WHAT EVERY TAX ADVISER NEEDS TO KNOW ABOUT HEDGE FUNDS

By

Paul S. Lee, J.D., LL.M.
National Managing Director
Bernstein Global Wealth Management[1]
New York, NY
(212) 756-4352
Email: paul.lee@bernstein.com

I. HEDGE FUNDS GENERALLY

A. Defined

1. A hedge fund is a lightly regulated investment pool, generally limited to high net worth individuals and institutions, in which the investment manager is given great flexibility to exploit inefficiencies in the global investment markets. To accomplish their investment goals, hedge fund managers utilize a far wider set of tools than traditional portfolio managers. The strategies may include the following:

a. In the classic configuration, hedge fund managers not only "go long" securities they believe are likely to appreciate, but also "short-sell" securities poised, in their judgment, to fall in price. This ability to go long and short allows hedge fund managers to profit from falling as well as rising prices. For example, when a stock is sold short, the investor borrows the shares and immediately sells them, giving the cash proceeds to the lender as collateral—which generates interest for the investor. Eventually the investor has the obligation to return the borrowed stock, which he hopes will have fallen in the interim, and hence can be returned at a lower price. The investor can then pocket the difference. Shorting can hedge unwanted risks by reducing a portfolio's exposure to the broad market, to a specific country or sector, or to factors associated with an individual security. But it can also add risk, since the technique bucks the stock market's general upward trend (and there's no limit to how much a stock can gain—and therefore to how much a short-seller could theoretically lose).

b. Most hedge funds utilize a wide variety of financial derivatives and instruments, including options, futures, forward contracts and swaps linked to equity or bond indexes, individual securities, currencies, or even changes in interest rates.

c. Other hedge funds invest in non-traditional or illiquid assets, such as private debt arrangements or private equity, while others may invest in distressed assets or employ arbitrage techniques that attempt to capitalize on merger opportunities or perceived misvaluations between two closely related securities

d. Many hedge funds also employ leverage, which simply is the practice of borrowing money to add to an investment position in order to amplify returns. It can be accomplished through borrowing (funds or securities) or the use of derivatives—both of which increase the potential for loss as well as profit. Some hedge fund strategies that attempt to exploit small pricing discrepancies (for example between the value of two different Treasury bonds of different maturities) in the marketplace require large amounts of leverage in order to generate an attractive return for investors.

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[1] Portions of this outline are taken from Bernstein Global Wealth Management, Hedge Funds: Too Much of a Good Thing? (2006).

e. Most hedge funds have flexible investment mandates (set out in the partnership agreement or other investment management agreement) which enable the funds to pursue opportunities with fewer constraints than typically imposed on traditional managers. Hedge funds can move quickly in and out of markets, take concentrated positions, and exploit unique sources of potential return—such as wagering on a merger agreement whose closure is uncertain (merger arbitrage or event-driven hedge funds).

2. There is no standard legal definition but most hedge funds share the following characteristics:

a. Invest in pools of securities and other assets that may not be required to register as securities offerings with the Securities and Exchange Commission.

b. The hedge fund is not required to register as an investment company under the Investment Company Act of 1940.[2]

c. Compensation of the general manager and/or investment manager is based upon a percentage of the hedge fund's assets and capital appreciation.

d. Fund often includes significant amount of the manager's own capital in the fund.

B. <u>"Categories" of Hedge Fund Styles</u>

1. Unlike traditional long-only investment strategies) which might be categorized as a value-oriented equity fund, index fund, etc.), there are no standard categories of hedge fund strategies.

2. Some commentators have categorized hedge funds into long/short equity, event-driven, absolute-return and global asset allocator funds. Others have categorized hedge fund styles according to their relative exposure and correlation to the market and thus categorized them into relative-value (including convertible arbitrage, fixed income arbitrage, equity market neutral strategies), event-driven (including risk arbitrage and distressed securities strategies) and opportunistic (macro, short sellers, emerging market and long/short equity).[3]

3. For purposes of this outline, we have categorize the hedge fund styles into two broad types, market neutral strategies and directional strategies.

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[2] Recently, the U.S. Court of Appeals for the D.C. circuit recently struck down Rule 203(b)(3)-2 under the Investment Advisers Act of 1940 which gave the SEC limited authority over hedge funds (defined as a private fund under Rule 203(b)(3)-1) and their managers by making a large number of previously exempt investment fund managers subject to registration under the act. The court ruled that the SEC had exceeded its authority. *Goldstein v. Securities and Exchange Commission*, [no citation], (D.C. Cir. 2006).

[3] Alexander M. Ineichen, <u>In Search of Alpha: Investing in Hedge Funds</u>, UBS Warburg (2000).

C. Market Neutral Strategies

1. Types of Market Neutral Strategies

a. Event-Driven

(1) Merger arbitrage which seeks to profit from merger transactions as they come to fruition (or as they do not); and

(2) Distressed securities, which seeks to profit from companies that are approaching or emerging from bankruptcy or other financial trouble.

(3) The requisite manager skills here include asset valuation, capital structure analysis, and evaluation of the details and timing of bankruptcies and mergers.

b. Equity Market-Neutral Strategies

(1) This type of strategy relies on the manager's ability to distinguish between stocks that will go up in price and stocks that will go down.

(2) The key success factor here is the quality of the research used to select long and short positions. In addition, investors are betting on the manager's ability to keep net exposure to the market at a minimum and to control the fund's dependence on related factors, such as style (value or growth) and sector.

c. Arbitrage Strategies

(1) This type of strategy typically seek to exploit relatively small mispricings between closely related securities—for example, a convertible bond and the common stock of the same issuer (hence the name "convertible arbitrage" hedge funds).

(2) Success factors include the ability to value these securities, often through the use of sophisticated statistical models; skill in setting and managing the net invested position; and the ability to manage portfolio risk, including leverage, which is often employed to a high degree.

		Return & Risk Drivers: Degree of Importance		
	Primary Skills Required	**Market**	**Security Selection**	**Leverage**
Equity Market-Neutral	Stock valuation; quantitative analysis	Low	High	Low
Arbitrage	Security valuation; quantitative analysis; financial modeling	Low	Moderate	High
Event-Driven	Deal valuation; asset valuation; capital-structure analysis; legal analysis	Low to Moderate	High	Low
Long/Short Equity	Stock valuation	Moderate	High	Low
Global Asset Allocators	Macroeconomic and quantitative analysis	Moderate	Moderate	High

2. How a Market-Neutral Hedge Fund Works

a. Here is an example of market-neutral fund might earn its return. To neutralize market exposure, the manager might invest (buy long) $100 in a group of securities he thinks will outpace the market—which we've assumed gains 9%—and at the same time sell short $100 worth of securities he believes will underperform. (The fund controls $200 of stock, but because the shares that are sold short are borrowed rather than bought outright, the manager needs only $100 of capital to fund the positions. In other words, the fund is leveraged two-to-one.) Since the fund's longs will tend to benefit from rising markets and its shorts from falling markets, their effects offset each other, netting a 0% return from the market, whether it goes up or down.

b. Of course, the manager's hope is that his longs and shorts each generate alpha, and let's say they do; we assume that the longs go up by three percentage points more than the market, with the shorts underperforming by the same amount. The fund has earned a total alpha return of 6%. It will also pick up a return in line with the prevailing cash rates—let's say 4%. That's because the fund manager can invest the proceeds from the short sales in Treasury bills while they are held as collateral until the shorts are covered. In total, the fund has earned 10% (pre-fee) modestly above the S&P's assumed return despite a strategy that removes all market exposure.

	Market Exposure	Market Return	Alpha Return	Interest on Short Sale	Total Return
Buy Long	$100	9%	3%	n/a	12%
Sell Short	($100)	(9%)	3%	4%	(2%)
Total	$0	0%	6%	4%	10%

c. Of course, had the manager's bets gone against him, the fund would have generated zero or negative alpha.

D. Directional Strategies

1. Long/Short Equity Strategies

a. This is by far the largest hedge fund category and most popular hedge fund strategy over the last few years.

b. Typically exposed to the long-term upward trend in the stock market, although the level of market exposure varies considerably by fund. As with market-neutral long/short funds, these strategies rely on the manager's ability to distinguish between stocks poised to rise in price and their opposite counterparts.

c. Long/short equity strategies encompass subcategories based on investment style (growth or value), geography (U.S., developed international or emerging market equities), and economic sector.

2. Global Asset Allocators

a. This type of strategy often bets on the direction of broad asset baskets such as commodities, currencies, interest rates, or country stock markets.

b. These strategies include strategies that are called "global macro" and "managed futures" funds.

II. TAX CONSIDERATIONS OF ONSHORE AND OFFSHORE HEDGE FUNDS

A. Introduction

1. The tax treatment of a hedge fund and its investors is dependent upon the type of entity (partnership, corporation, trust, etc.) used for the hedge fund, the jurisdiction in which the entity is formed and doing business, the type of interest the investor takes in the fund and the restrictions, terms under which the investor holds the investment units (for example, under the terms of a partnership agreement or the articles of incorporation) and, last but certainly not least, the strategies and financial instruments used by the hedge fund.

2. Because hedge funds use a myriad of investment strategies and come in a number of different legal forms, I have limited the tax discussion in this outline to the most popular types of entities (partnerships and limited liability companies in the U.S. and corporations and limited companies outside of the U.S.), the most popular strategies (long/short strategies) and the most common securities and financial instruments or derivatives utilized (options, forward contracts, short sales, etc.),[4] and generally from the perspective of U.S. based investors.

[4] Specifically, I am not discussing notional principal contracts (also known as "swaps") in detail in this outline. Generally, a swap is a contract between two parties where one party goes "long" a particular security (equity or debt) and the counterparty goes "short" the same security. The difference here is that neither party actually owns the security. Their investment in the security is purely "notional" or "hypothetical." Under this type of arrangement, each party to the swap agrees to exchange payments based upon whether that security goes up or down and on other variables like the interest rates. For example, the short party agrees to pay the long party an amount equal to the appreciation of 10 shares of IBM and dividends that are paid on those 10 shares of IBM. The long party agrees to pay to the short party an amount equal to any depreciation in 10 shares of IBM over that same period and a rate of interest. At the expiration of the contract, one party pays the other party depending on the foregoing formula. Generally, payments under a notional principal contract are paid in installments over a period of time. The taxation

B. Choice of Entity for U.S. Hedge Funds and Non-U.S. Hedge Funds

1. The vast majority of U.S. hedge funds are formed as either partnerships or limited liability companies. On the other hand, most offshore hedge funds are formed as corporations or limited companies in low or no tax jurisdictions like the Cayman Islands, Isle of Man, Bermuda and Luxembourg.

2. The primary investors in U.S. hedge funds are U.S. Persons (residents or citizens of the United States and entities organized under the laws of the United States) other than tax exempt U.S. persons like endowments, charitable organizations and qualified retirement plans.

a. Investors in U.S. hedge funds generally will take a limited partnership interest in the hedge fund. The rights, restrictions and obligations with respect to the limited partnership interest are generally set out in the partnership agreement and are often dependent upon the fee arrangement (including any incentive fee) agreed upon by the investor. Investors will generally realize all or a portion of their investment in the fund through partnership distributions or a redemption of all or a part of their interest in the hedge fund, pursuant to the terms of the partnership agreement.

b. The general partner of the fund will generally be a corporation that is related or wholly owned by the investment manager, which manages the investments pursuant to a separate investment management agreement.

3. The non-US or "offshore" hedge funds are consequently offered primarily to non-U.S. persons and these tax exempt U.S. Persons.

a. Investors in these offshore hedge funds generally take corporation shares in the hedge fund. The rights and restrictions with respect to the shares are generally set out in the articles of incorporation and the class of share subscribed for by the investor is often dependent upon the fee arrangement (including any incentive fee) agreed upon by the investor.

b. The board of directors will generally be appointed by and controlled by the incorporator, which is related to or controlled by the investment manager, which in turn manages the investments pursuant to a separate investment management agreement.

c. Many offshore hedge funds will use a master feeder fund structure where the hedge fund itself invests all or substantially all of its assets in one or more master funds (structured as another corporation or partnership), where the actual investments will take place.

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of notional principal contracts is still evolving and quite complex, generally determined under Section 446 of the Code and taxed according to the timing of the payments under the contract. *See* Rev. Rul. 2002-30, 2002 I.R.B. 971, IRS Notice 2002-35, IRS Notice 2006-16, and the proposed Regulations under Section 446 of the Code.

C. Taxation of US Hedge Funds (Onshore)

1. Classification of the Partnership for Tax Purposes

a. Under Section 7704 of the Code, "publicly traded partnerships" are generally treated as corporations for Federal tax purposes. A publicly traded partnership is any partnership the interests in which are traded on an established securities market or which are readily tradable on a secondary market (or the substantial equivalent thereof).[5]

b. However, a partnership will be exempt from classification as a publicly traded partnership if 90% or more of its annual gross income consists of "qualifying income" within the meaning of Section 7704(d) of the Code and the Regulations. “Qualifying income” includes:

(1) dividends,

(2) real property rents;[6]

(3) gain from the sale or other disposition of real property, including Section 1221(a)(1) property;

(4) gain from the sale or disposition of a capital asset or Section 1231 property; and

(5) in the case of a partnership, where a principal activity of the partnership is the buying and selling of such items, income and gain from commodities (not described in Section 1221(a)(1)) or futures, options or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool).

c. The vast majority of U.S. hedge funds are classified as partnerships for tax purposes. As such, the taxation of the hedge fund and its investors is pursuant to subchapter K of the Code. Generally, most hedge funds will file an annual partnership information return with the IRS on the operations of the partnership and the investments. Each investor, as a limited partner, is required to report separately on its income tax return its distributive share of the hedge-fund’s net long-term capital gain or loss, net short-term capital gain or loss and all other items of ordinary income or loss. Each investor is taxed on its distributive share of the partnership's taxable income and gain (regardless of whether it has received or will receive a distribution from the hedge fund).

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[5] § 7704.

[6] Generally, the definition found for real estate investment trusts (REITs) under § 856(d).

2. Tax Issues for the Investor/Limited Partner

a. Contribution of Assets In-Kind to the Hedge Fund

(1) A contribution of a portfolio of stocks and securities to a partnership such as the Partnership generally results in the contributor recognizing gain, but not loss, if the effect of the contribution is a "diversification" of the contributor's assets.[7]

(2) However, a contribution of such a portfolio to a partnership would not result in taxable gain if (i) the portfolio constitutes a "diversified portfolio" at the time of the transfer and (ii) such contribution is not part of a plan whereby another person contributes an "undiversified" portfolio of stock and securities to the same investment partnership.

(3) A contributed portfolio will be considered diversified if, taken in the aggregate, (a) the stock or securities of any one issuer do not constitute more than 25% of the value of the contributed assets and (b) the stock and securities of 5 or fewer issuers do not constitute more than 50% of the value of the transferred assets.

(4) In making this determination, all cash and cash items (including receivables) are excluded as well as any assets acquired for purposes of meeting the requirements of diversification. U.S. Government securities are included in "total assets" for purposes of the denominator of the 25% and 50% tests, but are not treated as securities of an issuer for purposes of the numerator of the 25% and 50% tests. For these purposes, stocks and securities include money, stock in a corporation, notes, bonds, debenture or other debts, and derivative financial instruments.

(5) There is an exception for contributions of assets which, in the aggregate, are an insignificant part of the total value of assets transferred. There have been a number of rulings on the issue of whether the contribution is insignificant. The rulings have generally held that if the contribution makes less than 5% of the total value, then it will be considered insignificant and thus will not trigger a taxable event.[8] For most hedge funds that have many investors, this is the exception that is applicable.

(6) Generally with hedge funds, it is within the discretion of the general partners regarding whether the hedge fund will accept contributions of stocks and securities from an investor. Many hedge funds strictly limit investments in the hedge fund to cash or cash equivalents and only in U.S. currency. However, if the general partners do accept contributed securities, they will generally not accept contributed securities which are subject to resale under Rule 144 of the Securities Act of 1933, as amended, or subject to other significant restrictions on transferability of the securities.

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[7] § 721(b) provides that provides that gain is realized on the contribution of property to a partnership if the partnership would be treated as an "investment company" under § 351(e). Section 351(e) of the Code and the Treasury Regulations provide that any contributions will be deemed to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor's interests, and the transferee is, in pertinent part, a corporation more than 80 percent of the value of whose assets are held for investment and are stocks or securities, or interests in regulated investment companies, or real estate investment trusts.

[8] *See* Rev. Rul. 87-9, 1987-1 C.B. 133 (contribution of cash representing 11% the total contribution was held to be significant, resulting in diversification), Ltr. Rul. 9451035 (cash in excess of 5% of the aggregate assets are considered significant, resulting in diversification) and Ltr. Rul. 9504025 (cash equal to 1% of the value of assets contributed is insignificant) and Ltr. Rul. 200006008 (contributions of stock portfolios to an LLC are insignificant because the assets constitute less than 5% of the company's total value after the transfer).

b. Allocations of Profit and Loss

(1) Generally, the partnership agreement for a hedge fund will provide that the partnership's net capital appreciation (increase in value of the partnership's net assets including unrealized gains) or net capital depreciation (decrease in value including unrealized losses) for each accounting period will be allocated among the investors and to their capital accounts without regard to the amount of income or loss actually recognized by the partnership for Federal income tax purposes.

(2) Items of income, deduction, gain, loss or credit actually recognized by the partnership for each taxable year generally are allocated for income tax purposes among the investors pursuant to the principles of Regulations issued under Sections 704(b) and 704(c) of the Code, based upon amounts of the partnership's net capital appreciation or net capital depreciation allocated to each partner's capital account for the current and prior taxable years.

(3) Most hedge funds provide for a variety of incentive fees in addition to the annual management charge. Commonly the incentive fee is a percentage of the profit (often, 15% to 30%) measured against either a benchmark (like the S&P 500 or other index) or actual profit above the original investment (often referred to as a high water mark). When this is the case, the partnership agreement will generally provide a special allocation to the general partner equal to the incentive fee, however calculated. Where the incentive fee is measured against a benchmark, there can be instances where the incentive fee allocation to the general partner actually exceeds the net capital appreciation. For example, if the benchmark loses 10% and the hedge fund loses 1%, the general partner will still be entitled to an incentive fee for beating the benchmark at 15% to 30% of the excess of 9%. In such case, the partnership agreement should provide for a special allocation to the general partners of an amount of taxable income and gain (including gross income), otherwise attributable to such investor, equal to such excess.

(4) If, as discussed above, an investor contributes property other than cash (including amounts of accrued interest) to the hedge fund, the investor will be specially allocated items of income, deduction, gain, loss or credit attributable to such property to the extent of the difference, if any, between the book value and the adjusted tax basis of the property at the time of such contribution.

(5) Furthermore, under the partnership agreement, the general partners will often have the discretion to allocate specially an amount of the partnership's capital gain (including short-term capital gain) for Federal income tax purposes to a withdrawing investor to the extent that the investor's capital account exceeds its Federal income tax basis in its partnership interest.

c. Section 754 Election

(1) Advisers should determine whether the partnership agreement provides for an election under Section 754 of the Code for adjustments to the basis of partnership property upon distributions of partnership property to a partner and transfers of partnership interests (including by reason of death).

(2) Most hedge funds provide that the general partners have the sole discretion (at the request of an investor) to make the election. Because such election, once made, cannot be revoked without the IRS's consent, most hedge funds will not make the election.[9]

[9] Regs. § 1.754-1. An election may be revoked if there exists: (i) a change in the nature of the partnership business; (ii) a substantial increase in or a change in the character of the partnership's assets; and (iii) an increase in the frequency of partner retirements or shifts in partnership interests (resulting in increased administrative costs attributable to the § 754 election).

d. Tax Matters Partner

(1) Most hedge fund partnership agreements authorize the general partners to decide how tax items with respect to the hedge fund investments will be reported and require that each investor report these items consistently on their own respective tax returns.

