Hedge Fund Capital Accounts and Revaluations: Are They Section 704(b) Compliant?

THOMAS GRAY

Hedge funds treated as partnerships for federal income tax purposes should carefully consider whether they are in compliance with the capital account maintenance rules when there is a revaluation of fund property.

When reviewing a partnership agreement, the same questions generally come up. Will the allocations be respected? Are the partners receiving at liquidation what they bargained for? The structure of many partnership agreements follows similar patterns, but partnership agreements of hedge funds stand out. One of the interesting things about hedge fund agreements is the determination of profits and losses and how such determination affects the capital accounts of the partners.

TYPICAL HEDGE FUND STRUCTURES

Generally, hedge funds are private investment funds that are run by professional investment managers. Investors contribute their funds to the hedge fund in return for equity in the fund. The managers of the hedge fund in turn invest those contributions in a variety of positions, usually long-short positions, and will also employ leverage in order to maximize returns. The investments can range from publicly traded stock to very sophisticated, exotic derivatives. In addition, a hedge fund can be set-up as a fund-of-funds to invest in other hedge funds.

The structure of the hedge fund will generally be a master-feeder structure, a parallel structure, or at least initially, a stand-alone structure. In a master-feeder structure, a domestic feeder fund and an offshore feeder fund are created and those two feeder funds will generally invest in an offshore master fund, which then does the actual investing. The domestic feeder fund and the master fund are generally treated as partnerships for U.S. federal income tax purposes while the offshore feeder fund is treated as a corporation for U.S. federal income tax purposes. In a parallel structure, no master fund is used, and the offshore and domestic funds make the investments directly.[1] If the managers do not expect to have any non-U.S. or tax-exempt investors, they may forgo the offshore fund and create only a domestic stand-alone fund that will also invest directly.

In certain instances the activities of a partnership will be attributed up to its partners, and in some situations, the assets of a partnership may be attributed up to a upper-tier partnership.

An investor in a hedge fund will want to track the value of his or her investment. A U.S. taxable investor in a domestic hedge fund will often be told that he or she will have a "capital account" in the hedge fund and that the capital account will increase by the amount of such investor's capital contributions and his or her allocable share of income and gains, whether realized or unrealized, and decreased by withdrawals and his or her allocable share of losses, whether realized or unrealized. Generally, the partner's capital account will reflect the partner's share of the fund's net asset value. Usually, the capital accounts are adjusted to take into account the fund's income, gains, and losses at specific times, such as when money is contributed or withdrawn from the fund, or at the end of an accounting period, which could be monthly or quarterly.

Because a domestic hedge fund will usually be formed as a partnership, the fund must comply with the rules under Section 704(b) and the underlying regulations in order for a partner's distributive share of income, gain, loss deduction, or credit to be respected for federal income tax purposes.[2] Will a fund that adjusts a partner's capital account balance to take into account realized and unrealized gain and losses be in compliance with the these rules? Sometimes it will, and sometimes it will not.

SECTION 704(b)

The Code very briefly establishes how a partner's distributive share is to be determined. Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) (PIP) if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocations to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) do not have substantial economic effect. It is the regulations, however, that tackle the complexity of the matter.

The regulations reiterate the Code, but note that if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credits (or items thereof) to a partner, there are three ways such allocations will be respected. First, the allocations can have substantial economic effect. Second, taking into account all the facts and circumstances, the allocations can be in accordance with PIP. And third, the allocations can be deemed to be in accordance with PIP pursuant to certain special rules.[3]

Substantial Economic Effect

For an allocation to a partner to have substantial economic effect, the allocation must have economic effect and the economic effect must be substantial.[4] Generally, when an economic benefit or burden corresponds to an allocation, the partner that receives such allocation must also receive such economic benefit or burden.[5] Allocations will have economic effect if, during the full term of the partnership, the partnership agreement provides that (1) capital accounts will follow the capital account maintenance rules, (2) the partnership liquidates in accordance with the positive capital account balances of the partners by the end of the applicable tax year (or, if later, 90 days after the date of such liquidation), and (3) partners have a capital account deficit restoration obligation.[6] If the requirements of (1) and (2) above are met and the partnership agreement contains a qualified income offset, allocations to a partner who does not have a deficit restoration obligation will be treated as having economic effect to the extent such allocation does not cause or increase a deficit balance in such partner's capital account as of the end of the partnership tax year to which such allocation relates.[7] In addition, allocations that do not have economic effect will be deemed to have economic effect, provided that, as of the end of each partnership tax year, a liquidation of the partnership at the end of such year, or at the end of any future year, would produce the same economic results to the partner as if the rules in (1), (2), and (3) above had been satisfied (economic effect equivalence).[8]

