

# Being in the Spotlight Is not Always a Good Thing: Recent Tax Developments that Impact Hedge Funds

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Increased attention has been directed at the tax situation of the alternatives industry since control of the U.S. Congress shifted in January. Given the nature of some recent proposals, it is clear that it is not always good to be the center of attention.

## Proposed Limitations on Deferred Compensation

A provision of the Senate's Small Business and Work Opportunity Act of 2007 (the "Small Business Act") would limit deferred compensation to US\$1 million, with certain modifications. While the Senate proposal is intended to affect executive compensation across all industry lines, this modification to IRS Code Section 409A would have a substantial impact on hedge funds that have deferred compensation arrangements, and may cause these funds to change their compensation structure from a deferred fee to an incentive allocation. As currently drafted, the provision limits the total amount of deferred compensation to the lesser of US\$1 million or the individual's average taxable compensation for the previous five years.

On March 14, 2007, the House Ways and Means Committee held a hearing on the Small Business Act and the deferred compensation provision was subject to harsh public criticism, largely because the deferral limitation relating to average taxable compensation would affect many individuals, including those not usually considered to be highly compensated.

The House passed its own version of small business tax incentives, but its bill did not include a comparable provision on deferred compensation. Until differences between the House and Senate bills are resolved in the conference committee, it is impossible to predict whether the proposed cap on deferred compensation will become law and, if so, what its effective date would be.

Several key Capitol Hill policymakers have cautioned that, while the Senate provision raises several technical concerns, there does appear to be significant bipartisan interest in a cap on annual deferred compensation elections to offset tax relief legislation under consideration. If not included in the pending small business tax bill, a deferred compensation cap could reemerge as an offset for other tax legislation this year.

## Speculation Regarding a Proposal to Change the Tax Treatment of Certain Partnership Interests

The Senate is considering drafting a proposal that would recharacterize from capital to ordinary income the tax treatment of partnership-carried interest, where income is received in exchange for services rendered. Such a proposal would have a negative impact on hedge funds, although not as significant as its potential effect on private equity funds.

If all hedge fund incentive allocations were taxed at ordinary income tax rates, the ability to recognize long-term capital gains from incentive allocations may be eliminated. There also is the potential that a partner's entire incentive allocation would be subject to current taxation, including the amounts attributable to unrealized gains.

For a partnership that qualifies as a trader in stocks and securities, changing the tax treatment of an incentive allocation is likely to have little impact on the limited partners because ordinary income paid to a general partner as an incentive fee could be netted against ordinary income allocable to the limited partners.

However, an individual who has invested in a private equity fund or "investor" partnership would be further disadvantaged because an ordinary deduction attributable to incentive fees would likely be subject to the 2 percent limitation on miscellaneous itemized deductions.

This type of proposal would have an effect that would be the reverse of the deferred compensation cap proposal. While the deferred compensation provision may cause funds to change their compensation structure from a deferred fee to an incentive allocation, the benefits of such a conversion would be

mitigated if the profits were taxed at ordinary rates of income. Thus, hedge fund principals and general partners may not be able to avoid current taxation, at ordinary rates, on income received in exchange for services rendered.

It is not clear whether these tax changes will be enacted into law. Given that both the House and Senate are operating under rules that require all new legislation to be revenue-neutral, the House Ways and Means Committee and the Senate Finance Committee are expected to consider a range of new revenue raisers this year to offset the cost of future tax relief legislation.

## Guidance for Tax-Exempt Investors in Hedge Funds

On the bright side for hedge funds, the Internal Revenue Service has provided much-needed guidance to tax-exempt investors in hedge funds making protective tax shelter disclosures on Form 8886.

Notice 2007-18, 2007-9 I.R.B. 608, was released on February 7, 2007. As part of the Tax Increase Prevention and Reconciliation Act of 2005, Congress enacted Code Section 4965. Under this section, a tax-exempt entity deemed to be a party to a prohibited tax shelter transaction will be subject to excise taxes with respect to proceeds received after August 15, 2006.

Notice 2007-18 generally provides that a tax-exempt entity will be deemed to be a party to a prohibited tax shelter transaction if it: (1) facilitates the transaction by reason of its tax-exempt, tax-indifferent or tax-favored status, or (2) is identified in published guidance by type, class or role as a party to a prohibited tax shelter transaction. The Notice clarifies that merely being a limited partner in a fund that reports on Form 8886 that it has entered into a swap transaction that is the same or substantially similar to the swap transaction identified as a listed transaction in Notice 2002-35, 2002-1 C.B. 992, will not cause a tax-exempt partner to be considered to be a “party” to a prohibited tax shelter transaction. ■

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