(2) One of the general partners of the hedge fund is designated the "Tax Matters Partner"[10] so that the tax treatment of the hedge funds income and deductions will be determined at the entity level in a single proceeding. As the Tax Matters Partner, the general partner will have the right to bind investors to settlement agreements[11] with the IRS and to extent any applicable statute of limitation.[12]

e. Withdrawing/Redeeming Investors and Distributions

(1) Disguised Sale Rules

(a) If an investor who has contributed appreciated property to a hedge fund receives a distribution of any other property or cash within two years of the contribution,[13] based on the applicable facts and circumstances, the distribution may cause the partner to recognize gain as of the original date of contribution with respect to his or her contributed securities under the "disguised sale" provisions of Section 707(a)(2)(B) of the Code.

(b) Distributions in a transaction determined to be a disguised sale are treated as payments by the hedge fund to the disguised seller/investor, acting in an independent capacity, and not as a partner.[14]

(c) Often investors in hedge funds will be given an option to receive annual distributions. An investor may elect to receive an annual distribution based upon a percentage of its share of the hedge fund's taxable income in partial redemption of his or her interest, in order to have sufficient funds to pay income taxes in respect of the hedge fund's earnings. Because the disguised sale rules are based on a facts and circumstances test, it is unclear whether the IRS will treat these distributions as a disguised sale. The Regulations provide that distributions accompanied by a corresponding allocation of gain or loss and distributions of a partner's share of operating cash flow may escape disguised sale treatment.[15]

(2) Distributions of Cash

(a) Generally, an investor receiving a liquidating cash distribution from a hedge fund (in connection with an investor's complete withdrawal from the hedge fund),[16] generally will

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[10] Regs. § 301.6231(a)(7)-1(a).

[11] § 6224(c)(3).

[12] § 6229(b)(1)(B).

[13] Distributions within two years are presumed to be part of a disguised sale, and those more than two years are presumed not to be part of a disguised sale. Regs. § 1.707-3.

[14] § 707(a)(2) and Regs. § 1.707-3.

[15] *See* Regs. § 1.707-4(a) and (b).

[16] § 761(d).

recognize capital gain or loss to the extent of the difference between the proceeds received by such investor and such investor's adjusted tax basis in its interest in the fund.[17] Such capital gain or loss will be short-term, long-term or some combination of both, depending upon the timing of the investor's contributions to the hedge fund. However, a withdrawing investor will recognize ordinary income to the extent such investor's allocable share of the fund's "unrealized receivables" exceeds the investor's basis in such unrealized receivables.[18] In a typical hedge fund context, accrued but untaxed market discount, if any, on securities held by the hedge fund will be treated as an unrealized receivable, with respect to which a withdrawing investor would recognize ordinary income.

(b) An investor receiving a non-liquidating cash distribution (often referred to as current distributions) will recognize income in a similar manner only to the extent that the amount of the distribution exceeds such investor's adjusted tax basis in its partnership interest.[19]

(c) Often the partnership agreement for hedge funds provides that the general partners may specially allocate items of the hedge fund's capital gain to a withdrawing investor to the extent its capital account would otherwise exceed its adjusted tax basis in its partnership interest. Such a special allocation may result in the withdrawing investor recognizing capital gain in the investor's last taxable year in the partnership, thereby reducing the amount of long-term capital gain recognized during the tax year in which it receives its liquidating distribution upon withdrawal.

(3) <u>Distributions of Securities</u>

(a) Generally, a partner's receipt of a distribution of property from a partnership is generally not taxable unless the distribution is in excess of the investor's adjusted basis in the hedge fund immediately before the distribution.[20]

(b) For these purposes, a distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property).[21] For these purposes, marketable securities includes financial instruments (stocks, equity interests, debt, options, forward or futures contracts, notional principal contracts and other derivatives) and foreign currencies which are actively traded.[22]

(c) There are a number of applicable exceptions to the foregoing treatment of distributions of marketable securities, including: (1) distributions of contributed securities to the investor who contributed them;[23] (2) distributions of securities that were not marketable when acquired by the hedge fund;[24] and (3) distributions of securities from an "investment partnership" to an "eligible partner."[25]

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[17] § 731(a)(1) and (c) and Regs. § 1.731-1(a)(1).

[18] § 751(b).

[19] § 731.

[20] § 731(a)(1).

[21] § 731(c).

[22] § 731(c)(2)(A) and (C).

[23] § 731(c)(3)(A) and Regs. § 1.731-2(d)(1).

[24] § 731(c)(3)(A)(ii) and Regs. § 1.731-2(d)(3). To qualify for this exception, the security must not have been marketable on the date acquired and the entity to which the security relates must not have had any outstanding marketable securities on that date. Further, the hedge fund must have held the security for at least 6 months prior to

(d) An "investment partnership" is defined as a partnership that substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.[26] Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).[27] A partnership will not be considered engaged in a trade or business by reason of any activity undertaken as an investor, trader or dealer in such specified investments.[28]

(e) An "eligible partner" is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.[29]

(4) Distribution of Securities to a Contributing Investor

(a) If an investor contributes appreciated securities (or other property) to the hedge fund and, within seven years of the date of contribution, that investor receives a distribution of any property other than these contributed securities, such investor generally will be required to recognize gain upon the receipt of such other property.[30] On the other hand, a distribution of securities previously contributed by the same investor does not trigger gain.[31]

(b) The amount of the gain is equal to the lesser of (a) the excess of the fair market value of the distributed property over the adjusted tax basis of such investor's partnership interest immediately before the distribution, reduced by the amount of money received in the distribution; (b) the excess of the fair market value of such investor's contributed securities over their adjusted tax basis at the time they were contributed to the hedge fund or (c) the excess of the fair market value of such investor's contributed securities over their adjusted tax basis in the hands of the hedge fund, at the time of the distribution of such other property.[32]

(c) The character of the gain is determined by the character of the contributed securities in the hands of the hedge fund.[33]

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the security becoming marketable, and the hedge fund must distribute the security within 5 years from the date the security became marketable.

[25] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

[26] § 731(c)(3)(C)(i).

[27] § 731(c)(3)(C)(i)(I) through (VIII).

[28] § 731(c)(3)(C)(ii)(I) and Regs. § 1.731-2(e)(3)(i).

[29] § 731(c)(3)(C)(iii)(I).

[30] §§ 704(c)(1)(B) and 737.

[31] § 737(d)(1) and Regs. § 1.737-3(d).

[32] §§ 737(a)(1) and (2).

[33] § 737(a) and Regs. § 1.737-1(d).

(d) The investor's adjusted tax basis in the hedge fund and the hedge fund's tax basis in the contributed securities are automatically adjusted without the need for a Section 754 election.[34] Further, the basis of the distributed securities is adjusted to reflect the recognized gain.

(5) Distributions of Securities to a "Non-Contributing" Investor

(a) If contributed securities are distributed within seven years of the date of contribution to any investor other than the investor who contributed such securities, the contributing investor must generally recognize a taxable gain or loss in the year of distribution.[35]

(b) The amount of such gain or loss would generally equal the lesser of (a) the difference between the fair market value of the contributed at the time such securities had been contributed to the hedge fund and the contributing investor's tax basis in such securities, or (b) the difference between the fair market value of the contributed securities and their adjusted tax basis in the hands of the hedge fund at the time of their distribution.[36]

(c) The character of any such gain or loss is determined by the character of the contributed securities in the hands of the hedge fund.[37]

(d) The adjusted tax basis of the contributing investor in the hedge fund and the adjusted tax basis in the contributed property to the hedge fund and the "non-contributing" investor (distributee) are immediately adjusted for any gain or loss without the need for a Section 754 election.[38]

(e) Since the gain or loss recognized under these provisions adjusts for differences in the adjusted tax basis and the book value of the contributed securities, it does not generally affect the contributing investor's capital account.

3. Tax Treatment of the Hedge Fund Investments

a. General Taxation Overview and Status of Hedge Fund

(1) Generally, most hedge funds will act as a trader or investor, and not as a dealer, with respect to its securities transactions. As a trader[39] and an investor,[40] hedge funds buy and sell securities for their own accounts. A dealer, on the other hand, purchases securities for resale to customers rather than for investment or speculation.[41]

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[34] § 737(c) and Regs. § 1.737-3.

[35] § 704(c)(1)(B).

[36] § 704(c)(2)(B)(i) and Regs. § 1.704-4(a).

[37] Regs. § 1.704-4(b).

[38] §§ 704(c)(1)(B)(iii) and Regs. 1.704-4(e).

[39] *See* Liang v. Commissioner, 23 T.C. 1040 (1955), *acq.*, 1955-1 C.B. 3.

[40] *See* Marrin v. Commissioner, T.C. Memo 1997-24, *aff'd*, 98-2 USTC ¶50,490 (2d Cir. 1998), and Hart v. Commissioner, T.C. Memo 1997-11.

[41] *See* Regs. § 1.471-5.

(2) The distinction between a trader and an investor for tax purposes is not clear and only makes a difference from a tax standpoint regarding the treatment certain itemized expenses or deductions. Generally, a trader buys and sells securities for short-term profit swings.

(3) Generally, the gains and losses realized by a trader or an investor on the sale of securities are capital gains and losses.

(4) Thus, subject to the treatment of certain currency exchange gains as ordinary income (for example, a Section 988 Transaction, as further discussed in this outline) and certain other transactions, hedge fund gains and losses from securities transactions typically will be capital gains and capital losses. These capital gains and losses may be long-term or short-term depending, in general, upon the length of time the hedge fund maintains a particular investment position and, in some cases, upon the nature of the transaction. Property held for more than one year generally will be eligible for long-term capital gain or loss treatment.

(5) The application of certain rules relating to short sales the "straddle" and "wash sale" transactions and to Section 1256 Contracts (all of which are discussed in more detail in this outline) will alter the manner in which the hedge fund's holding period for a security is determined or may otherwise affect the characterization as short-term or long-term, and also the timing of the realization, of certain gains or losses. Moreover, the straddle rules and short sale rules may require the capitalization of certain related expenses of the hedge fund.

(6) Depending on the investments held by the hedge fund, the fund may realize ordinary income from dividends and accruals of interest on securities. Often, hedge funds may hold debt obligations with "original issue discount." In such a case, the hedge fund would generally be required to include amounts in taxable income on a current basis even though receipt of such amounts may occur in a subsequent year.[42] Furthermore, many hedge funds also acquire debt obligations with "market discount." Upon disposition of such an obligation, the hedge fund generally would be required to treat gain realized as interest income to the extent of the market discount which accrued during the period the debt obligation was held by the hedge fund.[43]

(7) Although not common, some hedge funds may realize ordinary income or loss with respect to its investments in other partnerships engaged in a trade or business.

(8) Income or loss from transactions involving certain derivative instruments, such as swap transactions, will also generally constitute ordinary income or loss. In addition, amounts, if any, payable by a hedge fund in connection with equity swaps, interest rate swaps, caps, floors and collars may be considered "miscellaneous itemized deductions" which, for a noncorporate investor, may be subject to restrictions on their deductibility, as discussed in more detail in this outline.

(9) Moreover, gain recognized from certain "conversion transactions," as discussed in more detail later in this outline, will be treated as ordinary income.[44]

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[42] *See* §§ 1271 *et seq.*

[43] *See* §§ 1276 through 1278.

[44] Generally, a conversion transaction is one of several enumerated transactions where substantially all of the taxpayer's return is attributable to the time value of the net investment in the transaction. The enumerated transactions are (i) the holding of any property (whether or not actively traded) and entering into a contract to sell such property (or substantially identical property) at a price determined in accordance with such contract, but only if such property was acquired and such contract was entered into on a substantially contemporaneous basis, (ii) certain straddles, (iii) generally any other transaction that is marketed or sold on the basis that it would have the economic

b. Currency Fluctuation (Section 988 Gains or Losses)

(1) Although there are some hedge funds that limit their investment universe to U.S. securities and financial instruments with respect to the same, most hedge funds will take long and short positions in securities and financial instruments denominated in foreign currency. The general rule is that gains or losses with respect to a hedge fund's investments in common stock of a foreign issuer will be taxed as capital gains or losses at the time of the disposition of such stock.

(2) However, Section 988(a) of the Code provides that any foreign currency gain or loss attributable to a "Section 988 Transaction" must be computed separately and treated as an ordinary income or loss.[45]

(3) A Section 988 Transaction is any transaction (listed below) if the amount which the taxpayer is entitled to received (or is required to pay) by reason of the transaction is denominated in terms of a non-functional currency (or determined by reference to one or more non-functional currencies). The "functional" currency of U.S. investors is the U.S. dollar and for business units, the currency is the currency in which a significant part of the unit's activities are conducted.[46] The listed Section 988 Transactions are:[47]

(a) The acquisition of or becoming the obligor under a debt instrument.

(b) Accruing (or otherwise taking into account) any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued (or taken into account).

(c) Entering into or acquiring any forward contract, futures contract, option or similar financial instrument.[48]

(4) In the hedge fund context, the following would be considered Section 988 Transactions:

(a) Gains and losses of the hedge fund on the acquisition and disposition of foreign currency (for example, the purchase of foreign currency and subsequent use of the currency to acquire stock).

(b) Gains or losses on disposition of debt securities denominated in a foreign currency to the extent attributable to fluctuation in the value of the foreign currency between the date of acquisition of the debt security and the date of disposition.

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characteristics of a loan but the interest-like return would be taxed as capital gain or (iv) any other transaction specified in Regulations.

[45] § 988(a)(1)(A).

[46] §§ 985(b) and 988(c)(1)(A).

[47] § 988(c)(1)(B).

[48] "Similar financial instrument" includes a notional principal contract only if the payments required to be made or received under contract are determined with reference to a non-functional currency. Regs. § 1.988-1(a)(2)(iii)(B).

(c) Gains or losses attributable to fluctuations in exchange rates that occur between the time the hedge fund accrues interest or other receivables or accrues expenses or other liabilities denominated in a foreign currency and the time the hedge fund actually collects such receivables or pays such liabilities.

(5) Many hedge funds acquire foreign currency forward contracts, enter into foreign currency futures contracts and acquire put and call options on foreign currencies. Generally, foreign currency regulated futures contracts and option contracts that qualify as "Section 1256 Contracts" (as discussed in more detail in this outline), will not be subject to ordinary income or loss treatment under Section 988.[49] However, if the hedge fund acquires currency futures contracts or option contracts that are not Section 1256 Contracts, or any currency forward contracts, any gain or loss realized by the hedge fund with respect to such instruments will be ordinary, unless (a) the contract is a capital asset in the hands of the hedge fund and is not a part of a straddle transaction, and (b) the hedge fund makes an election (by the close of the day the transaction is entered into) to treat the gain or loss attributable to such contract as capital gain or loss.

c. Section 1256 Contracts

(1) In the case of "Section 1256 Contracts," the Code generally applies a "mark to market" system of taxing unrealized gains and losses on such contracts and otherwise provides for special rules of taxation.

(2) A Section 1256 Contract is any:[50]

(a) Regulated futures contract;

(b) Foreign currency contract;

(c) Nonequity option;

(d) Dealer equity option; and

(e) Dealer securities futures contract.[51]

(3) Generally, a futures contract is a contract under which a specified number of units of actively traded property (for example, in the hedge fund context, foreign currencies, stock indexes and financial instruments) is to be delivered between designated dates at a price per unit negotiated between the parties to the transaction. The holder of a futures contract can either buy (establish a long position) or sell (short position) the subject property. A "regulated futures contract" is defined as a contract with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market and which is traded on or subject to the rules of a qualified board or exchange (for example, the Commodities Futures Trading Commission (CFTC)).[52]

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[49] § 988(c)(1)(D)(i). Section 988(c)(1)(B) does not apply to an regulated futures contract or nonequity option "which would be marked to market under section 1256 if held on the last day of the taxable year."

[50] § 1256(b)(1) through (5).

[51] The flush language in § 1256(b) provides "the term section 1256 contract shall *not* include any securities futures contract . . . unless such contract . . . is a securities futures contract."

[52] § 1256(g)(1).

(4) A foreign currency contract[53] is defined as a contract (generally, forward purchases or sales[54] of foreign currency): (a) that requires the delivery of a foreign currency which is a currency in which positions are also traded through regulated futures contracts (not all currencies qualify), (b) traded in the interbank market, and (c) entered into at arm's length at a price determined by reference to the price established by the interbank market. Keep in mind, a regulated futures contract (as defined above) for a foreign currency (as opposed to a forward sales contract) qualify as Section 1256 Contracts.

(5) A nonequity option[55] is defined as any listed option[56] which is not an equity option.[57] Generally, a listed option is any option traded on a qualified board or exchange. Said another way, options not traded on an exchange are not Section 1256 Contracts. However, exchange-traded options on a broad-based stock index, like the S&P 500, are considered nonequity options because the definition of an equity option is limited to options on a particular stock or a narrowly based stock index. Nonequity options also include listed options on commodities, commodity futures, foreign currencies and financial instruments.

(6) A dealer equity option is an equity option granted or purchased by an options dealer in the normal course of the dealer's activity as a market maker or specialist. An equity option is defined as any option to buy or sell stock or any option the value of which is determined directly or indirectly by reference to any stock (or narrowly based stock index).[58] As mentioned above, hedge funds generally do not act as a dealer, rather they act either as a trader or investor for tax purposes, and to that extent these options are not considered Section 1256 Contracts in their own respect.

(7) Securities futures contract is defined "a contract of sale for future delivery of a single security or a narrow-based security index, including any interest therein or based on the value thereof."[59] Futures contracts are essentially standardized forward contracts that are traded on an exchange. A "dealer securities futures contract" is a securities futures contract, or an option to enter into such a contract, that (a) is entered into by a dealer (or, in the case of an option, is purchased or granted by the dealer) in the normal course of its trade or business activity of dealing in the contracts, and (b) is traded on a qualified board of trade or exchange.[60]

(8) Section 1256 Contracts held by a hedge fund at the end of each taxable year are treated for Federal income tax purposes as if they were sold by the hedge fund for their fair market value on the last business day of such taxable year.[61] The net gain or loss, if any, resulting from

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53 § 1256(g)(2)(A).

54 Forward sales contracts differ from futures contracts in that these contracts are generally not standardized and are not traded on a recognized exchange. They are primarily used to hedge specific currency risks.

55 § 1256(g)(3).

56 § 1256(g)(5).

57 § 1256(g)(6).

58 An index is considered broad if: (1) it is comprised of nine or more stocks; (2) no single stock makes up more than 30% of the value of the index; and (3) five or fewer stocks do not make up more than 60% of the value of the index.

59 *See* § 1256(g)(9)(C), § 1234B, § 3(a)(55)(A) of the Securities Exchange Act of 1934, and The Commodity Futures Modernization Act of 2000, Public Law 106–554, §1(a)(5) (H.R. 5660), December 21, 2000, 114 Stat. 2763, 2763A–365, 7 U.S.C. § 1.

60 § 1256(g)(9)(A).

61 § 1256(a)(1).

such deemed sales (known as "marking to market"), together with any gain or loss resulting from actual sales of Section 1256 Contracts, must be taken into account by the hedge fund in computing its taxable income for such year. If a Section 1256 Contract held by the hedge fund at the end of a taxable year is sold in the following year, the amount of any gain or loss realized on such sale will be adjusted to reflect the gain or loss previously taken into account under the "mark to market" rules.[62]

(9) Capital gains and losses from such Section 1256 Contracts generally are characterized as 60% long-term capital gains or losses and 40% short-term capital gains or losses.[63]

(10) As mentioned in this outline, gains and losses from certain foreign currency transactions will be treated as ordinary income and losses (Section 988 foreign currency gains and losses).

(11) If an individual investor in the hedge fund incurs a net capital loss for a year, the portion thereof, if any, which consists of a net loss on Section 1256 Contracts may, at the election of the taxpayer, be carried back three years.[64] Losses so carried back may be deducted only against net capital gain to the extent that such gain includes gains on Section 1256 Contracts. To the extent this election is not made, the losses are carried forward indefinitely.[65]

d. <u>Securities Futures Contracts That Are Not Section 1256 Contracts</u>

(1) As mentioned above, options on broad-based equity index futures contracts are Section 1256 Contracts, falling within the definition of a regulated futures contract, as discussed above.[66] On the other hand, options on narrowly-based equity index futures contracts and futures contracts on individual issues of stocks are not Section 1256 Contracts when entered into by an investor or trader, the capacity in which most hedge funds will act (as opposed to dealer securities futures contracts).

