expenses, startup costs, and home office expenses, and are entitled to elect Section 475 MTM ordinary gain or loss treatment.
  - *To deduct health insurance and retirement plan contributions, a TTS trader needs an S-Corp to create earned income with officer compensation.*
- Don’t confuse TTS with the Section 475 election.
  - *Only qualified business traders may use Section 475 MTM; investors may not. Section 475 trades are also exempt from wash-sale loss adjustments.*
- The 20% deduction on QBI includes Section 475 ordinary income but excludes capital gains, interest, and dividend income. The QBI deduction for TTS/475 traders is subject to a taxable income threshold and cap.
- Business traders may only use Section 475 MTM if they filed an election on time, either by April 15 of the current year or within 75 days of inception of a new taxpayer (i.e., a new entity).

Trader vs Investor Fund
Considering the TCJA & MTM (475) Election (continued)

Investor Fund Status

- By default, the IRS lumps all traders into “investor tax status,” and investors get penalized in the tax code — more so with TCJA. Investors have restricted investment interest expense deductions, and investment fees and expenses are suspended.
- Investors have capital-loss limitations against ordinary income ($3,000 per year), and wash-sale loss deferrals; they do not have the Section 475 MTM election option or health insurance and retirement plan deduction strategies.
- Investors benefit from lower long-term capital gains rates (0%, 15%, and 20%) on positions held for 12 months or more before sale. If active traders have segregated long-term investment positions, this is available to them as well.

Tax Cuts and Jobs Act (TCJA)

Since TCJA was enacted on December 22, 2017 (into effect in the 2018 tax year), traders eligible for trader tax status (TTS) have restructured their business to take advantage of TCJA.

Two changes:

- 20% deduction on qualified business income (QBI) in pass-through entities
- Suspended investment fees and expenses, making TTS even more crucial
  - TCJA continues to allow itemized deductions for investment-interest expenses.

No changes:

- Trader tax matters - including business expense treatment, Section 475 MTM ordinary gain or loss treatment, and wash-sale loss adjustments on securities
- TTS S-Corps' Solo 401(k) retirement contributions and health-insurance deductions
- TCJA also retains the lower Section 1256 60/40 capital gains tax rates; the Section 1256 loss carryback election; Section 988 for extraordinary gain or loss; and tax treatment on financial products including options, ETFs, ETNs, swaps, precious metals, and more.

Choosing Right Service Providers by Emerging Managers

1. Law Firm
2. Bank
3. Prime Broker
4. Third Party Fund Admin
5. Independent Auditor

Choosing Right Service Providers by Emerging Managers
(continued)

What Factors Emerging Managers should consider before choosing Service Providers for their fund?

- Industry Experience, Reputation, Firm Size, and Team quality.

Tax Efficient Hedge Fund Strategies

1. Plan for changes to the taxation of carried interests. Consider changing the carried interest allocation to a fee or the management fee to an allocation.
2. When to recognize gains and losses; Loss harvesting
   - Consider your current year tax situation and your projected tax situation for next year to determine in which year it would be preferable to recognize gains and losses for tax purposes.
3. Miscellaneous itemized deductions
   - Under the TCJA, individuals can no longer deduct miscellaneous itemized deductions for 2018 through 2025
   - Evaluate whether your fund is a trader or an investor and whether that may change. Alternatively, it might be possible to see if such expenses can be capitalized, otherwise recharacterized or paid in a different manner.
4. Consider making a Section 475(f) mark-to-market election.
   - A Section 475 election may offer significant tax benefits, including for built-in gains or losses.

Tax Efficient Hedge Fund Strategies (continued)

5. Consider the use of stock-settled stock appreciation rights.
   - If a substantial portion of the carried interest will now be taxable as short-term capital gains, consider the use of stock appreciation rights ("SARs"). SARs allow the deferral of income but there is a built-in clawback, they are very complex and no, or very few, funds have implemented SARs. Since there are several issues regarding the use of SARs, it might take a significant amount of time to implement a SARs plan.
6. Private Placement Life Insurance / Insurance Dedicated Funds
   - Hedge fund managers should consider offering insurance dedicated funds ("IDFs") as a way for investors to invest in their fund strategy in a more tax-efficient manner. Conversely, investors should consider whether investing in a fund via private placement life insurance or private placement variable annuities is potentially a more tax-efficient way to invest. Investing in an IDF can eliminate income and estate taxes if done properly.

Tax Efficient Hedge Fund Strategies (continued)

7. Opportunity Zones
   - If you have recognized capital gains, consider whether it makes sense to reinvest some or all of your capital gains in opportunity zone funds. Opportunity zone provisions were enacted in the TCJA and offer significant tax benefits including deferral of income tax and potential elimination of income tax on future appreciation.

8. Section 1256 Contracts
   - IRC section 1256 (b)(1) –The term "section 1256 contract" means
     - 1256(b)(1)(A) any Regulated Futures Contracts
     - 1256(b)(1)(B) any foreign currency contract
     - 1256(b)(1)(C) any nonequity option
     - 1256(b)(1)(D) any dealer equity options
     - 1256(b)(1)(E) any dealer securities futures contract

Tax Efficient Hedge Fund Strategies (continued)

8. Section 1256 Contracts (continued)

- IRC section 1256 Tax Treatment
  - Mark to market – Each §1256 Contract held at the close of the taxable year should be treated as sold for its FMV. Basis in the contract is adjusted for any mark inclusion.
  - 60/40 Treatment – Any gain or loss attributable to a §1256 contract will be treated as 40% short term and 60% long term capital gain or loss.
  - Exception - Foreign Currency Contract – Mark to Market as ordinary treatment unless election is made.

POLLING QUESTION #4

1256 Contracts provide long term capital gain treatment?

Yes

No

THANK YOU FOR PARTICIPATING

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