The capital account maintenance rules are a set of very complex and detailed rules that, if not followed, will result in the partnership allocations not having substantial economic effect and certain other allocations, such as allocations of nonrecourse debt deductions, not being deemed made in accordance with PIP.[9] One of the many capital account maintenance rules addresses when the partnership may adjust the balance of the capital account of the partners to reflect a revaluation of property.[10] Such adjustment may be made (1) in connection with the contribution of money or

NOTES

1 For a more in-depth discussion see August and Cohen "Hedge Funds—Structure, Regulation, and Tax Implications: Part I. Structure and Regulation," 6 Business Entities 14, (July/August 2006).

2 Reg. 1.704-1(b)(1)(i).

3 *Id.*

4 Reg. 1.704-1(b)(2)(i).

5 Reg. 1.704-1(b)(2)(ii)(*a*).

6 Reg. 1.704-1(b)(2)(ii)(*b*).

7 Reg. 1.704-1(b)(2)(ii)(*d*).

8 Reg. 1704-1(b)(2)(ii)(*i*).

9 Reg. 1.1704-1(b)(2)(iv)(*a*) and Reg. 1.704-2(e)(1).

10 Reg. 1.704-1(b)(2)(iv)(*f*).

other property (other than a de minimis amount) to the partnership by a new or existing partner for an interest in the partnership, (2) in connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner for consideration for an interest in the partnership, (3) in connection with the issuance of an interest in the partnership (other than a de minimis amount) in exchange for services, (4) in connection with the issuance of noncompensatory options (other than an option for a de minimis partnership interest), or (5) under generally accepted industry accounting practices (GAAP), provided that substantially all of the partnership's property (excluding money) consists of stocks, securities, commodities, options, warrants, futures, or similar interests that are readily tradable on an established securities market.[11] Thus, to the extent that a partnership revalues its property and such revaluation is reflected in the capital accounts of the partners, the timing of the revaluation must follow the above rules. If a partnership is revaluing its property at times other than as described above and the allocations do not meet the economic effect equivalence requirements of Reg. 1.704-1(b)(2)(ii)(i), the allocations will not have economic effect and will be determined pursuant to PIP.[12]

PIP

A PIP means the manner in which the partners have agreed to share the economic benefit or burden corresponding to the income, gain, loss deduction, or credit (or item thereof) that is allocated.[13] A PIP takes into account all facts and circumstances relating to the economic arrangement of the partners. The factors considered include (1) the partners' relative contributions, (2) the partners' interests in the economic profits and losses (if different than the taxable income), (3) the partners' interests in cash-flow and other non-liquidating distributions, and (4) the rights upon liquidation.[14] The regulations do not provide much guidance as to the application of these rules, but do supply a specific rule where an unlimited capital account restoration obligation is not imposed on the partners.

The regulations provide that if the partnership maintains capital account balance as described in Reg. 1.704-1(b)(2)(iv) and liquidates pursuant to positive capital account balances, but the allocations do not have economic effect, the PIP will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the tax year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior tax year.[15]

It would seem difficult to argue that the allocations of a hedge fund have economic effect based on economic effect equivalence when there is no deficit restoration obligation.

Because the regulations do not provide a significant amount of support for implementing the PIP rules in a partnership agreement, there is some uncertainty on its application. Generally, the results of a PIP partnership agreement should be the same (or close to the same) as an agreement that meets the substantial economic effect test.

ATTRIBUTION OF A PARTNERSHIP'S ITEMS OR ACTIVITIES

In certain instances the activities of a partnership will be attributed up to its partners, and in some situations, the assets of a partnership may be attributed up to an upper-tier partnership. If an upper-tier partnership could treat a lower-tier partnership's investments as its own for purposes of the capital account maintenance rules then whether a fund invests directly or indirectly through a master fund or other fund in the assets described in Reg. 1.704-1(b)(2)(iv)(f)(v) would not affect whether the fund is complying with the revaluations rules. Similarly, if the activities of a lower-tier partnership could be attributed up to an upper-tier partnership then the upper-tier partnership may have an argument that the assets associated with the activity should also be attributed up to the upper-tier partnership. This then leads to the age old question of whether the fund should be viewed as an aggregate of the partners or as a separate entity. The aggregate approach tends to dominate in the taxation of partnership income while the entity approach is more applicable in transfers of interest.[16] However, when to apply the aggregate or entity approach can be confusing and unclear.