(2) Gain or loss on a securities futures contract can be realized in a number of different ways:

(a) Sale or exchange of the contract;

(b) Physical settlement on the contract at maturity;

(c) Offsetting by entering into another futures contract on the same number of shares, at the same strike price and maturity; or

(d) Cash settlement on the contract at maturity.

(3) Generally, the tax treatment of the gain or loss is the same regardless of the manner in which it was generated. If the underlying security would be a capital asset in the taxpayer's

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[62] § 1256(a)(2).

[63] § 1256(a)(3).

[64] § 1212(c).

[65] § 1212(b).

[66] As a reminder, these are "regulated futures contracts" under § 1256(g)(1) but they are not excluded from the definition of Section 1256 Contracts in § 1256(b) with respect to contracts entered into by a dealer.

hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss.[67] Capital gain or loss from the sale or exchange of a securities futures contract to sell property (for example, the short side of a securities futures contract) generally will be short term capital gain or loss, unless otherwise characterized pursuant to the straddle rules and short sale rules, as discussed in more detail in this outline. Any gain or loss from physical settlement and an offsetting contract will be treated as the sale or exchange of these securities futures contracts and thus treated as gain or loss from the sale or exchange of property that has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer.[68] If the contract is physically settled, the seller recognizes gain or loss at the time it delivers the stock in an amount determined by reference to its adjusted basis in the stock and the amount received in the sale. If the contract is cash-settled, the recipient recognizes gain and the person remitting the cash (the party on the losing side of the transaction) recognizes a loss, all of which should be capital in nature.[69]

(4) If the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss.[70] Capital gain or loss from the sale or exchange of a securities futures contract to sell property (for example, the short side of a securities futures contract) generally will be short term capital gain or loss, unless otherwise characterized pursuant to the straddle rules and short sale rules, as discussed in more detail in this outline.

(5) The source of the gain under a securities futures contract is determined by the residence of the recipient of the income (the seller).[71] U.S. selling parties in securities futures contract generally recognize U.S. source gain or loss on the sale, and non-U.S. selling parties generally recognize foreign source gain or loss on the sale and are not subject to U.S. withholding tax on the sale proceeds.[72]

(6) Under certain circumstances, the gain or loss from securities futures contract will be considered ordinary, if the contract is considered a conversion transaction, as defined in more detail in this outline.

e. Short Sales

(1) In a short sale, the owner of the stock (the lender) transfers the stock to the borrower who agrees to (a) return identical stock (same number of shares, issuer, class but obviously not the same exact shares), and (b) make substitute payments equal to the dividends that otherwise would

[67] § 1234A provides that "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset." *See also* Prop. Regs. § 1.1234A-1(c)(1).

[68] § 1234B(a). *See* Rev. Rul. 79-294, 1979-2 C.B. 305 (offsetting futures contract does not constitute a purchase or sale of the underlying property, rather it is treated as a sale or exchange of the contract itself).

[69] § 1001.

[70] § 1234A(2).

[71] § 865(a). The source of cash-settled contracts is not clear under current law. Generally, in a cash-settled contract, the source of the gain is based on the residence of the relevant taxpayer. For example, a cash payment made by a U.S. taxpayer to a foreign taxpayer would generally result in a U.S. source loss to the U.S. taxpayer and foreign source income to the foreign taxpayer. Also, under § 865(j)(2), the IRS has authority to promulgate Regulations on the source rules with respect to traders in forward and futures contracts, but no Regulations have been promulgated.

[72] *See* Regs. § 1.1441-2(b)(2)(i).

be payable to the original owners of the stock but for the short sale transaction. The borrower then sells the stock for cash (the short sale). When the borrower repays the lender, it closes out the short sale. If the stock has dropped in price, the borrower is able to purchase the stock in the open market at a lower price than the cash proceeds, thus making a profit. If, consequently, the stock price rises, the borrower will have a loss, which theoretically is unlimited since stock prices can rise infinitely.

(2) From the lender's standpoint, entering into the short sale transaction is a realization event but the lender does not recognize gain or less at that time.[73] The payments made to the lender in lieu of the dividends are not considered dividends (thus, not qualifying for "qualified dividend"[74] status), rather they are treated as ordinary income.[75]

(3) From the borrower's standpoint, there is no gain or loss when the borrower sells the stock in the market on the short sale. Gain or loss occurs when the borrower closes out the short through delivery of identical shares.[76] The amount of gain or loss is the difference between its basis in the stock it purchases (to replace the shares) and the amount realized on the short sale. Payments made by the borrower in lieu of dividends are deductible under Sections 162 or 212 of the Code, but there are a number of limitations on the deductibility of these payments, as discussed in more detail later in this outline.

(4) Under the constructive sale rules of Section 1259 of the Code, if the borrower already owns the stock that is the subject of a short sale and the original stock has appreciated, then the appreciated stock will be deemed to have been sold and the borrower will recognize the inherent gain in the position.[77] This is called a "short against the box" position. This constructive sale or deemed sale is taken into account if the original shares are used to close out the short sale position, so the subsequent holding period for any appreciated financial position that is subject to these constructive sale rules will be determined as if such position were acquired on the date of the constructive sale.[78] In the hedge fund context this could arise in a number of contexts:

(a) If the hedge fund holds an appreciated financial position (whether contributed by an investor or not) with respect to stock, certain debt obligations or partnership interests and then enters into a short sale with respect to the same or substantially identical property, the hedge fund (and its investors) generally will recognize gain as if the appreciated financial position were sold at its fair market value on the date it enters into the short sale.

(b) If the hedge fund holds a short sale position with respect to stock, certain debt obligations or partnership interests that has appreciated in value and then acquires property that is the same as or substantially identical to the property sold short, the hedge fund (and its investors) generally will recognize gain on the date it acquires such property as if the short sale were closed on such date with such property.

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[73] § 1058.

[74] §1(h)(11).

[75] *See* Prop. Regs. §1.1058-1(d) and Rev. Rul. 80-135, 1980-1 C.B. 18.

[76] Regs. §1.1233-1(a) provides "[F]or federal income tax purposes a short sale is not deemed to be consummated until the delivery of property to close out the short sale."

[77] § 1259.

[78] § 1259(a)(2)(B). The holding period of the position starts at the date of the deemed sale.

(c) The Code provides that a constructive sale under Section 1259 will be deemed to occur when taxpayers enter into short sales against the box or other hedges that transfer substantially all of an appreciated asset's risk and return.[79] For these purposes, activities of certain related persons are attributed to the taxpayer when a "transaction is entered into with a view toward avoiding the purposes of this section."[80] The legislative history describes a constructive sale occurring when there is a hedge that "substantially eliminates risk of loss and opportunity for gain." However, the Code enumerates four examples: (1) a short sale against the box; (2) an offsetting notional principal contract, (3) a forward contract; and (4) a long purchase by a taxpayer who has an appreciated short position.[81] Query: if an investor in a hedge fund holds an appreciated financial position in his or her personal account outside of the hedge fund and the hedge fund shorts or otherwise hedges that same position within the fund, will a constructive sale be deemed to have occurred?[82]

(5) Furthermore, the pre-existing position in the stock may cause the straddle rules to apply and may cause the wash sale rules to apply in a different manner.[83]

(6) Gain or loss from a short sale of property is generally considered a capital gain or loss to the extent the property used to close the short sale constitutes a capital asset in the hedge fund's hands.[84] Except with respect to certain situations where the property used to close a short sale has a long-term holding period on the date the short sale is entered into, gains on short sales generally are short-term capital gains. Generally, the characterization of any gain is made by reference to the period the borrower has held stock that is being used to close out the short sale.[85] However, in order to avoid situations where an investor is trying use a short sale to convert short term gains to long term gains or long term losses to short term losses, the following rules apply:

(a) If at the time of the short sale, the borrower owns stock that is substantially identical to the stock that was sold short, and such stock has been held for a year or less, or following the short sale but before the close out, the borrower acquires such stock, then any gain (not loss) will be short term (even if the stock delivered to close out the short sale was held for more than a year).[86] Furthermore, the holding period of the substantially identical stock begins on the earlier of the date the short sale is closed or the date the substantially identical stock is sold.

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[79] § 1259(c)(1).

[80] § 1259(c)(4).

[81] § 1259(c)(1).

[82] If the constructive sales rules were deemed to apply under these circumstances, it is more often than not that the investor will be deemed to have hedged a fewer number of shares than owned by the investor (because it would be likely be limited to the investor's distributive share in the hedge fund). Under these circumstances, the Code provides, "[i]f a taxpayer holds multiple positions in property, the determination of whether a specific transaction is a constructive sale and, if so, which appreciated financial position is deemed sold shall be made in the same manner as actual sales." § 1259(e)(3). As such, the taxpayer is allowed to identify which shares have been constructively sold under the Treasury Regulations. *See* Regs. § 1.1012-1(c) (allowing taxpayers to designate which stock as been sold if it can be adequately identified).

[83] *See* §§ 1233(e)(2)(A) and 1091(e).

[84] § 1233(a).

[85] § 1233(a) and Regs. § 1.1233-1(a)(3).

[86] § 1233(b)(1) and Regs. § 1.1233-1(c)(2). Furthermore, the holding period of the substantially identical stock begins on the earlier of the date the short sale is closed or the date the substantially identical stock is sold. § 1233(b)(2) and Regs. § 1.1233-1(c)(2).

(b) If at the time of the short sale, the borrower owns stock that is substantially identical to the stock that was sold short, and such stock has been held for more than a year, then any loss (not gain) recognized upon closing of the short sale will be considered long term (even if the borrower delivers stock had been held for less than a year to close out the short sale).[87]

(7) The source of any gain or loss on a short sale realized by a borrower is generally sourced according to the residence of the recipient.[88] As such, U.S. borrowers to short sales generally recognize U.S. source gain or loss at the time of the closing transaction, and non-U.S. borrowers recognize foreign source gain or loss (not subject to U.S. withholding). Payments in lieu of dividends have the same source as the dividend income from the transferred security (regardless of the residence of the payer of such payment).[89]

f. Equity Options

(1) An equity option is a contract that gives the holder (buyer) of the option the right to buy (call option) or sell (put option) to the seller (writer) a specific amount of stock (or group of stocks) at a fixed strike price at a specific time or over a specific term.[90] For this contractual right, the holder or buyer of the option pays a premium to the seller of the option.

(2) Specifically to call options, the holder of a call option has the right to buy a certain number of shares (generally in 100 share increments) of the underlying stock, at a fixed price. If the holder of a call option exercises the option, the writer of the call option is obligated to deliver the stock.

(a) The holder of a call option pays a premium and has the right to purchase 100 shares of the underlying stock at the stated stock price. The buyer of a call option hopes the stock price will appreciate. If the stock appreciates above the strike price, the buyer of a call option will exercise the right to purchase the underlying stock at the strike price. Because the value of the underlying stock price theoretically can appreciate infinitely, the maximum gain that the buyer or holder of a call can make is unlimited. If the stock depreciates or does not appreciate above the strike price, the call option will go unexercised. Thus, the maximum loss for a call buyer is the premium paid.

(b) The writer of a call option receives the option premium and is obligated to sell the underlying stock at the stated price. The writer of a call option hopes the stock price will depreciate or not go above the strike price. An uncovered call is when the writer of a call does not own the underlying stock (writing a naked call). If the stock depreciates or does not go above the strike price, the option will go unexercised and the writer of the will not have to sell the underlying stock. Thus, the maximum gain that the writer of a call option can make is the premium already received. If the stock appreciates above the strike price, the option will be exercised. The writer of a naked call option must purchase the underlying stock and sell that stock, at the stated price, to the holder of the call option. Because the value of the underlying stock price can theoretically appreciate infinitely, the maximum loss is unlimited. On the other hand, if the writer of a call option owns the underlying stock, it is a covered call and the maximum loss is quite different. As with a naked call, if the stock depreciates or does not go

[87] § 1233(d) and Regs. § 1.1233-1(c)(4).

[88] § 865(a).

[89] Regs. §§ 1.861-3(a)(6), 1.864-5(b)(2)(ii), 1.871-7(b)(2), 1.881-2(b)(2) and 1.894-1(c).

[90] An option that is exercisable at a specific time is called a European style option and one that is exercisable at any time during the specified period is called an American style option.

above the strike price, the option will go unexercised and the writer of the will not have to sell the underlying stock. Thus, the maximum gain that the writer of a call option can make is the premium already received. If the stock appreciates above the strike price, the option will be exercised. The writer of a covered call option already owns the underlying stock and will sell that stock, at the stated price, to the holder of the call option. Thus, the loss to the covered call writer is the lost appreciation foregone as a result of having to sell the stock at the strike price.

(3) Specifically to put options, the holder of a put option has the right to sell a certain number of shares (generally in 100 share increments) of the underlying stock, at a fixed price. If the holder of a put option exercises the option, the writer of the put option is obligated to buy the stock.

(a) The holder of a put option pays a premium and has the right to sell 100 shares of the underlying stock at the stated stock price. The buyer of a put option hopes the stock price will depreciate. If the stock depreciates below the strike price, the buyer of a put option will exercise the right to sell the underlying stock at the strike price. Because the value of the underlying stock price can only depreciate to zero, the maximum gain that the buyer or holder of a put can make is the strike price at which it can be sold (minus the premium paid). If the stock appreciates above the strike price, the put option will go unexercised. Thus, the maximum loss for a put buyer is the premium paid.

(b) The writer of a put option receives the option premium and is obligated to buy the underlying stock at the stated price. The writer of a put option hopes the stock price will appreciate. If the stock appreciates above the strike price, the put option will go unexercised and the writer of the put option will not have the obligation to purchase the underlying security. Thus, the maximum gain that the writer of a put option can make is the premium paid. If the stock depreciates below the strike price, the put option will be exercised and the writer of the put option will have the obligation to purchase the underlying stock at the stated price. Because the value of the underlying stock price can only depreciate to zero, the maximum loss that the writer of a put can have is the strike price at which he is obligated to purchase (minus the premium paid).

(4) For liquidity, credit risk and valuation purposes, many hedge funds prefer to invest in equity options that are actively traded on a national exchange like the Chicago Board of Options Exchange whose trades are cleared and insured by the Options Clearing Corporation. An option contract quoted on the exchange will have the following primary terms:

(a) Underlying security.

(b) Expiration date.

(c) Exercise or strike price.

(d) Type of option (put or call).

(e) Premium (which is essentially determined by buyers and sellers of the option in the market. General option theory provides that the premium of an equity option is equal to the intrinsic value of the option [the difference between the value of the security and the strike price] and the time value of the option).

(5) For non-publicly traded options,[91] the IRS will value equity options using a modified version of the Black Scholes model.[92]

(6) There are a number of tax realization events that are possible with respect to equity options:

(a) The options can be exercised and physically settled or cash settled. Physical settlement involves the actual exchange of shares pursuant to the terms of the option. Cash settlement involves the writer or issuer of the option making a cash payment equal to the difference in price between the value of the underlying stock and the strike price (keep in mind, if the option goes unexercised the writer or issuer of the option already has the premium and no exchange or payment is required).

(b) The options can lapse (go unexercised).

(c) The options contracts can be sold or exchanged (or enter into a closing or offsetting position) prior to the expiration date.

(7) The general rules regarding these tax realization events are as follows:[93]

(a) When a buyer or holder of an option pays a premium, the buyer is not entitled to a deduction nor is the seller of the option required to take the premium into account for tax purposes.

(b) If the option lapses, the holder of the option recognizes a loss equal to the premium previously paid, and the seller recognizes gain equal to the same.

(c) If a call option is exercised and physically settled, the option premium is added to the amount realized by the seller of the option (strike price plus the premium), and the tax basis in the stock purchased by the call option holder is equal to the same amount (strike price plus the premium).

(d) If a put option is exercised and physically settled, the option premium is subtracted from the amount realized by the holder of the option (strike price minus the premium), and the tax basis in the stock received by the put option seller is equal to the same (strike price paid by the seller of the put option minus premium previously paid).

(e) If an option is exercised and cash settled, gain or loss is determined at that time and such amount of gain or loss is simply the difference between the amounts paid (the premium for the holder of the option and the cash settlement amount, if any, for the seller of the option) and the amounts received (the premium for the seller of the option and the cash settlement amount, if any, for the holder of the option).

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[91] Options that are not publicly-traded or that are negotiated in the over the counter market will only be considered "options" for tax purposes if they can be exercised by the holder without substantial contingencies. *See* Rev. Rul. 89-64, 1989-1 C.B. 1, and Rev. Rul. 68-601, 1968-2 C.B. 124.

[92] *See* Rev. Proc. 98-34, 1998-18 IRB 15 (1998), Rev. Proc. 2002-13, 2002-8 IRB 549 (Feb 25, 2002) as modified by Rev. Proc. 2002-45, 2002-27 IRB 40 (July 8, 2002).

[93] *See* Rev. Rul. 88-31, 1988-1 C.B. 302, Rev. Rul. 78-182, 1978-1 C.B. 265, Rev. Rul. 68-151, 1968-1 C.B. 363, and Rev. Rul. 58-234, 1958-1 C.B. 279.

(f) If the holder of an option sells, exchanges, closes or otherwise offsets its option position, the premium originally paid is incorporated into calculating any gain or loss upon the sale (the difference between the amount received or the closing price of the offsetting position) and the original price paid for the option.

(8) For the holder of an option, any gain or loss attributable to the sale or exchange of an option, and loss attributable to the lapse of an option shall have the "same character as the property to which the option relates in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him)."[94] The gain or loss will be long-term or short-term depending on how long the holder has held the option.[95] However, except for specialized long-term options, most actively-traded options have a term of 9 months. The character with respect to cash settlement upon exercise of an option is essentially the same as discussed above.[96]

(9) For the seller of an option,[97] Section 1234(b) of the Code provides that any gain or loss attributable to any "closing transaction"[98] (which includes any termination of the seller's obligations other than the exercise or lapse of the option) and any gain attributable to the lapse of an option will be treated as short-term gain or loss regardless of holding period.[99] If seller has gain or loss as a result of something other than a "closing transaction," then Section 1234A of the Code is applicable and that specifically provides for capital asset treatment and the regular holding rules.[100] Thus, the Section 1234(b) short-term gain or loss rule is applicable for only lapsed option and cash-settled option.

(10) The foregoing general tax rules are altered if the equity options (or any combination of them) are considered Section 1256 Contracts (as discussed in more detail in this outline), a constructive sale under Section 1259 of the Code[101] (as discussed also in the short sale section of this

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[94] § 1234(a) and Regs. § 1.1234-1(a). Equity options do not get capital character treatment with respect to: options that are inventory in the hands of the taxpayer (under § 1221(a)(1)); (2) gain attributable to the sale or exchange of an option that would not otherwise be treated as a sale of a capital asset (for example, the option is used to hedge another exposure); or (3) loss resulting from the lapse of certain "married" puts described in § 1233(c) where the taxpayer owns the property to which the option relates. § 1234(a)(3) and Regs. §1.1234-1(c). Holders of equity options that are compensatory do not get capital character treatment. *See* Regs. § 1.1234-1(e).

[95] § 1234(a)(2) provides that options that lapse will be deemed to have been sold or exchanged on the date of expiration.

[96] § 1234(a) does not apply to cash settlement payments. Rather § 1234A provides that "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of--a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset."

[97] It should be noted that this rule specifically applies to all sellers of options on stock, securities, commodities, or commodity futures (but not other property). With respect to options on property other than stock and securities, commodities, or commodity futures, the Regulations provide that "any gain to the grantor of an option arising from the failure of the holder to exercise it, and any gain or loss realized by the grantor of an option as a result of a closing transaction, such as repurchasing the option from the holder, is considered ordinary income or loss." Regs. § 1.1234-1(b).

[98] § 1234(b)(2)(A).

[99] § 1234(b).

[100] § 1234A.

