Seward & Kissel LLP

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MEMORANDUM TO OUR CLIENTS

TAX TREATMENT OF MANAGEMENT FEES FOR "FUND-OF-FUNDS"

Introduction

The Internal Revenue Service (the "IRS") recently issued Revenue Ruling 2008-39 (the "Ruling") concerning the deductibility of management fees paid by a domestic fund-of-funds ("FOF") directly to its investment manager where the FOF invests all of its assets in other domestic investment partnerships ("Underlying Funds") that are treated as "traders" in securities for federal income tax purposes. As discussed below, the particular tax issues involved in the Ruling are (i) whether the management fees paid by the FOF are deductible by the non-corporate limited partners of the FOF (the "LPs") as business expenses or as "miscellaneous itemized deductions", and (ii) the tax treatment to the LPs of the management fees paid by the Underlying Funds to their own investment managers.

Background

In general, expenses incurred in carrying out a trade or business (such as trading securities) are deductible under Section 162 of the Internal Revenue Code of 1986, as amended (the "Code"). In contrast, expenses connected with mere investment activities (such as investing in securities) are investment expenses deductible by non-corporate taxpayers under Code Section 212. Investment expenses deductible under Code Section 212 are treated as "miscellaneous itemized deductions".

The "miscellaneous itemized deductions" of an individual are subject to certain limitations on deductibility. For example, "miscellaneous itemized deductions" are deductible with respect to any taxable year only to the extent that they exceed 2% of the individual's adjusted gross income for the year (the "2% Floor"). In addition, the amount of itemized deductions otherwise allowable for an individual whose adjusted gross income exceeds a threshold amount (for 2008, $159,950 for most taxpayers) is reduced by the lesser of (i) a percentage (which for 2008 is 1%) of the excess of adjusted gross income over such threshold amount, or (ii) a percentage (which for 2008 is 26.67%) of the amount of itemized deductions otherwise allowable. Also, the amount of "miscellaneous itemized deductions" in excess of the 2% Floor is considered a tax preference item in computing an individual's alternative minimum tax. In contrast, business expenses deductible under Code Section 162 are not subject to these limitations on deductibility.

Facts of the Ruling

An individual LP owned an interest in a FOF that owned limited partnership interests in several Underlying Funds. Each Underlying Fund was engaged for federal income tax purposes in the business of trading securities (as opposed to investing in securities). The

FOF's activities consisted solely of acquiring, holding and disposing of interests in the Underlying Funds. The Ruling assumes as a fact that such activities of the FOF, without regard to the activities of the Underlying Funds, did not constitute a trade or business of the FOF for federal income tax purposes. The FOF and each Underlying Fund paid asset-based management fees to their respective investment managers. The Ruling stated that the management fees paid by the FOF were expenses relating to its own activities and were not expenses incurred by the FOF on behalf of the Underlying Funds.

Conclusions Reached in the Ruling

The Ruling holds that, because (i) the FOF itself was not engaged in a trade or business for tax purposes, and (ii) the management fees paid by the FOF were not expenses incurred by the FOF on behalf of the Underlying Funds in carrying on their business (i.e., trading) activities, the management fees constituted expenses deductible by the individuals LPs under Code Section 212.

The Ruling also holds that the management fees paid or incurred by an Underlying Fund (including the FOF) constituted business expenses that are deductible by the Underlying Fund under Code Section 162 in computing its taxable income or loss that is reported to the partners of the Underlying Fund (including the FOF). Therefore, the FOF's distributive share of these management fees are also effectively treated as business expenses by the FOF for purposes of computing the FOF's annual taxable income that it reported to its own partners.

Impact of the Ruling

Under the facts assumed in the Ruling (e.g., the FOF was not itself engaged in a "trade or business" for tax purposes), the Ruling expresses the official litigation position of the IRS that the management fees paid by a FOF to its own investment manager are subject to the various limitations on deductibility that the Code imposes on the "miscellaneous itemized deductions" of non-corporate taxpayers. The Ruling does not, however, represent legally binding authority that precludes any particular FOF (or any other multi-tier partnership structure) from taking the position that its own management fees constitute, in whole or in part, business expenses. Nevertheless, the issuance of the Ruling puts taxpayers on notice that the IRS will challenge any such position by a FOF with the same or very similar fact pattern as contained in the Ruling if it were to audit the FOF's tax returns.

Further, although the first holding of the Ruling only addresses the deductibility of management fees paid by a FOF, it seems reasonable to conclude that the IRS would apply the analysis contained in the Ruling to other expenses (such as legal and accounting expenses) directly incurred by a FOF. In light of the Ruling, there may be certain steps that a FOF may want to consider to minimize the impact of the ruling on the non-corporate LPs of the FOF.

If you have any questions regarding this Memorandum, please contact Dan Murphy (212-574-1210), Peter Pront (212-574-1221), Ron Cima (212-574-1471) or Jim Cofer (212-574-1688) of our Tax Group.

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