Section 751(f) specifically addresses tiered partnerships and provides a look-through rule of a lower-tiered partnership's unrealized receivables and inventory. Section 751 generally provides that when a partner disposes of his or her partnership interest in a taxable sale, the consideration received by the partner attributable to unrealized receivables or inventory items of the partnership will be treated as amount realized other than from a sale or exchange of a capital asset. In determining the amount of the partnership's unrealized receivables and inventory items, the partnership will be treated as

THOMAS GRAY is a partner at Drinker Biddle & Reath LLP in New York City. Copyright © 2015 Thomas Gray.

owning its proportionate share of a lower-tier partnership in which it is a partner. The purpose of this rule is to ensure that the requirement that the "hot asset" rule is applied whether or not the assets are held directly or indirectly by the partnership.

By maintaining a lower-case capital account that follows the capital account maintenance rules, allocations should be respected under the PIP rules.

The Code has also addressed certain situations in which the activities of a partnership will be attributed to its partners. Section 875(1) provides that "a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged." Section 1402(a) provides that net earnings from self-employment include a partner's distributive share of income or loss from any trade or business carried on by a partnership of which he or she is a member. In addition, Section 702(a) allows for the character of income and loss to pass through to the partners in the partnership. Furthermore, the courts have addressed whether the activities of a partnership are attributable to its partners.

In *Butler*, 36 TC 1097 (1961), *acq.* 1962-1 CB 3, the taxpayer was a limited partner in a partnership that manufactured and sold prefabricated houses. The taxpayer lent money to the partnership, which became worthless. The court found that the loan was made in furtherance of the business of which he was a limited partner and was proximately related to the business activity of the partnership. The taxpayer could therefore take a business bad debt deduction. The court implied that by being a partner the partner was individually engaged in the business of the partnership.[17] *Butler* and other similar cases, however, have been held to stand:

> for the proposition that a taxpayer may be individually engaged in a trade or business by reason of his participation in a partnership. Thus, under appropriate circumstances, a partner may be able to deduct as an ordinary and necessary business expense an amount paid by him on behalf of the partnership for which he was not reimbursed. However, these cases in no way support [the] contention that the business activities of an individual who later becomes a partner have a bearing on whether his distributive share of partnership deductions were incurred in the course of a trade or business.[18]

In the self-employment context, the Tax Court has looked at the role a limited partner can play in a partnership to determine whether the activities of the partnership are attributable to a partner. In *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137 (2011), a law firm was formed as an LLP and the taxpayer argued his interest in the LLP should be treated as a limited partnership for purposes of Section 1402(a)(13). Section 1402(a)(13) generally excludes from self-employment tax the distributive income of a limited partner. Since Section 1402(a)(13) does not define what a limited partner is, the court used rules of construction to determine the meaning of limited partner. The court found "that the intent of Section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage." Because the LLP earned a majority of its revenues from legal services provided by the taxpayers, the taxpayer's distributive share of income was not a return on investment but rather income related to the legal services provided by them on behalf of the partnership. That income, therefore, is subject to self-employment taxes.[19]

Although the Code does provide for situations in which a partnership's activities and certain assets are attributable to its partners, it is not a blanket proposition. It would seem, therefore, that without some clear congressional intent such as in Sections 751(f), 875, and 1402, or guidance from the IRS, a partnership with respect to the capital account maintenance rules should be viewed as a separate entity, as opposed to an aggregate of its partners.[20]

Hedge Fund Capital Accounts

As noted above, investors usually expect to track their investments in a hedge fund through their capital accounts. The general partner will expect to base its carried interest on the profit generated, which would be reflected in the change to the capital account balances of the limited partners for such measurement period. In addition, the investment manager will expect his or fee to be based on the value of the assets under management, which also would generally be reflected in the capital account balances after adjusting the balances for realized and unrealized gains and losses.

Many domestic hedge fund agreements provide that the capital ac-

NOTES

11 Reg. 1.704-1(b)(2)(iv)(*f*)(*5*).

12 *Id.* See *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137 (2011) (holding that a special allocation was not consistent with the partnership agreement and the court looked at the partners' respective interest in the partnership to determine the proper allocations).