[101] Appreciated financial positions include appreciated options on stock. § 1259(b). A constructive sale under Section 1259 of the Code will occur if the taxpayer enters into: (1) a short sale of the same or substantially identical property; (2) an offsetting notional principal contract with respect to the same or substantially identical property; (3) a futures

outline), the straddle rules (also discussed in more detail later in this outline) and Conversion Transactions (discussed in more detail later in this outline).

(11) Gain or loss with respect to equity options is sourced according to the residence of the recipient of such gain or loss.[102] For offshore hedge funds which are generally non-U.S. corporations (as discussed later in this outline), any gain or loss on equity options will generally be considered foreign source income and generally not subject to U.S. withholding tax.[103]

g. Conversion Transactions

(1) A conversion transaction is generally defined as a transaction where substantially all of the taxpayer's return is attributable to the time value of the net investment in the transaction.[104] Conversion transactions include transactions where: (a) the holding of any property (whether or not actively traded) and entering into a contract to sell such property (or substantially identical property) at a price determined in accordance with such contract, but only if such property was acquired and such contract was entered into on a substantially contemporaneous basis, (b) certain straddles, (c) generally any other transaction that is marketed or sold on the basis that it would have the economic characteristics of a loan but the interest-like return would be taxed as capital gain or (d) any other transaction specified in the Regulations.

(2) A conversion transaction would be one where the investor holds two opposing positions with respect to a stock and all of the return form the combined positions is generated by the time value of money. For example, an investor purchases stock in a corporation and enters into a forward contract as the selling party of the same stock (thus establishing both a long and a short position in the stock). The price at which the stock is ultimately sold under the forward contract will represent an interest-like return.

(3) When a conversion transaction exists, Section 1258 of the Code converts the capital gain to ordinary income.

h. Straddle Rules

(1) Generally, as defined in the Code, a "straddle" refers to a holding of two or more offsetting positions in actively traded personal property.[105] It applies generally to positions that are valued on an established market, which can be sold, exchanged or otherwise liquidated, and the value change in one position will result in an inverse change in value in the offsetting position. From a tax standpoint, prior to the enactment of the straddle rules,[106] investors used these offsetting positions, which gave them the discretion to recognize losses on one side of the transaction and defer the gain on the other side of the transaction.

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or forward contract to deliver the same or substantially identical property; or (4) one or more other transactions (or acquires one or more positions) that have substantially the same effect.

[102] §§ 865(a) and 865(j)(2) (Treasury has authority to issue Regulations regarding the sourcing rules of options but none have been issued at this point).

[103] Generally, provided the hedge fund is not effectively connected with a U.S. trade or business, there is no withholding on capital gains or option premiums. *See* Regs. §1.1441-2(b)(2)(i).

[104] § 1258.

[105] *See* § 1092.

[106] Generally, "straddle rules" are encompassed by §§ 263(g), 1092, 1234A and 1256.

(2) A straddle is defined as "offsetting positions with respect to personal property."[107]

(a) In the hedge fund context, a position can include direct ownership, and interests through the use of financial derivatives like futures contracts, forward contracts and options.[108]

(b) Personal property is defined as any personal property which is actively traded on an established financial market (where such positions can be easily sold, exchanged or otherwise liquidated).[109] Stock is considered personal property if: (1) such stock is of a type which is actively traded and at least 1 of the positions offsetting such stock is a position with respect to such stock or "substantially similar or related property," or (2) such stock is of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.[110]

(c) A taxpayer is deemed to have "offsetting positions" if "there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of holding one or more positions with respect to personal property (whether or not of the same kind)."[111]

(d) Specifically exempted from the definition of straddle are "covered call," which are established when the owner of a stock sells a call option on the stock, as long as the option is not "deep in the money" (where the strike price is significantly below fair market value).[112]

(e) Certain "hedging transactions" are exempted from the definition of a straddle and thus the loss deferral provisions. However, because most hedge funds act as traders or investors for tax purposes, most transactions entered into by hedge funds would not fall into this exemption. This is because the term "hedging transaction" is generally defined as a transaction, which are entered into in the normal course of the taxpayer's business to reduce or to manage the risk of price change or currency fluctuations with respect to property held by the taxpayer, are used to hedge with respect to ordinary property, and are specifically identified by the taxpayer as a hedging transaction.[113] Specifically, the Regulations provide that transactions entered into for speculative purposes are not treated as hedging transactions.[114]

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[107] § 1092(c)(1).

[108] § 1092(d)(2) and (3).

[109] Defined as a national securities exchange that is registered under § 6 of the Securities Exchange Act of 1934, 15 USC §78f, an interdealer quotation market registered under §15A of the Securities Exchange Act of 1934, domestic board of trade registered with the Commodities Futures Trading Association, foreign securities exchange or board of trade registered with a similar regulatory authority and rules, an interbank market, interdealer market and a debt market. Regs. § 1.1092(d)-1(b)(1).

[110] § 1092(d)(3)(A)(ii).

[111] § 1092(c)(2)(A).

[112] § 1092(c)(4).

[113] § 1256(e)(2).

[114] Regs. § 1.1221-2(c)(4)(ii).

(3) Property is considered substantially similar or related to stock when the following are, based on the facts and circumstances, present:[115]

(a) The fair market values of the stock and the property primarily reflect the performance of (1) an single firm or enterprise, (2) the same industry or industries, or (3) the same economic factors such as interest rates, commodity prices or foreign currency exchange rates; and

(b) Changes in the market value of the stock are reasonably expected to approximate, directly or indirectly, changes in the market value of the property in questions or a fraction or a multiple of the market value of the property.

(4) A taxpayer is deemed to have a diminished risk of loss on stock if it holds a position with respect to a substantially similar or related property if changes in the fair market value of the stock and the positions are reasonably expected to vary inversely.[116]

(5) Since 2004, if a taxpayer holds stock and enters into a short sale with respect to such stock or substantially identical stock, the taxpayer will establish a straddle. Where a taxpayer establishes a short position in respect of a stock index, in order to determine whether a straddle has been established, the Regulations apply a mechanical test. This test differentiates between indices representing 20 or more stocks and those of fewer stocks.[117]

(6) Certain other specific positions often established by hedge funds are considered to specifically diminish a taxpayer's risk of loss: [118]

(a) A short sale with respect to common stock while holding convertible preferred of the same issue and the price change of the convertible preferred and the common stock are related;

(b) A short sale of a convertible debt while holding convertible preferred stock into which the debt is convertible or while holding the common stock; and

(c) A short sale of convertible preferred stock while holding common stock of the same issuer.

(7) When a straddle has been established, the straddle rules apply to defer some or all of the losses realized with respect to the straddle.

(a) Any loss realized from the disposition of one or more positions of a straddle is taken into account for any taxable year only to the extent that the amount of such loss exceeds the unrecognized gain with respect to the positions that were offsetting positions.[119]

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[115] Regs. § 1.246-5(b)(1). § 246 deals with certain limitations with respect to the dividends received deduction for corporations under § 243 of the Code. However, the definition of substantially similar or related property under § 246 is applied with respect to the interpretation of the same phrase in the straddle rules under § 1092 and the Regulations under Regs. § 1.1092(d)(2) and the Prop. Regs. under the same.

[116] Regs. § 1.246-5(b)(2).

[117] *See* Regs. § 1.246-5(c)(1). Furthermore, the Code has a general anti-abuse section under Regs. § 1.246-5(c)(1)(vi).

[118] Regs. § 1.246-5(c)(2).

[119] § 1092(a)(1)(A).

(b) Unrecognized gain is the amount that would be taken into account if the positions were marked to market on the last day of the taxable year.[120]

(c) Any such loss disallowed is carried forward to successive taxable years until the taxpayer no longer holds offsetting positions with unrecognized gain.[121]

i. Straddle Rules and Securities Held by Investors/Limited Partners

(1) The IRS may treat certain positions in securities held (directly or indirectly) by an investor and its indirect interest in similar securities held by the hedge fund as "straddles" for Federal income tax purposes. The application of the "straddle rules," as discussed herein, in such a case could affect a investor's holding period for the securities involved and may defer the recognition of losses with respect to such securities.

(2) The Regulations provide that a taxpayer is treated as diminishing its risk of loss under the straddle rules if it holds an interest in, or is the beneficiary of, a pass-thru entity or other arrangement with a view to avoiding the application of the straddle rules.[122]

j. Mixed Straddle Taxation and Election

(1) A "mixed straddle" is any "straddle," as defined herein, that is comprised of non-Section 1256 Contracts and one or more Section 1256 Contracts, as defined herein. When a "mixed straddle" the following could occur:

(a) If a Section 1256 Contract is marked to market at the end of the year for a gain, the gain is recognized without taking into account losses from non-Section 1256 Contracts.

(b) If a Section 1256 Contract is marked to market and it results in a loss, the loss may be disallowed under the straddle rules.

(2) To avoid the foregoing adverse tax consequences, the Code allows a taxpayer to elect to offset gains and losses from positions which are part of a "mixed straddle." This "mixed straddle" election in the hedge fund context is made by the fund itself.[123]

(3) With this election, which is irrevocable unless the IRS consents otherwise, the hedge fund elects to have the mark to market and the 60/40 rules not apply to the Section 1256 Contracts in the mixed straddle. This election applies on a straddle by straddle basis, and thus the hedge fund must identify each straddle that will be subject to this election.

(4) Whether a hedge fund should or will make a mixed straddle election is dependant upon whether forfeiting 60/40 treatment on Section 1256 Contract gains is outweighed by not

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[120] § 1092(a)(3)(A)(i).

[121] § 1092(a)(1)(B). There are some specific rules regarding "identified straddles" under § 1092(a)(2)(B) where this loss deferral rule is replaced with an adjustment of basis, but that is beyond the scope of this discussion.

[122] Regs. § 1.246-5(c)(6).

[123] § 1256(d).

having to mark to market the positions. For individual investors in a hedge fund, the 60/40 treatment of Section 1256 Contracts is an attractive features because of the rate differential between long and short term gain.

k. Convertible Debt

(1) Generally, convertible debt is a debt instrument that gives the holder the option to exchange the instrument for a certain number of shares of the debt issuer's stock.

(2) Prior to conversion, convertible debt is treated like any other debt instrument. As such, interest received on a convertible bond is ordinary income and the source of the interest is based upon the residence of the payer of such interest.[124] The conversion of the debt into stock is a non-taxable event.[125]

(3) Under certain circumstances, if the convertible debt is considered "deep in the money" so that it is likely the debt will be converted to stock, it will be treated for tax purposes like equity.[126]

l. Deductibility of Interest and Short Sale Expenses

(1) For noncorporate investors, Section 163(d) of the Code limits the deduction for "investment interest."

(a) "Investment interest" includes interest "which is paid or accrued on indebtedness properly allocable to property held for investment"[127] which also includes short sale expenses.

(b) Investment interest is not deductible in the current year to the extent that it exceeds the taxpayer's "net investment income," consisting of net gain and ordinary income derived from investments in the current year less certain directly connected expenses (other than interest or short sale expenses).[128]

(c) To the extent a deduction is disallowed in one year, investors may carry forward such amounts to succeeding taxable years.[129]

(d) If a partnership has individual partners, the partnership must separately state any investment interest expense it incurs so that each individual can aggregate his or her share of the investment interest expenses with other investment interest expenses and determine weather the limitation on the deduction for investment interest expenses Section 163(d) is exceeded.[130]

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[124] §§ 861(a)(1) and 862(a)(1).

[125] § 1.1001-3(c)(2)(ii) (as long as it is pursuant to the holder's option) and Rev. Rul. 72-265, 1972-1 C.B. 222.

[126] *See* Rev. Rul 82-150, 1982-2 C.B. 110 and Rev. Rul. 93-98, 1983-2 C.B. 40.

[127] § 163(d)(3)(A).

[128] § 163(d)(1).

[129] § 163(d)(2).

[130] Rev. Rul. 84-131, 1984-2 C.B. 37. *See* Regs. § 1.163-8T, Notice 88-20, 1988-1 C.B. 487, and Notice 89-35, 1989-1 C.B. 675.

(e) "Net investment income" is the excess of investment income over investment expenses.[131] Investment income, in turn, is the sum of the gross income from property held for investment plus ordinary gain attributable to the disposition of such property, but only to the extent that such amounts are not derived from the conduct of a trade or business.[132] For purposes of this calculation, qualified dividends[133] and long-term capital gains are excluded from net investment income unless the taxpayer elects to pay tax on such amounts at ordinary income tax rates.[134] The election is made on IRS Form 4952.

(f) Generally, a hedge fund's activities will be treated as giving rise to investment income for investors, and the investment interest limitation would apply to a noncorporate investor's share of the interest and short sale expenses attributable to the hedge fund's operations.[135] In such case, a noncorporate investor would be denied a deduction for all or part of that portion of its distributive share of the hedge fund's ordinary losses attributable to interest and short sale expenses unless it had sufficient investment income from all sources including from the hedge fund.

(g) The investment interest limitation would also apply to interest paid by a noncorporate investor on money borrowed to finance its investment in the hedge fund.[136]

(2) As mentioned above, payments in lieu of dividends with respect to a short sale are generally deductible. However, if fewer than 46 days elapse between the date of a short sale and the date the borrower of the stock closes out the short sale, then payments in lieu of dividends are not deductible. Rather, the payments must be capitalized into the basis of the stock purchased to repay the lender.[137] Furthermore, payments in lieu of dividends may not be deductible if the property is part of a straddle.[138]

(3) The Code provides that there will be no deduction with respect to "interest and carrying charges properly allocable to personal property which is part of a straddle."[139] In such circumstances, the interest and carrying charges are capitalized and added to basis. This would include interest and other expenses with respect to short sales.

m. Deductibility of Hedge Fund Investment Expenses

(1) As mentioned above, each of the investment activities of hedge funds are either as an investor or a trader. To the extent a hedge fund's activities qualify as trading rather than investment activities, the expenses would not be treated as investment expenses. Advisors should inquire

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131 § 163(d)(4)(A).

132 § 163(d)(4)(B).

133 § 1(h)(11)(B).

134 § 163(d)(4)(B)(iii) and the flush language of § 163(d)(4)(B).

135 *See* Regs. § 1.58-2(b)(2)(i). *See also* FSA 200111001 (whether noncorporate partners are subject to §163(d) limitations on their share of partnership's interest expense attributable to partnership's activity as a securities trader depends on each partner's participation).

136 *See* § 163(d)(5)(A).

137 § 263(h).

138 § 263(g).

139 § 263(g).

how the hedge fund will treat the investment management fee (which in all likelihood will be considered an investment expense and thus subject to the limitations discussed above) and any incentive allocation fee (some portion of which may be treated by the hedge fund as a trading expense).

(2) Investment expenses (for example, investment advisory fees) of an individual, trust or estate are deductible only to the extent they exceed 2% of adjusted gross income.[140]

(3) The IRS has the authority to issue regulations that prohibit an individual from indirectly deducting, through pass-through entities, amounts that are not allowable if paid or incurred directly by an individual.[141] Pursuant to this, the IRS issued temporary regulations that introduce the terms "affected investor" and "affected expenses."[142]

(a) Generally, an affected investor in a pass-through entity must separately take into account, as an item of income and as an item of expense, an amount equal to the affected investor's allocable share of the affected expenses. The expenses separately taken into account are treated as paid or incurred by the affected investor in the same manner as they were paid or incurred by the entity.[143]

(b) An affected investor is essentially anyone who owns an interest in a pass-through entity and who is subject to the 2% of adjusted gross income floor.[144]

(c) Affected expenses are expenses that, if paid or incurred by an individual, would treated as Section 67(b) of the Code miscellaneous itemized deductions

(d) This prohibition against using pass-thru entities to avoid the 2% floor limitation does not apply to publicly-offered regulated investment companies (mutual funds).[145] However, as mentioned herein, hedge funds generally are not publicly-offered and thus would not qualify for this exception.

(e) Each partner in a partnership must separately take into account the partner's distributive share of any partnership deductions that are miscellaneous itemized deductions. The

[140] §67(a) and Regs. §1.67-1T(a)(1). However, § 67(e) of the Code provides that, in the case of a trust or an estate, such limitation does not apply to deductions or costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such trust or estate. There is a disagreement among the courts on the question of whether the investment advisory fees incurred by a trust are exempt (under Section 67(e)) from the 2% of adjusted gross income floor on deductibility. O'Neill Irrevocable Trust v. Commissioner, 98 T.C. 227 (1992), *nonacq*., AOD 1994-6, 1994-2 C.B (9/12/94).1, *rev'd*, 994 F.2d 302 (6th Cir. 1993), Scott v. U.S., 328 F.3d 132 (4th Cir. 2003), Mellon Bank N.A. v. U.S., 265 F.3d 1275 (Fed. Cir. 2001), *aff'g* 2001-1 USTC ¶50,153 (Fed. Cl. Ct. 2000), and Rudkin Testamentary Trust v. Commissioner., 124 T.C. 304 (2005).

[141] § 67(c)(1).

[142] Regs. § 1.67-2T(a), (h), (i).

[143] Regs. § 1.67-2T(a).

[144] Regs. §1.67-2T(h)(1).

[145] § 67(c)(2)(A). A mutual fund is publicly offered if its shares are: (1) continuously offered pursuant to a public offering, as defined in § 4 of the Securities Act of 1933, (2) regularly traded on an established securities market, or (3) held by or for no fewer than 500 persons at all times during the taxable year. § 67(c)(2)(B)(i) and Regs. § 1.67-2T(g)(3)(ii).

2% floor does not apply to the partnership but does apply to the partners with respect to these deductions.[146]

(4) The Code further restricts the ability of an individual with an adjusted gross income in excess of a specified amount (for 2006, $150,500 or $75,250 for a married person filing a separate return) to deduct hedge fund investment expenses.[147] Under this limitation, investment expenses in excess of 2% of adjusted gross income may only be deducted to the extent such excess expenses (along with certain other itemized deductions) exceed the lesser of (i) 3% of the excess of the individual's adjusted gross income over the specified amount[148] or (ii) 80% of the amount of certain itemized deductions otherwise allowable for the taxable year.[149]

(5) The investment expenses of the hedge fund are miscellaneous itemized deductions which are not deductible by a noncorporate taxpayer in calculating its alternative minimum tax liability.[150]

n. Passive Activity Rules

(1) The Code restricts the deductibility of losses from a "passive activity" against certain income which is not derived from a passive activity.[151] This restriction applies to individuals (including partners in partnerships), personal service corporations and certain closely held corporations.

(2) Pursuant to Temporary Regulations, income or loss from the hedge fund's securities investment and trading activity generally will not constitute income or loss from a passive activity.[152] Therefore, passive losses from other sources generally could not be deducted against an investor's share of such income and gain from the hedge fund. Income or loss attributable to the hedge fund's investments in other partnerships, however, engaged in certain trades or businesses may constitute passive activity income or loss.

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[146] Regs. §1.67-2T(b)(1).

[147] § 68(a).

[148] § 68(a)(1).

[149] § 68(a)(1). The 2001 Tax Relief Act, P.L. 107-16, provides for the eventual repeal of the overall limitation on itemized deductions, to be phased in over five years beginning in 2006. The otherwise applicable overall limitation on itemized deductions will be reduced by one-third in tax years beginning in 2006 and 2007, and by two-thirds in tax years beginning in 2008 and 2009. Thus, for 2006 and 2007, the amount by which otherwise allowable deductions must be reduced is 2/3 of the reduction amount calculated under § 68(a), and for 2008 and 2009, the amount by which otherwise allowable deductions must be reduced is 1/3 of the reduction amount calculated under § 68(a). The 3% limitation is fully repealed after 2009. However, this legislation contains a "sunset" provision that will result in the limitation on itemized deductions being restored in 2011.

[150] §§ 55 through 58.

[151] § 469.

