# FUNDS OF HEDGE FUNDS: INTERNAL REVENUE SERVICE RULES THAT ADVISORY FEES OF A FUND OF HEDGE FUNDS ARE INVESTMENT-RELATED EXPENSES EVEN IF LOWER-TIER FUNDS ARE TRADER PARTNERSHIPS

Recently, the Internal Revenue Service issued Revenue Ruling 2008-39, which generally treats advisory fees paid by a fund of hedge funds as "investment expenses" for tax purposes, thereby subjecting their deductibility to the limitations applicable to "miscellaneous itemized deductions." Under the Ruling, this conclusion does not depend on whether or not the fund of hedge funds invests exclusively in funds that are themselves viewed as "trading" -- rather than investing -- in securities. The Ruling addresses only structures involving upper-tier and lower-tier funds classified as partnerships for tax purposes.

## Background

Investors taxed as individuals are generally permitted to deduct expenses incurred (1) for the production of income or (2) in connection with a trade or business. However, the first type of expense, which includes most expenses incurred in connection with an investment activity (as opposed to a trading activity), is treated as a miscellaneous itemized deduction, the deductibility of which is limited. For example, miscellaneous itemized deductions are allowable only to the extent they exceed two percent of an individual's adjusted gross income, are subject to certain overall limitations on itemized deductions, and are not allowable for alternative minimum tax purposes, with a number of states also limiting or disallowing such deductions. By contrast, trade or business expenses (including those incurred in connection with trading in stocks and securities) are not subject to these limitations.

Generally, if a partner invests in a partnership engaged in a trade or business, the partner's share of the partnership's expenses incurred as part of that trade or business is treated as trade or business expenses in the hands of the partner. The Ruling confirms the application of that rule to expenses of investment partnerships and, more importantly, addresses the treatment of expenses incurred by a partner in connection with the partner's investment in a partnership in circumstances where the investee partnership is engaged in a trade or business and the partner is not so engaged other than in the partner's capacity as a partner of such partnership.

## General Scope of Revenue Ruling 2008-39

Rev. Rul. 2008-39 describes a fund of hedge funds structure in which an investment partnership (the "upper-tier partnership") has as its only activity the buying, holding and disposing of interests in other investment partnerships (the "lower-tier partnerships") and is not otherwise engaged in a trade or business. The lower-tier partnerships, however, each trade securities so extensively that their trading activities constitute a "trade or business" for tax purposes. The fund of hedge funds and all of the lower-tier partnerships pay investment advisory fees, computed as a percentage of their assets, to their respective investment advisors. The upper-tier partnership's advisory fee is not paid on behalf of any of the lower-tier partnerships.

The Ruling concludes that the advisory fees paid by the lower-tier partnerships are fully deductible trade or business expenses of those partnerships. The upper-tier partnership's share of the advisory fees of the lower-tier partnerships is treated as trade or business expenses instead of miscellaneous itemized deductions.

The Ruling, however, treats differently the upper-tier partnership's own advisory fee expenses. These expenses, it concludes, are miscellaneous itemized deductions, based on the fact that the upper-tier partnership (1) is engaged in an investment activity (instead of a trade or business) and (2) does not incur those expenses on behalf of the lower-tier partnerships in connection with its trade or business. The Ruling articulates the view that only activities of the upper-tier partnership are taken into account in determining the tax treatment of payments incurred at that level. This view is by no means clear under existing authorities and is at variance with the so-called "aggregate" concept of partnerships that the Service has pressed for in numerous circumstances, in order to curb perceived abuses that arose from treating a partnership as an entity. As a result, the validity of the Ruling seems open to question. Nonetheless, many fund managers and investors may determine to follow the Ruling's position rather than take on the risk of dispute with the Service over amounts that may not be material.

**Limitations of Revenue Ruling 2008-39**

The Ruling implies that its conclusion does not apply to expenses incurred by an upper-tier partnership on behalf of a lower-tier partnership engaged in trader activities, at least in some circumstances. In our view, consistent with the Ruling, there are many common structures in which expenses paid by an upper-tier partnership should be treated as trader expenses (assuming the lower-tier partnership is a trader). We believe that this treatment depends on the connection of those expenses to the lower-tier partnership's trading activity and basis for the upper-tier partnership payment of the expenses.

For example, we would expect that investment advisory fees of most master-feeder partnerships (*i.e.*, arrangements whereby "feeder" fund partnerships invest substantially all their assets in a single "master" fund partnership) ought to be properly regarded as trade or business expenses, provided that the master fund is a trader, regardless of whether those expenses are paid by the master fund or the feeder fund. We also believe, however, that partnership expenses other than advisory fees warrant special consideration. For example, expenses specific to an upper-tier partnership's separate existence, even if paid by a lower-tier partnership that is part of a master-feeder, should be carefully scrutinized before concluding that they are expenses connected to the lower-tier partnership's trade or business and therefore not treated as miscellaneous itemized deductions of the upper-tier partnership under the Ruling.

In some cases, it may be possible to avoid the result of the Ruling if the upper-tier fund is a non-US corporation, though investing in such an entity may present other tax disadvantages.

Irrespective of whether the Ruling is ultimately determined to be valid, the government's position in the Ruling will have to be reckoned with in most if not all tiered-partnership structures. While in many cases settled planning for investment funds will need no adjustment, the government's attention to the area, and the Ruling's possible impact on development of the law, will no doubt affect future planning and fund tax disclosure. Consideration also will have to be given to the possible need for tax return disclosure in situations in which the validity of the Ruling is being challenged.

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