13 Reg. 1.704-1(b)(3)(i).

14 Reg. 1.704-1(b)(3)(ii).

15 Reg. 1.704-1(b)(3)(iii).

16 See McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships & Partners 4th ed.* (WG&L, 2007), § 1.02.

17 See also *Ward*, 20 TC 332 (1953), *aff'd* 224 F.2d 547, 47 AFTR 1472 (CA-9, 1955) (holding that a general partner was individually engaged in business by being a partner).

18 *Goodwin*, 75 TC 424 (1980), *aff'd without published opinion* 691 F.2d 490 (CA-3, 1982).

19 See also CCA 201436049 (limited partners of partnership providing management investment services subject to self-employment taxes); but see GCM 38201, 12/14/79 (a fixed investment trust is not attributed to the trade or business of a limited partnership in which it holds a limited partnership interest) . For a more in-depth discussion on the matter see Banoff, "When Will an LLC's Trade or Business Be Imputed to its Members" 87 JTAX 3 (September 1997).

20 See GCM 38201, 12/14/79. For a more in-depth discussion on the matter, see Banoff, *supra* note 19.

counts will be maintained in accordance with the capital account maintenance rules under Reg. 1.704-1(b)(2)(iv). In addition, private placement memorandums of hedge funds may explicitly state that the allocations will have substantial economic effect.[21] When amounts are contributed to or distributed from the fund, or at certain other times,[22] and the fund performs a revaluation of its property, these revaluations should be permissible revaluations under the capital account maintenance rules. In addition, if the revaluations occur at times other than those referred to in the preceding sentence and the profits and losses of the fund are based on GAAP, at first glance the capital accounts would still appear to conform to the capital account maintenance rules regarding revaluations.[23] The fund, however, may not meet the investment requirements of Reg. 1.704-1(b)(2)(iv)(*f*)(*v*), either because its investment strategy calls for investments other than those described in Reg. 1.704-1(b)(2)(iv)(*f*)(*v*),[24] it invests in a master fund, and/or it is a fund-of-funds. By not meeting the requirements of Reg. 1.704-1(b)(2)(iv)(*f*)(*v*), any revaluations other than those made pursuant to Regs. 1.704-1(b)(2)(iv)(*f*)(*i*)-(*iv*) may result in (1) the fund failing to follow the capital account maintenance rules and (2) the allocations of fund income and loss not having economic effect. The remainder of this article will assume that substantially all of the domestic hedge fund's property does not consist of the property described in Reg. 1.704-1(b)(2)(iv)(*f*)(*v*).

When preparing a hedge fund partnership agreement, it is important to understand what the investment structure is intended to be.

Economic Effect Equivalence

As noted above, under economic effect equivalence, allocations that do not have economic effect will be deemed to have economic effect if certain conditions are met. One of those conditions appears to be that the partners have a capital account deficit restoration obligation.[25] A limited partner generally will not have a deficit restoration obligation and most investors in hedge funds would balk at a deficit restoration obligation. It would seem difficult to argue that the allocations of a hedge fund have economic effect based on economic effect equivalence when there is no deficit restoration obligation.[26]

Attribution

Many hedge funds take the position that they are engaged in the trade or business of investing in securities, allowing investors to deduct fund expenses under Section 162, as opposed to Section 212 if the fund was just an investor. If the hedge fund invested in a master-fund or was a fund-of-funds, and the master fund, or a lower-tier fund, was considered engaged in a trade or business and the activity was buying and selling publicly traded securities, could these activities be attributed up to the top-tier fund so that the fund would be considered investing in such securities for purposes of the capital account maintenance rules?

As noted above, there's no general rule that a partner is treated for federal income tax purposes as being in the same trade or business as the partnership solely by being a partner in that partnership. Similarly there is no general rule for attributing the assets of a lower-tier partnership to an upper-tier partnership. Certain sections of the Code, such as Sections 751(f), 875, and 1402, contain attribution provisions. Reg. 1.704-1(b)(2)(iv)(*f*)(*v*), however, does not provide such attribution. Specifically, the regulations provide that "all of the partnership's property (excluding cash) consists of stock . . ." and do not reference indirect ownership or ownership of partnership interests where such underlying partnership's property consist of such publicly traded investments.[27] Without explicit language providing for attribution of a lower-tier partnership's property or guidance from the IRS permitting such attribution, a fund investing in either a master fund or a fund-of-funds may not be able to meet the property requirement of Reg. 1.704-1(b)(2)(iv)(*f*)(*v*).