[152] § 469(e)(1)(A). *See also* Regs. § 1.469-2T(c)(3)(i). Although there is an exception for income and gains derived in the ordinary course of a trade or business under § 469(e)(1)(A)(i)(I), it is limited to certain circumstances that generally are applicable in the hedge fund context. *See generally* Regs. §1.469-2T(c)(3)(ii).

o. The "At Risk" Limitations

(1) Under the "at risk" rules, the amount of any loss of a hedge fund that an investor is entitled to include in its income tax return is generally limited to its adjusted tax basis in hedge fund (partnership interest) as of the end of the fund's taxable year in which such loss occurred.[153] However, for purposes of the at risk computations, there may be certain differences:

(a) The adjusted basis in the hedge fund interest will generally include nonrecourse debt (partnership liabilities), whereas the at risk amount may not include such debt.[154]

(b) A partner's at risk amount may not include any amount to the extent that there is an arrangement protecting the partner against loss.[155]

(2) Generally, an investor's adjusted tax basis for its interest in a hedge fund (and at risk amount) is equal to the amount paid for such interest, increased by the sum of (i) its share of the hedge fund liabilities,[156] and (ii) its distributive share of the hedge fund's realized income and gains, and decreased (but not below zero)[157] by the sum of (i) distributions (including decreases in its share of hedge fund liabilities) made by the hedge fund to such investor and (ii) such investor's distributive share of the hedge fund's realized losses and expenses.

(3) However, with partnerships, with the exception of qualified nonrecourse financing (dealing with real property primarily), no partner is considered at-risk with respect to a partnership loan if the loan is secured by partnership property and neither the partnership nor any of the partners are personally liable for the debt.[158]

(4) An investor that is subject to the "at risk" limitations (generally, non-corporate taxpayers and closely held corporations)[159] may not deduct losses of the hedge fund to the extent that they exceed the amount such investor has "at risk" with respect to its interest in the hedge fund at the end of the year.[160]

(5) Losses denied under the basis or "at risk" limitations are suspended and may be carried forward in subsequent taxable years, subject to these and other applicable limitations.[161]

(6) The Regulations provide that amounts "at risk in any activity" are "amounts determinable at the partnership level."[162]

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[153] § 465(b).

[154] Except as provided in § 465(b)(2)(B) and qualified nonrecourse financing in § 465(b)(6). *See also* Regs. § 1.752-2(c)(1).

[155] § 465(b)(4).

[156] *See* Regs, § 1.752-2(b)(1).

[157] § 704(d).

[158] Prop. Regs. § 1.465-25(b)(1)(i).

[159] § 465(a)(1)(A) and (B).

[160] § 465(a)(1).

[161] § 465(a)(2).

[162] Regs. § 301.6231(a)(3)-1(a)(1)(vi)(C).

p. Foreign Investment and Foreign Tax Considerations

(1) Pursuant to various "anti-deferral" provisions of the Code including provisions relating to Subpart F, passive foreign investment companies (as discussed in more detail in the offshore hedge fund section of this outline), foreign personal holding companies, investments (if any) by a hedge fund in certain foreign corporations may cause investors to (i) recognize taxable income prior to the hedge fund receipt of distributable proceeds, (ii) pay an interest charge on receipts that are deemed as having been deferred or (iii) recognize ordinary income that, but for the "anti-deferral" provisions, would have been treated as long-term or short-term capital gain.

(2) It is possible that certain dividends and interest received by a hedge fund from sources within foreign countries will be subject to withholding taxes imposed by such countries. In addition, the hedge fund may also be subject to capital gains taxes in some of the foreign countries where it purchases and sells securities. Tax treaties between certain countries and the United States may reduce or eliminate such taxes.

(3) Investors, as part of their distributive share of partnership tax items,[163] generally will be entitled to claim either a foreign tax credit (subject to the limitations discussed below and provided that, in the case of dividends, the foreign stock is held for the requisite holding period) or, if they itemize their deductions, a deduction (subject to the limitations generally applicable to deductions) for their share of such foreign taxes in computing their Federal income taxes.[164] Each investor, not the hedge fund, must make a separate election with respect to the foreign tax credit.[165]

(4) Generally, a credit for foreign taxes is subject to the limitation that it may not exceed the investor’s Federal tax (before the credit) attributable to its total foreign source taxable income.[166] An investor’s share of the hedge fund's dividends and interest from non-U.S. securities generally will qualify as foreign source income. Generally, the source of gain and loss realized upon the sale of personal property, such as securities, will be based on the residence of the seller. In the case of a partnership, the determining factor is the residence of the partner. Thus, absent a tax treaty to the contrary, the gains and losses from the sale of securities allocable to an investor that is a U.S. resident generally will be treated as derived from U.S. sources (even though the securities are sold in foreign countries). For purposes of the foreign tax credit limitation calculation, investors entitled to the 15% tax rate on qualified dividends and long-term capital gains, must adjust their foreign tax credit limitation calculation to take into account the preferential tax rate on such income to the extent it is derived from foreign sources. Certain currency fluctuation gains, including fluctuation gains from foreign currency denominated debt securities, receivables and payables, will also be treated as ordinary income derived from U.S. sources.

(5) The limitation on the foreign tax credit is applied separately to foreign source passive income, such as dividends and interest.[167] In addition, the foreign tax credit is allowed to offset only 90% of the alternative minimum tax imposed on corporations and individuals.[168] Furthermore,

[163] § 702(a). *See* Regs. § 1.704-1(b)(4)(ii).

[164] §§ 27(a) and 901(a).

[165] § 703(b).

[166] §§ 901(b) and 904.

[167] § 904(d)(1)(A) and (2)(A).

[168] *See* § 59(a).

for foreign tax credit limitation purposes, the amount of an investor's foreign source income is reduced by various deductions that are allocated and/or apportioned to such foreign source income. One such deduction is interest expense, a portion of which will generally reduce the foreign source income of any investor who owns (directly or indirectly) foreign assets. For these purposes, foreign assets owned by the hedge fund will be treated as owned by the investors in the hedge fund and indebtedness incurred by the hedge fund will be treated as incurred by investors in the hedge fund.

q. Constructive Ownership Transactions

(1) Because hedge funds strategies tend to be investment strategies that involve frequent trading and high turnover of the portfolio, the vast majority of hedge fund returns are tax disadvantaged, generating short-term capital gains or ordinary income. In response to this, a number of investment banks created "hedge fund derivatives," particularly forward contracts, whose return was specifically tied to the return of an underlying hedge fund. Prior to the enactment of Section 1260 of the Code, the hedge fund derivative would provide both deferral of any gain and a conversion of those gains to long-term capital gain.[169] The transaction had to be structured in a manner to ensure that the taxpayer was not deemed an owner, investor or partner in the hedge fund.[170]

(2) Section 1260 of the Code applies to derivatives that are tied to the return of a hedge fund or other specified investment strategies or assets. If any such transaction qualifies as a "Constructive Ownership Transaction," certain gains that otherwise would be given long-term gain treatment are treated as ordinary income,[171] and an interest charge levied to compensate for any deferral of any applicable tax.[172]

(3) A Constructive Ownership Transaction is defined or deemed to exist when:

(a) The transaction must offer "substantially all" of the economic return in the underlying property (for example, hedge fund or hedge fund strategy);[173]

(b) The underlying property must be one of certain specified types, in this case, a "financial asset," which in turn is defined as "any equity interest in a pass-thru entity;"[174]

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[169] *See* § 1234A.

[170] *See* Rev. Proc. 77-37, 1977-2 C.B. 568 and Regs. § 1.704-1(e) on the issue of whether the taxpayer had dominion and control over the partnership interest. Furthermore, the investment bank, in turn, had to take an interest in the hedge fund in order to hedge its exposure under the forward contract. The investment bank received favorable tax treatment under Section 475 of the Code because it allowed the investment bank, as a dealer, to mark to market their securities, including the hedge fund interest, but then offset these gains and losses by taking a deduction on the corresponding financial derivative tied to the ultimate investor under the forward contract.

[171] § 1260(a)(1).

[172] § 1260(b).

[173] § 1260(d)(1). *See also* § 1259(c)(1) (the "short against the box" provisions, on which Constructive Ownership Transactions were, in part, based upon).

[174] § 1260(c)(2) which includes in the definition of pass-thru entity, a partnership, passive foreign investment company, S corporation, trust and REMIC. Specifically not included are short sale transactions, derivatives based on debt instruments and direct interests in common stock. It is also notable that because this definition requires a pass-thru entity, the definition would not include a specified portfolio (index-based or actively managed account) managed by an investment bank. However, the IRS has the authority to promulgate Regulations to include in the

(c) The transaction must be one of the enumerated derivative transactions, particularly a forward contract, swap, and a combination of options, or any transaction have substantially the same effect as one of the enumerated derivative transactions; and

(d) The taxpayer in question seeks to get the benefit of converting the character of the gains and deferral of such gains.

(4) When a Constructive Ownership Transaction exists the following rules will apply to the investor's tax position with respect to such transaction:

(a) If the investor has long-term capital gain upon closing the Constructive Ownership Transaction, the gain will be treated as ordinary income to the extent that it exceeds the net underlying long-term capital gain that the investor would have had if the investor had invested directly in such transaction or financial asset.[175]

(b) Any gains recharacterized as ordinary income as provided above are subject to an interest charge at the underpayment rate.[176] For these purposes, gains are deemed to accrue at a constant rate equal to the applicable federal rate (AFR) that is in effect at the time the transaction is settled or closed.[177]

(5) If an investor dies with an unsettled and appreciated Constructive Ownership Transaction, the investor will in all likelihood receive a step-up in tax basis.[178]

(6) If an investor physically settles (takes an interest in the hedge fund) a Constructive Ownership Transaction, which generally would be a non-recognition event, it will be deemed as if the investor had cash settled, and the above rules apply.[179] For purposes of determining the adjusted tax basis in the hedge fund, the recharacterized gain is added to the cost of the hedge fund (the price set out in the derivative), the interest is not added to the basis, but the investor is not charged on the full value of the hedge fund interest.

(7) The IRS may promulgate Regulations to allow investors to "mark to market" their Constructive Ownership Transactions, and presumably do away with the interest charge, but to date no Regulations have been issued.[180]

(8) Some investors have sought to avoid Section 1260 treatment by investing through a foreign corporation (wrapper). Although the foreign corporation would constitute a passive

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term "financial asset" a debt instrument and a stock in any corporation which is not a pass-thru entity. § 1260(c)(1)(B).

[175] §§ 1260(a)(1) and 1260(e). The burden of proof is on the taxpayer to demonstrate what the net underlying long-term capital gain is or otherwise would be.

[176] §§ 1260(b) and 6601.

[177] The rate used to allocate the gain (essentially a time value computation) is a constant AFR rate, not a variable rate like the passive foreign investment company regime. The interest rate is not charged on the net underlying long-term gain, and the interest charge is not levied against the last year when the transaction is settled or closed.

[178] § 1014.

[179] § 1260(f).

[180] § 1260(g)(1).

foreign investment company,[181] which is discussed later in this outline, the corporation makes a "qualified electing fund" election in order to get pass-thru taxation. Often these transactions are carefully structured to avoid the controlled foreign corporation[182] rules. Other strategies include the use of onshore or offshore variable insurance whose investments are tied to one or more hedge funds. This is beyond the scope of this outline, although each of these strategies has varying degrees of dubious validity and effectiveness.

r. Tax Shelter Reporting Requirements

(1) Under recently issued Regulations, the activities of many hedge funds may include one or more "reportable transactions," requiring the hedge fund and, in certain circumstances, an investor to file information returns.[183] As a result, the fund and other material advisors to the fund may each be required to maintain for a specified period of time a list containing certain information regarding the "reportable transactions" and the investors, all of which the IRS can inspect upon request.

(2) A "reportable transaction" of a partnership includes, among others, a transaction that results in a loss claimed under Section 165[184] of the Code (computed without taking into account offsetting income or gain items, and without regard to limitations on its deductibility) generally of at least $2 million in any one taxable year or an aggregate of at least $4 million over a period of six taxable years (losses from the year in which the transaction is entered into plus the five succeeding taxable years), unless the transaction has been exempted from reporting by the IRS. Subject to certain exemptions, a partner will be treated as participating in a partnership's "loss transaction," and thus be required to report the transaction, if (i) the partner's allocable share of such a partnership's loss exceeds certain thresholds,[185] or (ii) the partner is an individual or a trust which is allocated in any one taxable year a loss of at least $50,000 from a Section 988 foreign currency transaction.

(3) The IRS has published guidance exempting many of investment strategies employed by hedge funds. These exempted transactions include, in pertinent part:[186]

(a) Losses from the sale or exchange of an asset with a "qualifying basis" (assets with a "qualifying basis" include, among others, certain assets purchased by the Partnership for cash);

(b) Losses from certain hedging transactions; and

(c) Losses from sales to persons other than related parties of property described in Section 1221(a)(4) in certain factoring transactions.

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[181] *See* §§ 1291, 1293 through 1298.

[182] *See* §§ 951 through 962, 964.

[183] Regs. §§ 1.6011-4 and 301.6112-1.

[184] *See* Regs. § 1.6011-4(b)(5)(iii). Section 165 losses for this purpose include amounts deductible under a provision that treats a transaction as sale or other disposition or that otherwise resulting in a deduction under Section 165 like a loss resulting from a sale or exchange of a partnership interest under Section 741.

[185] For non-corporate partners, individuals, S corporations and trusts the thresholds are $2 million in any one taxable year or an aggregate of $4 million over the six-year period described above, and for corporate partners, the thresholds are $10 million in any one taxable year or $20 million over the six-year period described above. Regs. § 1.6011-4(b)(5)(i)

[186] Rev. Proc. 2004-66, *superseding* Rev. Proc. 2003-24. *See also* Regs. § 1.6011-4(b)(8) authorizing the issuance of safe harbors.

(4) Significantly, however, even if the hedge fund has a "qualifying basis" in the asset generating the loss, each of the following transactions is still subject to the reporting requirements unless it is marked to market under the Code (for example, as a Section 1256 contract):

(a) A transaction involving an asset that is, or was, part of a straddle (other than a mixed straddle);

(b) A transaction involving certain "stripped" instruments;

(c) The disposition of an interest in a pass-through entity, and

(d) Certain foreign currency transactions which generate an ordinary loss (foreign currency, Section 988 losses).

(5) Generally, the Regulations will require hedge funds to complete and file IRS Form 8886 ("Reportable Transaction Disclosure Statement") with its tax return for each taxable year in which the particular hedge fund participates in a "reportable transaction." Additionally, each investor which is treated as participating in a reportable transaction of the hedge fund will be required to file IRS Form 8886 with its tax return. Furthermore, the hedge fund and each investor, respectively, must also submit a copy of the completed form with the IRS's Office of Tax Shelter Analysis.

(6) Finally, if an investor recognizes a loss upon the redemption or other disposition of its interest in the hedge fund, this may constitute a "reportable transaction" for the investor, based upon the rules set out above.

D. Taxation of non-US Hedge Funds (Offshore)

1. Generally

a. As mentioned above, the vast majority of offshore hedge funds are formed as foreign corporations in low or no tax foreign jurisdictions.

b. Offshore hedge funds are primarily marketed to tax-exempt U.S. persons or non-U.S. investors. In fact, many hedge funds prohibit taxable U.S. persons from investing due to securities law issues. However, if a taxable U.S. person invests in an offshore hedge fund, generally the hedge fund will be considered a passive foreign investment company, as discussed here, and subject to taxation thereunder.

2. Passive Foreign Investment Company Issues

a. A PFIC is a non-U.S. entity classified as a corporation for federal income tax purposes[187] and which meets a gross income test or asset test:[188]

(1) The gross income test is met if 75% or more of the entity's gross income for the taxable year is passive income;[189] and

[187] § 7701 and Regs. § 301-7701-3.

[188] § 1297(a).

[189] § 954(c) defines passive income for these purposes but with respect to a foreign personal holding company.

(2) The asset test is met if 50% or more of the entity's assets produce passive income or are held for the production of passive income.

b. The vast majority of offshore hedge funds will qualify as a PFIC. When a PFIC is deemed to exist, there are generally three possible taxation methodologies:

(1) Under the excess distribution methodology, an interest charge is imposed on the U.S. tax on excess distributions from a PFIC.[190] This is the default taxation methodology, and it generally results in the entire return on the hedge fund (including gain on the sale on the disposition of PFIC stock, which is treated as an excess distribution) to be considered ordinary income.

(2) Under the qualified electing fund ("QEF") methodology, a U.S. investor is taxed under rules similar to the controlled foreign corporation[191] inclusion rules.[192] An investor, however, can only make this election if the hedge fund agrees to provide all of the information necessary to compute the tax liability of the investor under the QEF rules.[193] Where a U.S. investor has elected to treat its interest in a PFIC under the QEF rules, the investor includes annually in its income its pro rata share of the PFIC's earnings and profits. This share is included as ordinary income to the extent of the portion that represents ordinary earnings of the PFIC, and as long-term capital gain to the extent of the portion that represents net capital gains of the PFIC.[194] From a tax standpoint, this is the most advantageous methodology under the PFIC rules. However, under the QEF rules, in determining the earnings and profits of the PFIC, certain tax advantaged items like state and local tax-exempt interest and qualified dividends do not retain their tax advantaged status. Furthermore, very few offshore hedge funds agree to provide all of the information necessary to compute the tax liability under the QEF rules.

(3) Under the mark-to-market methodology, which applies to "marketable" stock of a PFIC, the U.S. investor marks its stock to market on an annual basis.[195] PFIC stock is considered marketable if it is regularly traded on a qualified exchange or other market[196] or if it is a PFIC that satisfies certain criteria similar to treating it like a U.S. mutual fund.[197] Most of the offshore hedge funds will not satisfy either of these marketability requirements. Even so, the "mark to market" regime, provides for current taxation at ordinary income rates of the annual appreciation in value of the PFIC stock.

3. U.S. Trade or Business

a. Foreign corporations are subject to income taxation, at the same progressive rates as domestic corporations, on their "taxable income which is effectively connected with the conduct of a trade or business within the United States"[198]

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[190] § 1291.

[191] §§ 951-964.

[192] §§ 1293-1295.

[193] Regs. § 1.1295-1(g)(1).

[194] § 1293(a)(1).

[195] § 1296.

[196] § 1296(e)(1)(A) and Regs. § 1.1296-2(c)(1)(i).

[197] § 1296(e)(1)(B) and Regs. § 1.1296-2(d)(1).

[198] § 882(a)(1).

b. Section 864(b)(2) of the Code, provides a safe harbor applicable to a non-U.S. corporations (other than a dealer in securities) that engages in the U.S. in trading securities (including contracts or options to buy or sell securities) for its own account pursuant to which such non-U.S. corporation will not be deemed to be engaged in a U.S. trade or business.[199]

c. The safe harbor also provides that a non-U.S. corporation (other than a dealer in commodities) that engages in the U.S. in trading commodities for its own account is not deemed to be engaged in a U.S. trade or business if "the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place."[200]

d. Pursuant to proposed Regulations, a non-U.S. taxpayer (other than a dealer in stocks, securities or derivatives) that effects transactions in the United States in derivatives (including (i) derivatives based upon stocks, securities and certain commodities, and (ii) certain notional principal contracts based upon an interest rate, equity or certain commodities and currencies) for its own account is not deemed to be engaged in a United States trade or business.[201]

e. Even if a hedge fund's securities trading activity does not constitute a U.S. trade or business, gains realized from the sale or disposition of stock or securities (other than debt instruments with no equity component) of U.S. Real Property Holding Corporations ("USRPHC"),[202] including stock or securities of certain Real Estate Investment Trusts ("REITs"), will be generally subject to U.S. income tax on a net basis. However, a principal exception to this rule of taxation would apply if such USRPHC has a class of stock which is regularly traded on an established securities market and the hedge fund generally did not hold (and was not deemed to hold under certain attribution rules) more than 5% of the value of a regularly traded class of stock or securities of such USRPHC at any time during the five year period ending on the date of disposition.[203]

f. If a hedge fund is deemed to be engaged in a U.S. trade or business as a result of owning a limited partnership interest in a U.S. business partnership or a similar ownership interest, income and gain realized from that investment would be subject to U.S. income and branch profits tax.

