The IRS recently released a revenue ruling addressing the tax treatment of management fees paid by a fund of funds (i.e., a fund that invests in other funds). Revenue Ruling 2008-39 involves an individual who owns a limited partnership interest in an upper tier partnership (UTP). UTP owns limited partnership interests in several lower tier partnerships (LTPs). UTP and the LTPs each pay annual management fees to their respective managers based on a percentage of the value of their assets.

The ruling states that for tax purposes, each LTP is a “trader” -- i.e., engaged in the business of trading in securities. On the other hand, the UTP’s activities consist solely of acquiring, holding and disposing of interests in the LTPs, which the ruling states does not rise to the level of a trade or business for tax purposes. That is, the UTP is considered an investor, not a trader, for tax purposes. In general, whether a partnership is considered a trader or an investor will largely depend on the partnership’s level of portfolio turnover and types of portfolio transactions.

For an individual, the distinction between being invested in a pass-through entity that is a trader and one that is an investor is critical. A trader can deduct its expenses under section 162 of the Internal Revenue Code, whereas an investor can only deduct its expenses under section 212 of the Code. Section 212 of the Code allows a deduction for expenses incurred in the production of income. However, expenses deductible under section 212 of the Code are treated as miscellaneous itemized deductions, and thus generally are deductible only to the extent that such expenses exceed two percent of an individual’s adjusted gross income. Miscellaneous itemized deductions may be further limited by the reduction in itemized deductions required where an individual’s adjusted gross income exceeds a certain threshold. Finally, miscellaneous itemized deductions are not deductible for alternative minimum tax purposes. Expenses deductible under section 162 of the Code are not subject to the same limitations.

The ruling concludes that the management fee paid by an LTP is a trade or business expense under section 162 of the Code. Therefore, an individual partner can deduct his or her allocable share (passed through the UTP) of such expense, without limitation, in computing his or her allocable share (passed through the UTP) of an LTP’s income or loss. This conclusion is straightforward.

Of more interest is the ruling’s conclusion with respect to the management fee paid by the UTP. According to the ruling, since the UTP is not itself a trader, and since the management fee is not paid on behalf of any LTP in connection with such LTP’s trade or business, the UTP’s management fee must be deducted under section 212 of the Code rather than Code section 162. Therefore, the UTP management fee is subject to the...
limitations applicable to miscellaneous itemized deductions described above, resulting in potentially adverse tax consequences for an individual limited partner.

If the IRS were to extend the reasoning in the ruling to hedge funds using a master-feeder structure, management fees paid at the domestic feeder fund level could be treated as miscellaneous itemized deductions, even if the master fund engaged in sufficient trading to be classified as a trader. We are available to discuss this and other implications of the ruling with you.

For Further Information

Please contact any of the attorneys below to discuss further the information covered in this alert.

Kenneth J. Slutsky, Esq.
973 597 2510
kslutsky@lowenstein.com

Marie T. DeFalco, Esq.
973 597 6180
mdefalco@lowenstein.com

Brian A. Silikovitz, Esq.
973 597 2562
bsilikovitz@lowenstein.com

Richard J. Horne, Esq.
646 414 6854
rhorne@lowenstein.com

Lowenstein Sandler’s Investment Management Practice Group will continue to monitor and report on developments regarding the issues affecting private investment funds and other matters of interest to our clients.