WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

MITIGATING TAX RISKS OF HEDGE FUND INVESTMENTS IN LOANS

The tax risks for offshore hedge funds of investing in loans, whether directly or through derivatives, are attracting more attention. (See, for example, "Hedge Funds See Tax Issue," *Wall Street Journal*, page C2, January 5, 2007.) We understand that these investments are also playing a larger role in funds' arbitrage strategies in the credit-derivatives markets.

Offshore hedge funds have been making these investments for years and generally take the position that the activity does not constitute a US trade or business and therefore does not result in US taxation. The funds rely on a special safe harbor rule that trading in stocks and securities by non-US persons, even if conducted in the United States, is generally not treated as constituting a US trade or business. By contrast, there is a substantial risk that regularly negotiating and originating loans in the US does constitute a US trade or business, and that the income and gain from such a business is subject to an effective federal tax rate of up to approximately 55% when earned by a non-US corporation (such as an offshore hedge fund). Engaging in a US trade or business also requires the filing of US tax returns.

Because of this risk of US taxation, most offshore hedge funds investing in loans avoid regularly originating loans. They instead invest in loans either by purchasing the loans in a secondary market or investing in derivatives on the loans. Such funds also usually take steps to minimize the risk that the seller or counterparty in these transactions might be treated as their agent, which would potentially result in the loan-origination activity of the agent being attributed to the fund, causing the fund to be treated as engaged in a US trade or business. The tax risks associated with these loans vary depending on the type of loan being made, how its terms are established, the amount of the loan held by other investors and who earns the profit from the origination work. There is a wide range of practices among funds for avoiding being treated as engaged in a loan-origination business.

The Internal Revenue Service has been aware of the issue for some time but has not provided specific guidance in the area. In the fall, the IRS added lending by foreign investors to the list of tax issues that it aims to address in future guidance.

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We regularly advise hedge funds on this issue and have helped them develop procedures appropriate to their circumstances for minimizing the risk of US taxation. If you have questions on these issues, please contact James R. Brown (212-728-8287, jbrown@willkie.com), Richard L. Reinhold (212-728-8292, rreinhold@willkie.com), Joseph A. Riley (212-728-8715, jriley@willkie.com), or the attorney with whom you regularly work.

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January 8, 2007

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