4. U.S. Withholding Tax

a. In general, under Section 881 of the Code, a non-U.S. corporation which does not conduct a U.S. trade or business is nonetheless subject to tax at a flat rate of 30% (or lower tax treaty rate) on the gross amount of certain U.S. source income which is not effectively connected with a U.S. trade or business, generally payable through withholding. Income subject to such a flat tax rate is of a

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[199] § 864(b)(2)(A)(ii).

[200] § 864(b)(2)(B)(ii) and (iii).

[201] Prop. Regs. § 1.864(b)-1.

[202] § 897.

[203] Most hedge funds will also be exempt from tax on direct or indirect dispositions of REIT shares, whether or not those shares are regularly traded, if less than 50% of the value of such shares is held, directly or indirectly, by non-U.S. persons at all times during the five year period ending on the date of disposition. However, even if the direct or indirect disposition of REIT shares would be exempt from tax on a net basis, distributions from a REIT (whether or not such REIT is a USRPHC), to the extent attributable to the REIT's disposition of interests in U.S. real property, are subject to tax on a net basis when directly or indirectly received by the hedge fund and may be subject to the branch profits tax.

fixed or determinable annual or periodic (FDAP) nature, including dividends and certain interest income.[204]

b. Dividends clearly fall within the purview of Section 881(a) of the Code. Payments in lieu of dividends, for example with short sales, are considered "substitute dividends" and are subject to this withholding tax.[205]

c. Certain types of income are specifically exempted from the 30% tax and thus withholding is not required on payments of such income to a non-U.S. corporation. The 30% tax does not apply to U.S. source capital gains[206] (whether long or short-term) or to interest paid to a non-U.S. corporation on its deposits with U.S. banks.[207]

d. The 30% tax also does not apply to interest which qualifies as portfolio interest.[208] The term "portfolio interest" generally includes interest (including original issue discount) on an obligation in registered form which has been issued after July 18, 1984 and with respect to which the person who would otherwise be required to deduct and withhold the 30% tax receives the required statement that the beneficial owner of the obligation is not a U.S. person.

e. Under certain circumstances, interest on bearer obligations may also be considered portfolio interest.[209]

f. A notional principal contract is a financial instrument, such as a swap, that provides for payments at specified intervals of amounts determined by applying a specified rate or index to a "notional" principal amount. If the specified index is an interest rate index, payments under the instrument may be equivalent to the interest that would be paid under an actual loan with a principal amount equal to the notional principal amount of the swap. Alternatively, if the instrument provides that the payment amounts are to be determined by reference to stock in a corporation (an "equity swap"), the payments under the instrument may be equivalent to the dividends that would be paid to an actual holder of the stock. Although the swap payments could thus be considered substitute interest or dividend payments, for FDAP purposes, however, the source of swap payments is not determined as if such payments were actually interest or dividends. Instead, such payments generally are sourced to the residence of the taxpayer who derives the payment.[210]

5. <u>Redemption of Shares</u>

a. Gain realized by shareholders of offshore hedge funds who are not U.S. persons within the meaning of the IRC ("non-U.S. shareholders") upon the sale, exchange or redemption of shares in an offshore hedge fund held as a capital asset should generally not be subject to U.S. federal income tax

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[204] § 881(a).

[205] Regs. §§ 1.881-2(b)(2) and 1.861-3(a)(6).

[206] *See* Regs. §1.1441-2(b)(2)(i)(excepting such gains from the definition of FDAP for purposes of the withholding rules).

[207] § 881(d).

[208] § 881(c)(1).

[209] § 881(c)(2)(A) (cross-referencing Section 871(h)(2)(A)) and Regs. § 1.871-14(b)(1). Generally, if the bearer security is described in § 163(f)(2)(B).

[210] Regs. § 1.863-7(b)(1). *See also* Regs. § 1.988-4(a) (dealing with currency swaps).

provided that the gain is not effectively connected with the conduct of a trade or business in the U.S. However, in the case of nonresident alien individuals, such gain will be subject to the 30% (or lower tax treaty rate) U.S. tax if (i) such person is present in the U.S. for 183 days or more during the taxable year (on a calendar year basis unless the nonresident alien individual has previously established a different taxable year) and (ii) such gain is derived from U.S. sources.

b. Generally, the source of gain upon the sale, exchange or redemption of shares in an offshore hedge fund is determined by the place of residence of the shareholder.[211] For purposes of determining the source of gain, the Code defines residency[212] in a manner that may result in an individual who is otherwise a nonresident alien with respect to the U.S. being treated as a U.S. resident only for purposes of determining the source of income.

c. Gain realized by a non-U.S. shareholder engaged in the conduct of a U.S. trade or business will be subject to U.S. federal income tax upon the sale, exchange or redemption of shares in an offshore hedge fund if such gain is effectively connected with its U.S. trade or business.

6. Tax-Exempt U.S. Persons and UBTI

a. A tax-exempt U.S. person is generally a U.S. person that is exempt from payment of U.S. federal income tax. Generally, a tax-exempt U.S. person is exempt from federal income tax on certain categories of income, such as dividends, interest, capital gains and similar income realized from securities investment or trading activity. This type of income is exempt even if it is realized from securities trading activity which constitutes a trade or business.

b. This general exemption from tax does not apply to the "unrelated business taxable income" ("UBTI") of a tax-exempt U.S. person.[213] Generally, except as noted above with respect to certain categories of exempt trading activity, UBTI includes income or gain derived from a trade or business, the conduct of which is substantially unrelated to the exercise or performance of the tax-exempt U.S. person's exempt purpose or function.[214] UBTI also includes (i) income derived from debt-financed property, and (ii) gains derived from the disposition of debt-financed property.[215] Hedge fund borrowings would give rise to UBTI if the related investment were to give rise to any income during the taxable year or years in which such borrowing was outstanding or if the related investment were disposed of at a gain within 12 months after such borrowing was repaid. Further, an investment by a hedge fund will result in acquisition indebtedness (i) if indebtedness incurred before the investment would not have been incurred but for the investment, (ii) if the investment is actually made with the use of borrowed funds, or (iii) if the investment necessitates future borrowings and this eventuality was foreseeable at the time the investment was made. For example, if a hedge fund were to purchase stock in a company and financed a one-third of the purchase price with debt and then sold the stock for a gain, the hedge fund would have UBTI equal to one-third of the gain offset by one-third of the net interest cost. A tax-exempt organization will be subject to a tax return filing requirement if it takes into account $1,000 or more of gross income in computing UBTI. Short sales transactions involving publicly traded securities do not generally give rise to UBTI. If a tax-exempt organization receives UBTI, the organization is required to File 990T.

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[211] § 865(a). *See* Ltr. Rul. 9847016 (capital gain from sale of securities by nonresident alien is not subject to U.S. tax).

[212] § 865(g).

[213] § 512(a).

[214] §§ 512(a)(1), 513(a) and Regs. § 1.513-1(a).

[215] § 514.

c. In 1996, Congress considered whether, under certain circumstances, income derived from the ownership of the shares of a non-U.S. corporation should be treated as UBTI to the extent that it would be so treated if earned directly by the shareholder. Subject to a narrow exception for certain insurance company income, Congress declined to amend the Code to require such treatment. Accordingly, based on the principles of that legislation, a tax-exempt U.S. person investing in a non-U.S. corporation should not realize UBTI with respect to an unleveraged investment in shares of such hedge fund.

d. Prior to the enactment of the Tax Relief and Health Care Act of 2006, signed into law on December 20, 2006, charitable remainder trusts invested primarily in the offshore version of hedge funds because it lost its tax exempt status if UBTI existed in any taxable year. [216] However, one issue that remained unresolved was whether the PFIC rules would or should apply because the unitrust or annuity recipient is a U.S. taxable person. Effective January 1, 2007, the Code now provides for a 100% excise tax on any such UBTI, rather a loss of tax exempt status for the entire taxable year.[217] The excise tax is payable by the trustee and out of principal. Query: With the specter of losing tax exempt status no longer in existence, should trustees of charitable remainder trusts now consider investments in the onshore version of hedge funds in order to avoid the reporting issue under the PFIC rules? Further, if the excise tax is payable out of principal, does this effectively mean that Net Income with Make-Up Provisions Charitable Remainder Unitrusts essentially put the entire burden of receiving UBTI on the charitable remainder beneficiary?

7. Reporting Requirements for U.S. Persons in Offshore Hedge Funds

a. Any U.S. person owning 10% or more (taking certain attribution rules into account) of either the total combined voting power or total value of all classes of the shares of a non-U.S. corporation will likely be required to file an information return with the IRS containing certain disclosure concerning the filing shareholder, other shareholders and the corporation.[218]

b. In addition, a U.S. person within that transfers cash to a non-U.S. corporation may be required to report the transfer to the IRS if (i) immediately after the transfer, such person holds (directly, indirectly or by attribution) at least 10% of the total voting power or total value of such corporation or (ii) the amount of cash transferred by such person (or any related person) to such corporation during the twelve-month period ending on the date of the transfer exceeds $100,000.[219]

c. As discussed above in more detail above, certain U.S. persons within the meaning of the IRC will have to file Form 8886 ("Reportable Transaction Disclosure Statement") with their U.S. tax return, and submit a copy of Form 8886 with the Office of Tax Shelter Analysis of the IRS if the Fund engages in certain "reportable transactions." Shareholders required to file this report include a U.S. person within the meaning of the IRC if the hedge fund is treated as a "controlled foreign

[216] Prior law had provided, a CRT is not subject to any income tax for any taxable year unless the trust, "for such year, has unrelated business taxable income (within the meaning of section 512, determined as if part III of subchapter F applied to such trust)." § 664(c). *See* Regs. § 1.664-1(c) and Leila G. Newhall Unitrust v. Commissioner., 104 T.C. 236 (1995), the Tax Court held that a charitable remainder unitrust was taxable on all of its income in taxable years during which it received unrelated business taxable income from certain limited partnerships.

[217] § 664(c)(2).

[218] § 6038 and Regs. § 1.6038-2.

[219] § 6038B and Regs. § 1.6038B-1(b)(3) and (g).

corporation" and such U.S. person owns a 10% voting interest. In certain situations, there may also be a requirement that a list be maintained of persons participating in such reportable transactions, which could be made available to the IRS at its request. Moreover, if a U.S. person within the meaning of the IRC recognizes a loss upon a disposition of shares of the offshore hedge fund, such loss could constitute a "reportable transaction" for such shareholder, and such shareholder would be required to file Form 8886.

III. EVALUATING HEDGE FUNDS FROM AN INVESTMENT STANDPOINT

A. Hedge Funds Are Strategies, Not Asset Classes

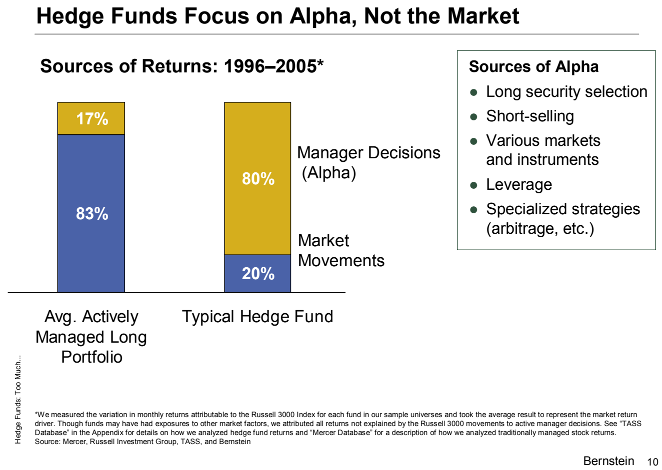
1. Given the wide array of hedge fund strategies, it's not surprising that the return profile of hedge funds is heavily dependent on a manager's investment skill—much more so than most traditional investment portfolios or asset classes. If investment strategies are arrayed according to their dependence on the market, index funds, which aim to replicate a benchmark, are at one end of the spectrum, in the middle are traditionally managed portfolios, which usually aren't structured very differently from the market—but rely on managers' investment selections to earn a premium return. At the far end of the spectrum are hedge funds, whose returns are driven primarily by manager strategies rather than by broad market direction.

	Index Fund	**Traditionally Managed Portfolio**	**Typical Hedge Fund**
Goal	Market return	Premium above the market return	Positive return in rising and falling markets
Strategy	Replicate the market	Benefit from rising markets Manager uses expertise in security selection	Reduce/eliminate risk of declining markets Exploit manager's ability to generate alpha through flexible investments
Sources of Alpha	N/A	Long-only security selection	Long-only security selection Short security selection Access to various investment markets Range of financial instruments Leverage Specialized strategies
Risks	Market decline	Market decline Poor security selection	Poor security selection/use of techniques and tools Underperforming a rising market

2. For example, over the 10 years ending in 2005, the market accounted for better than 80% of the ups and downs generated by the average traditional equity manager.[220] In contrast, hedge funds were virtually a mirror image: only 20% dependent on the broad market and fully 80% on manager decision making.[221]

[220] Traditionally managed bond portfolios rely most heavily on broad movements in the market to generate their returns too. We found that 89% of the variation in the average active bond manager's return was driven by broad bond market movements, with the remaining 11% driven by manager decisions.

[221] We measured the variation in monthly returns (using a statistical measure called r-squared) that is attributable to the Russell 3000 Index for each fund in our sample universes and took the average result to represent the market return driver. We attributed all returns not explained by the Russell 3000 movements to active manager decisions. Source: Mercer, Russell Investment Group, TASS, and Bernstein



3. The technical term for the portion of an investment's return deriving from the manager's decisions is alpha.[222] When so much of a portfolio's return is a function of alpha rather than market movements—beta[223]—successful managers have the potential to produce a very attractive return profile. They can avoid the inevitable market downturns and target positive absolute returns regardless of the prevailing environment. Of course, such heavy reliance on manager skill is a double-edged sword: If achieving alpha proves elusive, a fund can do very poorly.

B. Hedge Fund Returns and Risks

1. To see whether hedge fund investing fulfills its promise, we looked at a number of widely used indexes that attempt to characterize industry performance. The average of those indexes from 1996 through 2005 shows enviable results: a compound return about four percentage points above the S&P 500's but with volatility closer to the level of bonds than stocks.

2. But were these results too good to be true? We took a harder look, trying to adjust for the biases that come with the territory in hedge fund performance reporting. It is at a fund's discretion to submit results—or not—and for however long a time period it chooses. Given this large degree of reporting discretion, hedge fund index results tend to be significantly overstated. We created our own composite of hedge fund returns by researching the performance of the 6,000+ funds in the TASS database[224] and

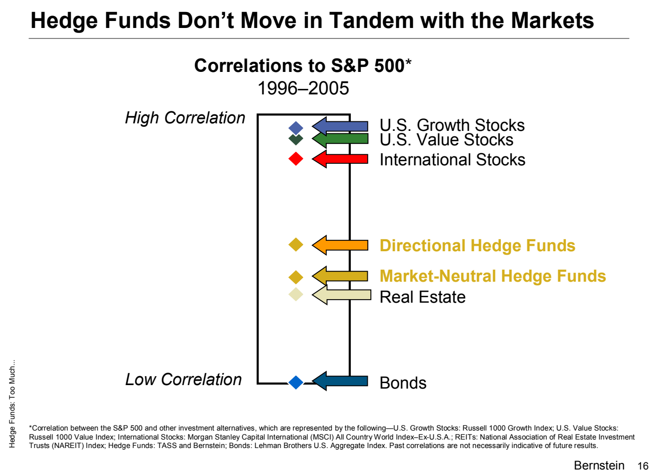
[222] In a simplistic sense, alpha is the extra return awarded to the investor for taking additional risk rather than simply accepting market return. It is one of the parameters in the capital asset pricing model. As such, the abnormal rate of return on a security or portfolio in excess of what would be predicted by an equilibrium model like the capital asset pricing model is said to be the alpha. The formula for determining a fund's risk relative to the market is: [y-b(x)]/n {where: y = rate of return for the fund, b = beta of the fund, x = rate of return for the market, and n = number of observations}. An alpha of 1 means the fund outperformed the market by 1%, so a positive alpha is generally the extra return awarded to the investor for taking additional risk.

[223] Beta is generally a measure of a security's or portfolio's volatility or systematic risk in comparison to the market as a whole. Beta is calculated using regression analysis, and you can think of beta as the tendency of a security's return to respond to swings in the market. A beta of 1 indicates that the security's price will move with the market. A beta less than 1 means that the security will be less volatile than the market. A beta greater than 1 indicates that eh security price will be more vaolatile than the market.

[224] The TASS database includes the net-of-fee performance of individual hedge funds whose managers have elected to report to the database. As of December 2005, more than 6,000 funds were included in the database. In constructing our Hedge Fund, Market-Neutral Hedge Fund, Directional Hedge Fund, and Fund of Funds indexes, we included the performance of funds only after their managers decided to report to the database, and only for those funds that had at

adjusting the reported returns with the goal of correcting for several biases. The result was a hedge fund composite whose performance was in line with that of the S&P 500 rather than exceeding it. But earning stock-like returns with much reduced volatility is still a compelling combination.

3. In fact, our hedge fund composite looked even better when we examined the decade from 1996 through 2005 year by year. In a period of extraordinary stock market volatility—which included both superb years and one of the worst bear markets since the Great Depression—hedge funds, on average, did what they were supposed to do. They participated in—or beat—the S&P in the six of the seven up years, and when the market dropped by 38% between 2000 and 2002, they gained a cumulative 5% (posting positive returns each year). In fact, when the S&P plummeted, cash flows into hedge funds spiked as investors looked to them for potential insulation from market risk. Further, although hedge fund correlations to the stock market haven't been quite as low as those of bonds, they were a diversifying investment—since their average exposure to the market was low, as seen below:



4. In light of this performance history, hedge funds appear to be a natural fit in the traditional asset allocation framework, designed to combine asset classes with attractive return, volatility, and correlation characteristics. Indeed, it wouldn't be surprising if an allocation model placed all of an investor's capital in hedge funds, barring a weighting cap by the investor or his advisor. But in our view, simply using annualized return and standard deviations to make allocation decisions would be a serious mistake, because hedge fund risks aren't adequately captured by volatility alone.

C. The Problem with Hedge Fund Indices and the Hedge Fund Composite Used in this Outline

1. Investors in traditional asset classes have the benefit of a long data series of index returns that profile their risk and return characteristics. For example, the S&P 500 and its predecessors comprise 80 years of stock-return history. Underpinning results like these are indexes comprising securities selected on the basis of a consistent methodology, with performance monitored over time. Given a reliable proxy for an asset class, investors have some basis for analyzing performance in a host of market environments—periods of strong economic growth, recessions, inflationary spirals, wars, etc.—and can

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least $10 million in assets under management. We also included the performance of all funds in the database that are no longer currently reporting. The indexes are equal-weighted. We calculated after-tax returns using ordinary-income and capital-gains tax rates at the highest marginal brackets in effect each month over the 1996–2005 period. In the case of directional hedge funds, we assumed that 75% of the return was characterized as ordinary income and 25% as long-term capital gain; for market-neutral funds we assumed 90% ordinary income and 10% capital gain. In the calculations for funds of funds we assumed a weighted average of the two fund categories.

draw reasonable conclusions about the risk and return potential of making large or small allocation commitments.

2. When it comes to hedge funds, however, the indexes do not represent a consistent group of assets selected and monitored over time. They are a collection of fund returns self-reported by the managers. Therefore, they include only managers who choose to report. In fact, managers can stop reporting at their discretion. Gaps such as these create the potential for a number of biases in reported results.

3. To get a better handle on the performance actually experienced by investors, we started with a universe of 6,000 hedge fund managers derived from one of the largest commercially available databases (the TASS database). When we analyzed the historical results of all funds reporting to the database as of year-end 2005, we calculated an average compound return of 15.1% over the prior 10 years. We then adjusted the results to correct as much as we could for several important biases:

a. With the hope of creating a longer, more comprehensive series of historical returns, some indexes include a fund's prior returns even though they have just begun to report their results to the index provider. Funds tended to "backfill" when their earlier results were superior; weak performance was far less likely to be added ex post facto. To correct for this problem, we included only fund returns from the point the manager began reporting to the database. This reduced our return estimate to 13.4%.

b. Some indexes exclude the historical returns of funds that were once in their database but are no longer reporting. The bias here is the mirror image of backfill bias (survivorship bias). Not surprisingly, we found that many such funds had been underperforming their peers when they stopped reporting. We included all of these funds in our analysis—reducing our return estimate to 8.9%.

c. Most hedge fund indexes began in the early 1990s, when there were few funds in the universe. When we corrected for backfill, there were even fewer. We therefore began our performance history in 1996, the point at which we felt we had a reliable sample of funds.

4. After making these adjustments to the data, we found that very few funds had reported returns for as long as 10 years. Only 18% of the funds that reported in 1996 were still reporting at the end of 2005. Even three-year records proved elusive. Fewer than two-thirds of the funds reporting in 2003 were still in the database by the end of 2005. The reason for the thin history was funds that stopped reporting had underperformed their peers during the prior 12 months by an average of 10%.

5. Many index providers have attempted to adjust for some of these biases, with varying degrees of success. Our research and methodology indicates that hedge fund returns have been substantially lower than the average of a group of commonly cited indexes--still superior results, mind you, but not as stellar as they would appear at first glance.[225]

[225] We weren't able to account for all the biases that could impact hedge fund performance. For example, there is no way of getting access to a fund's returns in the months after it stops reporting to a database. Another is the potential impact of the time-sensitivity of our analysis. The 10-year period we studied (1996–2005) may in retrospect turn out to have been unusually good for hedge funds, or unusually poor. Further, numerous commentators have discussed the possibility that hedge fund returns are more volatile than they appear owing to the difficulty of accurately marking many of their illiquid holdings to market.

D. Hedge Fund Risk Is About Manager Mistakes

1. During hedge funds' short history, the industry has experienced massive change: growth in the array of fund strategies, tremendous capital inflows, and a surge in the number of managers. As more assets chase "alpha" in the global markets, the heightened competition may make it harder for managers to add value.

2. But the need to carefully assess hedge fund risks runs deeper. Hedge funds are not an asset class—like stocks or bonds—whose returns are underpinned by fundamentals like corporate earnings growth or the cash-flow-generating power of companies or governments. Rather, hedge funds are collections of discrete managers, each relying on their own ability to exploit inefficiencies in the capital markets by means of a specific tool set and orientation (stock-picking, arbitrage, wagering on macro scenarios, and so forth).

3. As a result, performance dispersion—the difference between the results of a particular manager and the index—runs high in hedge funds; much higher, incidentally, than in traditionally managed stock and bond portfolios. From 1996 through 2005 for the same adjusted hedge fund composite we measured the annual performance of the top decile manager (the manager who outperformed 90% of his peers) with the bottom decile manager who underperformed to a corresponding degree. In some years the range between top- and bottom-decile managers was 80 percentage points in 1999, 55 points in the previous year.[226] In all years, the dispersion was notable. So while it's always important to choose good managers, in the hedge fund landscape it's critical—because knowing the results of a hedge fund index does little to prepare the investor for what to expect from the fund he has chosen.

4. Unfortunately, simple techniques to differentiate between managers, such as relying on a fund's past return levels, are a poor guide to future success. We found that managers' total returns in the past were weakly correlated with their performance in subsequent periods. For example, between 1996 and 2005 only 28% of top-quartile hedge fund managers over three-year periods maintained their edge over the next three-year period; in fact, another 28% of these managers fell to the bottom of the pack.[227] In other words, the odds of top managers maintaining their rankings were in line with a random distribution.

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[226] TASS and Bernstein.

[227] More sophisticated techniques to differentiate between managers, such as selecting based on past Sharpe Ratios and Information Ratios may offer a better indication of future performance, but our analysis found that, even so, the correlations were generally weak and variable by strategy. The Sharpe Ratio is a measure of risk-adjusted performance of an investment or trading strategy. The formula for the Sharpe Ratio is (R-RF)/S {where R = expected rate of return of the portfolio, RF = risk free rate of return, S = the portfolio's standard deviation}. When comparing the Sharpe Ratio of two different portfolios against the same risk free rate benchmark, the portfolio with the higher Sharpe Ratio gives more return for the same unit of risk. The Information Ratio concept is one measure of volatility-adjusted return and is used in the analysis of performance of mutual funds, hedge funds, etc. Specifically, the information ratio is defined as excess return divided by tracking error. Excess return is the amount of performance over or under a given benchmark index. Thus, excess return can be positive or negative. Tracking error is the standard deviation of the excess return. The ratio compares the annualized returns of the fund in question with those of a selected benchmark (e.g, 3 month Treasuries). Since this ratio considers the annualized standard deviation of both series (as measures of risks inherent in owning either the fund or the benchmark), the ratio shows the risk-adjusted excess return of the fund over the benchmark. The higher the Information Ratio, the higher the excess return of the fund, given the amount of risk involved, and the better, the theory goes, a fund manager. The Information ratio is similar to the Sharpe Ratio, but there is a major difference. The Sharpe Ratio compares the return of an asset generally against the return of Treasury bills, but the Information Ratio compares excess return to the most relevant equity (or debt) benchmark index.

E. Alpha, Beta and Uncertainty

1. Key determinants of return and risk

a. Manager skill is the centerpiece of a hedge fund investment, value-added security selection, or the lack thereof, tends to make or break returns. The more an investor knows about the value a fund has produced above and beyond market movements and the more insight it can gain into the fund's future strategies, the more prepared it'll be to assess the uncertainties going forward.

b. With respect to market exposure, the name "hedge fund" notwithstanding, the returns of many of them are tied to some extent to market movements—in some cases, a *great* extent. The magnitude of a fund's market tilt has clear implications for a fund's risk/reward profile; knowing its dimensions is critical.

c. Investors can earn a cash rate of return on the proceeds from selling securities short. These proceeds are held as collateral for short positions and generate interest until the positions are closed.

2. Costs, Fees and Taxes

a. Fees in hedge funds are levied on both assets under management and profits, typically 10% to 30%, fees loom large for hedge fund investors.

b. Always a consideration for private investors, taxes can be particularly detrimental to hedge fund returns. Most hedge funds trade frequently and are notoriously tax-inefficient.

3. Alpha Today, Gone Tomorrow

a. In the introduction to hedge funds, we categorized hedge funds into two broad categories, market-neutral funds and directional funds.

(1) Market-neutral funds attempt to fully hedge out broad market exposure, whether in equity or fixed income. By fully hedging their position, they start out with a cash return—but all or most of their value added is dependent on alpha. Because they're not tied to market movements, their volatility is typically low. In fact, investors tend to think of market-neutral hedge funds as substitutes for a portion of their bond portfolios (a mistake, in our view).

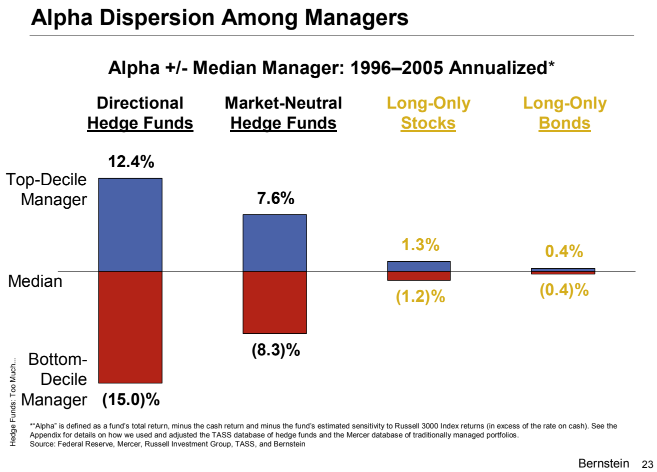
(2) Directional funds maintain some exposure to the market, so their returns combine alpha and beta to varying degrees, depending on the manager's strategy. Directional funds have higher volatility than their market-neutral counterparts and might be used as stock substitutes in an asset allocation.

b. If we strip out the portion of returns that were driven by broad market exposures or cash yields, we can estimate the alpha that has been produced by hedge fund managers over the 10-year period we analyzed.[228] We found that the median hedge fund manager did indeed produce superior

[228] We used a statistical technique called linear regression analysis to estimate the sensitivity of returns to the market and cash yields. The portion that is unexplained by those variables is considered alpha. Though funds may have had exposures to other market factors, we found their impact generally to be minimal. As proxies for market exposures we used three-month LIBOR (the London Inter-Bank Offered Rate) for the cash return and the Russell 3000 Index

results, generating an alpha of about 3% per year net of fees. Remember, this is in addition to the return generated by however much the fund was exposed to the markets. While 3% might not seem like much, it is actually an impressive result over these 10 years compared with the median traditional active manager, whose security selections marginally detracted from performance (approximately negative 0.4%).

c. Over the last 10 years, top-decile funds earned as much as 12 percentage points of alpha above the median (for a total alpha that exceeded 15%), while the bottom decile of funds posted dismal results. Traditional portfolios, on the other hand, have had a much tighter range of alphas. But as we've discussed, typically their strategy is to participate fully in the market; they owe most of their return to *beta*: the ups and downs of the market.



d. So how does a strategy that is far more reliant on alpha than on beta (the market) affect risk and return? For one thing, while losses can be severe over the short term in the stock market, they tend to turn positive over time, lifted by the long-term upward trend in corporate profits.

e. Although the alpha opportunity is enticing, it doesn't necessarily grow over time and isn't as dependable for several reasons:

(1) It's difficult to distinguish hedge fund managers with above- versus below-average skill;

(2) A given hedge fund strategy may temporarily fall out of favor or face increased competition (for example, see the discussion on convertible arbitrage discussed later in this outline); or

(3) Hedge funds as a whole may go through a rough patch.

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for the broad market.

4. When Alpha is Really Beta

a. Our research indicates that within the so-called market-neutral category we found that some strategies can have unexpectedly high sensitivity to the market, either directly or indirectly. We estimated, for instance, that over the 1996–2005 period, 42%—not far from half—of the return earned by the average event-driven hedge fund derived from a combination of market movements and market-related factors.

b. Consider merger arbitrage, a popular event-driven hedge fund strategy that seeks to make money by correctly forecasting whether or not a merger will successfully close while hedging exposure to day-to-day stock market movements. The strategy is theoretically market-neutral, but:

(1) It tends to do well or poorly in sync with the broad market, since merger activity booms in bull markets and dries up during downturns;

(2) It tends to go long smaller-cap stocks (the usual acquisition targets) and short-sell the larger-cap acquirers; and

(3) It typically has a value orientation because attractive acquisition targets are usually bargain-priced stocks.

5. Quantifying Alpha Uncertainty

a. In hedge funds, the variability in alpha can make a big difference in wealth accumulation. In the display below, we show a range of outcomes for a $1 million portfolio invested in the stock market on the one hand, and in the average hedge fund on the other, after 20 years. To generate the results, we simulated 10,000 market outcomes ranging from spectacular to dismal. In this analysis:

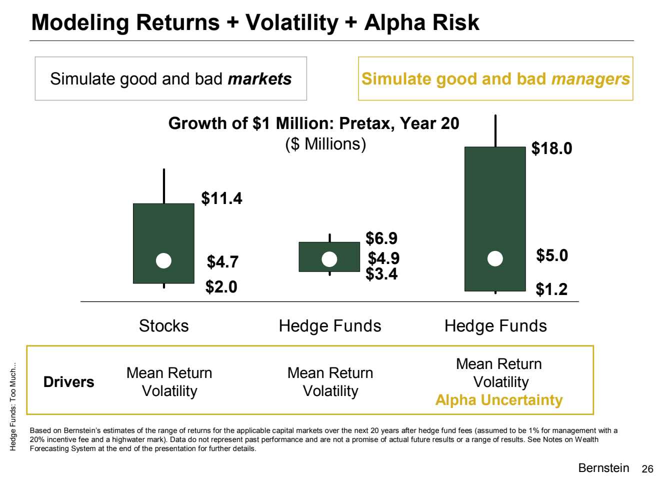
(1) We've used the standard return/risk metrics: average growth rate and volatility, which we assumed were 9% and 18%, respectively, for the S&P 500. Given those assumptions, we show our estimated results on "box-and-whiskers" charts that array the probability of outcomes from the 5th to the 95th percentiles—though we focus on the 10th, 50th, and 90th percentiles as proxies for the upside, median, and downside cases, respectively.

(2) The figures in the center present the same probability analysis for hedge funds, using the average return and volatility we measured over the past 10 years: 9% and 7%, respectively—stock-market-like growth with far less fluctuation.

(3) But we took our analysis a critical step further. The figures add additional hedge fund risk to the analysis: the uncertainty around a fund's ability to add alpha. Volatility simply measures short-term fluctuations around a mean return; uncertainty incorporates the concept that the mean itself might be significantly higher or lower than expected. Therefore, in half the scenarios we input into our model we bumped up the mean return to reflect superior alpha; in the other half, we dropped the mean by corresponding amounts.

b. After just one year, considering volatility as the sole metric for risk, when the market is strong the S&P 500 beats hedge funds; when it's weak, hedge funds outperform. That's just as you'd expect, since we've assumed that stocks grow at the same rate as hedge funds but with much more fluctuation. When we factor in alpha uncertainty (the rightmost bar), hedge fund risk increases—but not by very much. The downside outcome for hedge funds, which had been roughly $1 million when risk was measured only by volatility, declines by about another $100,000.

c. After two decades, though, the picture is entirely different. If alpha uncertainty is ignored, the spread of hedge fund outcomes is much tighter than the market's—implying a safer, more consistent investment. However, when hedge fund alpha risk is added, *both* upside and downside outcomes versus the market are magnified. That's because changing a portfolio's growth rate by several percentage points has a huge impact over time. We estimate an additional huge impact over time. We estimate an additional \$6½ million over the S&P 500 for investors fortunate enough to have selected top managers all along, but a shortfall of almost \$1 million if the managers were among the poorest. And what was a \$3½ million spread between good and bad hedge fund outcomes when volatility was the gauge widens into a \$17 million chasm.



6. Hedge Funds Are Not Protective Like Bonds

a. There's another aspect of hedge fund risk that may operate below the investor's radar, since the unstable behavior of hedge fund returns is not adequately captured by traditional measures. To appreciate the implications of that instability, we need to look at peak-to-trough loss and correlations in down stock markets. Peak-to-trough declines measure the size of losses, even if short-term, that investors have actually realized—and therefore should anticipate in their planning. Could they withstand the loss financially if they had to withdraw money at the wrong time? Could they tolerate the ups and downs emotionally? Downside correlation tests the durability of hedge funds as a diversifier during periods when the stock market declines—when protection against equity risk really counts.

b. Remember, over the 10-year period ending in 2005, market-neutral hedge funds had roughly the same level of volatility as bonds. But they experienced a peak-to-trough loss that was more than 2½ times the size of bonds, as measured by the Lehman Aggregate bond index (negative 3.6% for bonds and negative 9.8% for market-neutral hedge funds).[229]

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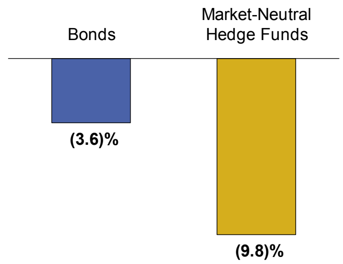
[229] Source: Lehman Brothers U.S. Aggregate Index, TASS and Bernstein.

Low Volatility Masks Full Downside Risk

Worst Peak-to-Trough Loss*
1996–2005



Hedge Funds: Too Much...

*Bonds are represented by the Lehman Brothers U.S. Aggregate Index. See "TASS Database" in the Appendix for details on our Market-Neutral Hedge Fund index.
Source: Lehman Brothers, TASS, and Bernstein

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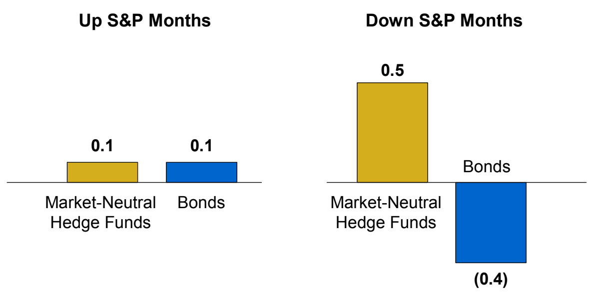
c. And correlations spiked upward for both directional and market-neutral strategies when the S&P 500 was down. That means they acted more like stocks when stocks moved lower. Meanwhile, bonds' negative correlation meant that when the stock market faltered, on average they posted gains. The data pointed to a clear conclusion—that bonds are a far more effective stabilizing force than hedge funds in a diversified portfolio.

More Like Stocks at Just the Wrong Times

Correlations to S&P 500*
1996–2005



Hedge Funds: Too Much...

*See "TASS Database" in the Appendix for details on our Market-Neutral Hedge Fund index. Bonds are represented by the Lehman Brothers U.S. Aggregate Index. Past correlations are not necessarily indicative of future results.
Source: Lehman Brothers, Standard & Poor's, TASS, and Bernstein

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7. <u>The Fall of Long Term Capital Management and Other Dark Possibilities</u>

a. While hedge funds can fare well in some broad stock market declines, they have often suffered when the financial system experienced a sudden disruption. Whether geopolitical or more limited in scope, these so-called systemic shocks tend to impact holders of the riskiest assets. A classic example of this occurred in the second half of 1998, when the Russian government defaulted on its bonds; this sent shock waves throughout the global financial system and triggered a rush out of risky assets as investors hastened into areas of the market deemed safest, such as Treasury bonds. Indeed, the S&P 500 lost 14½% in August 1998. Almost as quickly, however, the market recouped its loss.

b. Such quick recoveries are more likely when the landscape is the broad market. In contrast, hedge funds—especially those that are more concentrated or focused on illiquid or lower-quality investments—may be hard hit. Indeed, these types of hedge funds were hurt badly in the 1998 fray; some were even forced into liquidation, most notably the giant Long-Term Capital Management. Admittedly, this was an unusual event—but big bumps in the road aren't rare in hedge fund investing. So while some funds may be characterized as “low-risk,” investors should be aware of what that really means.

c. One of the potential clouds we see on the horizon is the burgeoning use of credit default swaps. These financial derivatives represented 85% of the securities outstanding in the $9 trillion global credit derivatives market as of 2006, and hedge funds are big players in the market. Credit default swaps allow counterparties to trade corporate credit risk in lieu of holding the actual bonds themselves. However, they also link the counterparties to one another. Should one or several counterparties on the losing side of a transaction be unable to pay the winners, a spiral of defaults could occur, causing a financial crisis (or simply fear that one is brewing). Regulators are taking steps to prevent counterparty risks from sparking the next financial crisis—but problems like these loom larger for hedge funds than traditional investments.

8. Fees and Taxes Can Be Corrosive

a. Further, hedge fund fees and—for taxable investors—taxes are key factors in analyzing hedge fund returns. While hedge fund fees come in many varieties, nearly all levy two layers: a percentage of the assets under management (like most traditional investments) and a percentage of the profit earned by the fund. The “classic” structure is 1% of the assets—with many funds charging 2%—and 10-30% of fund profits. “Highwater marks” are common, which eliminate all incentive (but not management) fees until investors recoup any losses.

b. When it comes to taxes, it’s not what the portfolio earns that counts, but what the investor keeps. Although the issue may not be relevant to institutions, it can be critical for a private investor. But hedge funds tend to be notoriously tax-inefficient for several reasons:

(1) For many hedge funds, frequent trading is the norm. The average annual turnover rate is 300%, making a significant portion of the average fund’s return subject to highly taxed short-term capital gains.

(2) Some popular hedge fund strategies, such as merger arbitrage, which attempts to capitalize on short-term price misvaluations between the stocks of an acquired and acquiring company, are by their nature tax-inefficient.

c. Other strategies—particularly long/short directional funds—can be managed with an eye to taxes by using techniques such as avoiding short-term gains, deferring long-term gains, and harvesting losses. Incorporating this type of tax awareness, our research finds, has the potential to reduce the annual tax bite of the average long/short fund from 35% of its return to about 15% without meaningfully lowering pretax results. But most hedge fund managers pay little attention to taxes.

F. Boom and Bust in Convertible Arbitrage

1. We have mentioned that certain strategies fall in and out of favour or attract so much capital that finding an edge to exploit becomes a problem. Convertible arbitrage (typically going long in a convertible bond and short-selling the common stock of the same company) is a perfect example.

2. Beginning in 1995, this strategy enjoyed several years of outsized returns (from 1995 to 2003 it made 12.9% annualized return) during a very favorable market environment. The result was a massive inflow of investor capital into this area and increased manager competition[230]

3. But while assets invested in convertible-arbitrage hedge funds were increasing exponentially, the convertible bond market itself was growing at a far slower pace. At one point, convertible arbitrage hedge funds were said to account for 70% of the daily trading volume of convertible bonds, a potentially dangerous concentration of hedge fund investors in a market that's fairly small. And indeed, by 2004 the large inflows of capital, coupled with deteriorating market conditions, took their toll, resulting in a sharp decline in performance: The 12.9% compound return generated by convertible hedge funds from 1995 through 2003 dwindled to 1%—and then to a 2% loss in 2005.

4. In the case of convertible arbitrage, what we witnessed was a hot market followed, almost inevitably, by capacity constraints. It's not that convertible arbitrage is by its nature a weak hedge fund strategy, nor are we taking a position about its prospects in the period ahead. One could argue that the downdraft has further to go—or that it's reached bottom. In fact, assets started to pour out of the strategy, and, as of mid-2006, there were some signs that the convertible-arbitrage market might be reviving. The point here is historical, not forward-looking. It's especially important for hedge fund investors to track movements like this, since a substantial number of hedge funds operate in narrow markets.

G. Fund of Funds

1. An investor who wants to diversify his hedge fund investments can go out on his own and select a group of funds he believes to be first-rate, or he can opt for the ready-made format, called a "fund of funds." With a fund of funds, a manager pools investor capital, collecting enough to give each investor access to multiple funds—often 20 or more. The selection of funds, which usually encompasses an array of strategies, is made by the fund of funds manager.

2. Funds of funds have become increasingly popular. Ten years ago, when measured by assets under management, funds of funds were dwarfed by direct hedge fund investments, but by the end of 2005 it's estimated that funds of funds had captured more than one-third of the dollars invested in hedge funds.[231] Their appeal is twofold: the potential for risk reduction through diversification and higher returns through superior manager selection. But does the strategy deliver on its promises?

3. A historical analysis indicates that the benefits of significant fund diversification are quickly marginalized when an investor's hedge funds are one component of an otherwise diversified portfolio. As for fund selection, most of the time it hasn't been robust enough for funds of funds to cover their costs.

[230] Source is HFR. In 1995 $0.7 billion was invested in convertible arbitrage strategies. By 2003, it had ballooned to $44.7 billion.

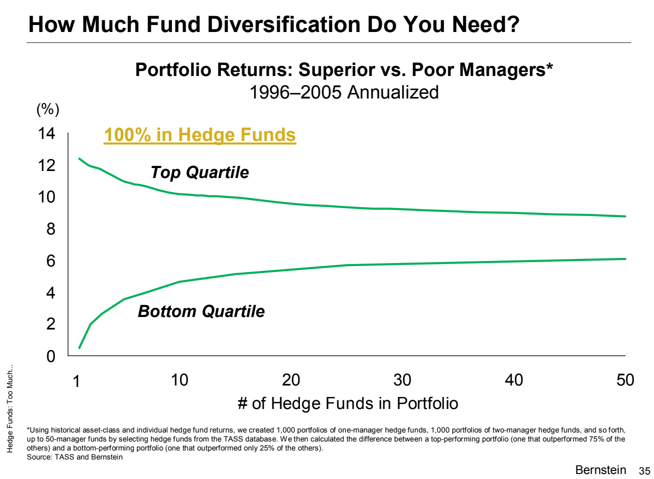
[231] Source is HFR. Another strategy that is gaining some traction today is the use of vehicles called "investable hedge fund indexes," established by several providers of hedge fund index returns. As in a fund of funds, investors still pay the fees to each of the managers in the index and another charge to the index manager (see page 19). Their performance to date has been poor; a 2006 study by Greenwich-Van Advisors reported that over the prior three years four major investable indexes underperformed the broad hedge fund indexes they were seeking to track, three of them by substantial amounts.

4. Too Many Funds and Over Diversification

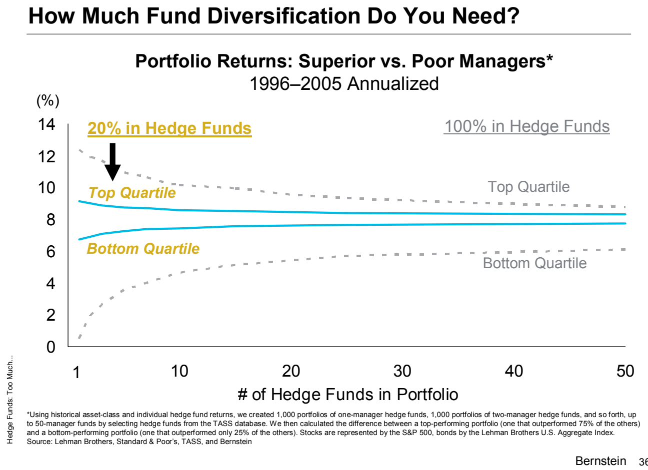
a. Now, diversification is not a bad thing; indeed, it's a tried-and-true tenet of investing. But few investors restrict their portfolios to hedge funds; their fund investments are one component of an already diversified mix. It's one thing to spread your money among 20 managers if your portfolio consists solely of hedge funds. But if only 20% of your total portfolio is in hedge funds—a more reasonable allocation for many investors—the advantage of owning 20 funds is much diminished.

b. To evaluate the benefits of diversification, we simulated portfolios of one-manager hedge funds, two-manager hedge funds, three-manager hedge funds, and so forth (up to 50 managers), using the historical returns of the hedge funds in the TASS database. We then sorted each of our sets of portfolios from best to worst and calculated the difference in return—the return dispersion—between the top- and bottom-quartile performers. What we wanted to see was how much the return differential would have been reduced by investing successively in more and more funds. The steeper the slope of the line, the more beneficial diversifying with additional funds would be.

c. We considered two allocations: one wholly in hedge funds, the other a mix 20% in hedge funds, 40% in stocks, and 40% in bonds. For both the all-hedge-fund and balanced portfolios, adding more funds reduces the dispersion in portfolio returns—but the two lines in Display 16 are markedly different. When hedge funds are viewed as a stand-alone investment, nearly 20 managers are needed before the curve begins to flatten (at which point additional managers have only a marginal impact). Even just by moving from one to two managers, return dispersion was reduced by more than three percentage points.



d. But when hedge funds represent a relatively small portion of an overall portfolio they don't add much risk to begin with, and the dispersion curve flattens quickly. Going with a few funds rather than just one could be a good strategy for reducing the uncertainty of returns—but adding *more* than a few would likely provide only marginal benefit, as is illustrated below:



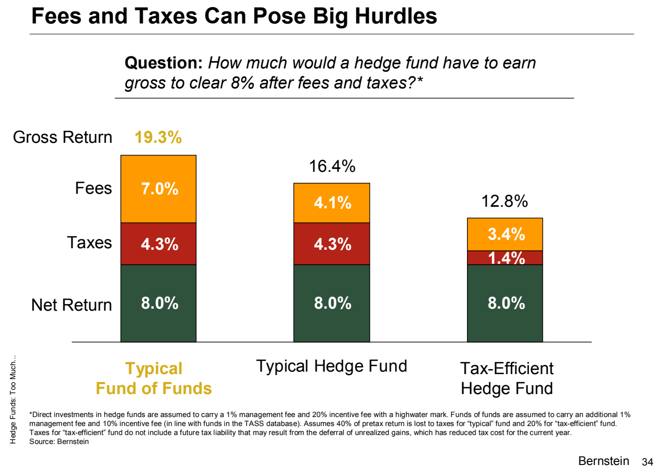
5. Fee Problem Magnified

a. On the other hand, if funds of funds can deliver on their other promise—above-average performance driven by superior manager selection—then any additional diversification benefit is icing on the cake. However, our research found that while there are certainly some excellent fund of funds managers in the marketplace, on average they've failed to deliver additional return. In fact, over the last 10 years the compound pretax return of a fund of funds composite (7.4% annualized return) would have been 1.5 percentage points lower than our hedge fund composite (8.9% return).[232]

b. The reason why funds of funds have not fared well overall has to do with their multiple fee structure. They usually add two more cost tiers: management and, in many cases, performance-based fees to the fund of funds manager on top of those paid to the underlying funds. (However, the incentive fee to the manager is more typically 10%, not 20%, of the profits.) These extra layers of fees raise the bar for a fund of funds. Further, funds of funds are unlikely to mitigate the tax burden, especially since the investor has ceded the power to select tax-efficient managers.

c. Combining both cost and (for taxable investors) the effect of taxes the display below shows how much a portfolio manager would need to earn gross in order to generate 8% return after fees and taxes. The hurdle is highest for funds of funds; their managers need to pick not just better-than-average funds to produce incremental return, but among the very best.

[232] TASS and Bernstein.



d. Is Diversification a Mistake?

(1) Are we saying that every hedge fund investor is best served by simply sticking to one or a couple of funds? Clearly not; a hedge fund investment, like any other, needs to be tailored to the investor's overall portfolio and long-term goals. However, given the marginal utility of successively adding hedge funds, we counsel caution when it comes to paying a significant cost for diversifying within hedge funds. One alternative, growing in popularity, is a so-called "multi-strategy" hedge fund, which diversifies not by hiring a group of external managers but by adopting and dynamically allocating among multiple strategies in-house. For example, such a fund might simultaneously utilize long/short equity, merger arbitrage, and convertible arbitrage strategies. Since multi-strategy funds manage their money in-house, their managers have a full view of all the positions held across all the strategies. That, in turn, allows them to take a more integrated approach to risk management and a more active stance on tax efficiency. Further, multi-strategy funds don't add the additional layers of fees associated with funds of funds. However, the technique is not without its risks. Investors are still dependent on the manager, who may or may not be successful in overseeing such a complex framework and in choosing the best strategies or the best securities at any given time.

(2) Regardless of whether an investor chooses a single-strategy fund, a multi-strategy fund, or a fund of funds, most important in our judgment is setting his sights on all the building blocks of return. These components include the ability of a manager to deliver a performance premium through active security selection, the degree of leverage used, the portfolio's exposure to market return sources, and the fee and tax costs that will detract from performance. While, clearly, there's no infallible guide to selecting a superior hedge fund manager, there are signs that investors should focus on: Does the manager inspire confidence that he has competitive strengths? Does he have the right team in place? A strong history? Can he articulate his strategy? Does he have a sound operational, trading, and reporting infrastructure in place? Are the risks he takes reasonable in relation to the return he's seeking? Still, even the best due diligence an investor can perform doesn't provide any guarantees. Ultimately, allocation is the pivotal decision for a hedge fund investment—as it is for all investing: whether to include hedge funds in a portfolio, and if so, to what degree.

H. Tailoring Hedge Fund Allocation

1. Arriving at a prudent hedge fund allocation geared to improve the investor's overall risk/return trade-off requires that each investor's unique circumstances be evaluated. While there will always be some art to this science, we have developed a framework that can be customized to each investor and that takes into account issues such as the uncertainty of the manager performance premium

and the specific market exposures unique to the manager's strategy. Our framework for determining allocation can be summarized by four main principles:

a. Limit allocation to no more than the investor's "excess capital."

b. Vary allocation based on risk tolerance; high-risk investors should be willing to tolerate more alpha uncertainty than low-risk investors.

c. Evaluate the potential impact of various allocation alternatives on the investor's long-term wealth.

d. Allocate hedge funds as a substitute for investments with similar volatilities and market exposures—which may not be as transparent as it seems.

2. <u>Begin with Excess Capital</u>

a. In our view, given the varied risks of hedge funds, investors should commit only capital that's not critical to their future spending needs. To quantify "excess capital," it's important to understand each investor's total financial picture—her assets, risk profile, income and expenses, and time horizon. Investors also need to bear in mind that hedge funds typically have limited liquidity; withdrawals can be made only periodically.

b. It's important that an allocation model be stress-tested, because if a hedge fund would put the investor's lifestyle in jeopardy in bad times, it's not a suitable investment. But in general, the higher an investor's net worth and the lower her spending needs, the greater the share of her total wealth that could be deemed "excess capital"—and hence available for a hedge fund allocation.

c. For example, consider an investor with $10 million in assets who is spending $300,000 per year (growing with inflation) and has a 20-year investment horizon. Our wealth-forecasting models suggest that as much as 34% of his total wealth could be deemed excess capital, while another investor—also with $10 million, but who is spending $450,000 per year—should consider only 7% of his wealth as his excess capital. A third investor—again with the same means but who is spending $550,000 a year—would have no excess capital available. But determining how much an investor can afford to allocate is just the starting point—the upper limit, as it were, of a hedge fund allocation. There are other key factors to consider, driven by the trade-off between the return potential of hedge funds and their multiple dimensions of risk.

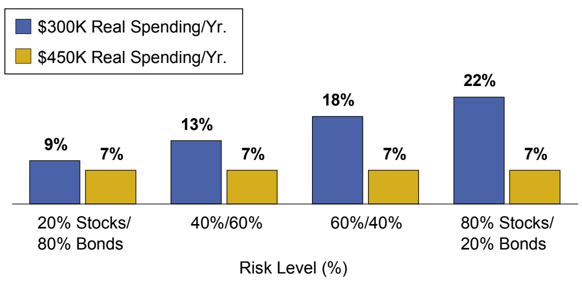
3. <u>Factoring In the Investor's Risk Profile</u>

a. Let's return to our investor who is spending $300,000 per year out of his $10 million. Assume that hedge funds fit his risk/return profile and that he's looking at a combination of two directional funds—one low in market exposure and volatility, the other high.

b. The recommended allocation would vary substantially—determined not so much by the volatility of the funds but by the investor's comfort level with risk, as illustrated in the display below. If his tolerance for risk is very low—indicated in this case by an overall portfolio 80% in bonds with the rest in stocks—a hedge fund allocation in the range of 5% to 10% might be the best course of action. He probably shouldn't invest more—since even the low-volatility fund has the potential for large performance dispersion, as measured by our alpha uncertainty factor. An investor with a larger appetite for risk—say he owns a portfolio 80% in *stocks*—would be willing to allocate far more to these two funds: Our analysis points to as much as 22%. For a moderate risk level, as indicated by a 60/40 mix of stocks and bonds, an allocation of just about 18% is recommended. However, if the investor is spending $450,000 per year and hence has less excess capital at his disposal, our analysis recommends allocating no more than 7% of his assets to the hedge funds—no matter how high his risk tolerance. In setting a hedge fund recommendation, spending and liquidity needs trump risk tolerance, as important a factor as that is.

Determining an Allocation: By Risk Profile and Spending

Recommended Hedge Fund % of Portfolio*
$10 Mil. Investment; 20-Year Time Horizon



Hedge Funds: Too Much...

*Hedge fund recommendations are sample recommendations based upon the characteristics of one specific investor and should not be construed to represent the appropriate allocation for every investor. See "Hedge Fund Allocation Recommendations" in the Appendix for details on the allocation process and its limitations.
Source: Bernstein

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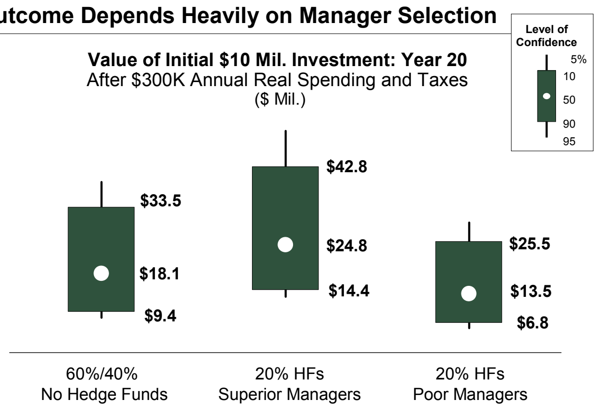
4. <u>Evaluating the Long-Term Impact on Wealth</u>

a. It's important for investors, both private and institutional, to be comfortable with the range of potential outcomes that a large allocation to hedge funds may bring. Returning to our hypothetical investor with $10 million in assets and $300,000 in annual real spending needs, let's assume a 60/40 risk profile.

b. The leftmost box in the display below presents our estimated range for the investor's projected wealth in 20 years' time if he owned no hedge funds in a classic 60% stock/40% bond indexed portfolio. The second two boxes shows the range if his 60/40 portfolio included a 20% allocation divided between two directional hedge funds, one with low volatility and the other high volatility. Were the investor able to select funds that posted above-average alpha, his wealth outcome would improve dramatically versus eschewing hedge funds: $7 million more in the median case, almost $12 million on the upside, and an incremental $5½ million cushion on the downside. On the other hand, if the selected funds were led by managers who generated below-average alphas, the investor's wealth would be far lower.

Outcome Depends Heavily on Manager Selection



Hedge Funds: Too Much...

Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years after hedge fund fees (assumed to be 1% for management with a 20% incentive fee and a highwater mark). In the "superior-managers" and "poor-managers" scenarios, we assumed that the hedge funds generated alphas above and below the historical average, respectively. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System at the end of the presentation for further details.

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c. As we've said, manager performance is the key to hedge fund success. Indeed, if an investor has no reason to believe he can choose a superior manager, he should probably forgo an allocation to hedge funds. The rationale for this strategy would be even stronger if the hedge fund manager paid no attention to taxes.

5. <u>How Should Hedge Fund Allocations Be Sourced?</u>

a. Once an investor has decided on the size of a commitment to a hedge fund, the sourcing of the allocation must be determined. The investor's goal normally will be to keep the volatility of her portfolio close to what it was without any hedge funds, and to avoid any unintended exposures to market and other risk factors.

b. For example, a $1 million allocation to a global long/short equity manager with 50% stock market exposure and a value orientation would ideally be funded with $500,000 from a long-only global value portfolio and $500,000 from a fixed income portfolio—or from portfolios as close as possible to those constructions.

6. <u>Customize</u>

a. Finally, hedge funds can provide meaningful opportunities for either adding return potential and/or reducing traditional risk—volatility—for qualified investors with excess capital. But as we've emphasized, hedge funds entail their own risks—mostly connected with the vagaries of manager performance and hedge fund sensitivity to market shocks. Investors should understand the nature and magnitude of these risks before earmarking an allocation to hedge funds.

b. In practical terms, they need to be aware of how widely the returns of individual hedge fund managers can vary, as well as their strategies. Investors can't change a manager's strategy—and the resources at their disposal for selecting a top performer (or a top fund of funds manager) are clearly limited. Indeed, for too many investors, picking a hedge fund is chasing yesterday's star. But the prudent investor considering hedge funds should amass the best information he can—as is the case in all investment decisions. He should utilize the resources of an established investment manager.

c. And of primary importance, the prudent investor should evaluate the funds in light of his overall portfolio.

d. Once an investor buys into a hedge fund, its performance should be monitored regularly—even if the manager's strategies aren't always transparent or the fund's liquidity is limited; in fact, regular monitoring is even more important in those circumstances. With a comprehensive plan of that nature in place, investors are more likely to reap hedge funds' considerable upside.

IV. <u>CONCLUSION</u>

A. It seems clear that hedge funds have become and will continue to be an important part the investment landscape. Because hedge funds are investment strategies, rather than traditional asset classes, they have their own idiosyncratic risks (and rewards for that matter). However, they have shown to be important components of return and diversification, particularly in the right proportion and with the right mix of traditional assets.

B. From a tax standpoint, just as each hedge fund has its own set of investment tools and strategies, the taxation of hedge funds is different form fund to fund. As tax advisers, in order to fully evaluate the tax consequences of investing in a particular hedge fund, the tax adviser must have an intimate knowledge of how the hedge fund is formed, the ownership interest taken by the investor and the particular strategies and financial instruments used by the hedge fund. Unfortunately, many hedge funds are "black boxes" and do not give information on the particular strategies and instruments utilized.