Since a fund that describes a partner's capital account as complying with the requirements of the capital account maintenance requirements most likely will not meet those requirements if the fund is not meeting the property requirements for revaluations, the fund documents may have to be modified.

SOLUTION

For a domestic hedge fund that feeds into a master fund, is a fund-of-funds, has property that does not substantially consist of the property described in the regulations, or does not follow GAAP accounting, the fund should

NOTES

21 Note that this article does not address stuffing provisions, which are found in many hedge fund agreements, and whether such provisions meet the substantial economic effect test. See Needham, "The Problem with Stuffing Allocations," 141 Tax Notes 737 (2013); Ladin, Lowy, and Woods II, "Hedge Fund Allocations: A Path Through the Maze," 121 Tax Notes 925 (2008).

22 See Regs. 1.704-1(b)(2)(iv)(*f*)(*i*)-(*iv*).

23 Although the fund agreement may not explicitly state it, most funds will determine profits and losses based on GAAP. Many times, however, a fund will deviate from GAAP reporting with respect to the amortization of start-up costs. Also, some funds may use IFRS, as opposed to GAAP. Presumably such funds also would not meet the standards of Reg. 1.704-1(b)(2)(iv)(*f*)(5)(*v*).

24 As noted above, revaluations of property may occur under GAAP, provided substantially all of the partnership's property (excluding money) consists of stocks, securities, commodities, options, warrants, futures, or similar interests that are readily tradable on an established securities market.

25 See Reg. 1.704-1(b)(5), examples 4(ii) and (iii),

26 For a more thorough discussion of economic effect equivalence see Cuff, "Working with Target Allocations—Idiot-Proof or Drafting for Idiots?" 35 J. Real Est. Tax'n 3 (Second Quarter 2008)

27 Compare Reg. 1.704-3(e)(3)(ii)(C) and what constitutes a qualified financial asset for security partnership purposes.

provide for a "Capital Account," which is a defined term and reflects the economics and financial reporting as the investors expect them to be reported. Another capital account, sometimes referred to in the fund agreement as a "tax capital account" or a lower-case "capital account," should also be maintained for the partner.

The intent of the lower-case capital accounts of the partners should be to correctly reflect their respective economic interests in the assets, gains, losses, income, expenses, and deductions of the partnership, but does so in a manner that best maintains them in accordance with the provisions of the capital account maintenance regulations of Reg. 1.704-1(b)(2)(iv), while causing them to correctly reflect the respective economic interests of the partners in the assets, income, gains, losses, expenses, and deductions of the partnership. In other words, by maintaining a lower-case capital account that follows the capital account maintenance rules, allocations should be respected under the PIP rules.

Taxable income and losses should generally follow the manner in which items of income and loss have been allocated to the lower-case capital account. If, however, the value of a fund asset is increased or decreased for purposes of adjusting lower-case capital accounts under the fund agreement, such increase or decrease should be included in the profits and losses of the fund, if not already included as a result of an early adjustment to the Capital Accounts. In accordance with Section 704(c) and for purposes of applying its principles to any "reverse Section 704(c)" situations, the items of income, deduction, gain, or loss with respect to any property held by the fund whose value is reflected on the books of the fund (the "tax book value") used to calculate the balance in the lower-case capital accounts at a value that differs from the adjusted tax basis of such property should, solely for tax purposes, be allocated among the partners so as to take account of any variation between the tax book value and the adjusted basis of such property to the fund for federal income tax purposes in a manner that the general partner determines to fairly reflect such variations. The allocations of income, deduction, gain, or loss related to Section 704(c), including reverse Section 704(c) amounts, should not be reflected in the lower-case capital accounts or the profits or losses of the fund.

At the end of each fiscal year, and after being adjusted for all distributions and allocations for such fiscal year, the lower-case capital account of each partner should equal the amount a partner would be entitled to receive if the partnership were to sell all of its assets for an amount equal to their respective tax basis (or, if the value of any asset has been adjusted, for an amount equal to such value) and distribute the proceeds of such sales in accordance with the liquidation provisions of the partnership agreement. In addition, the general partner can have the power to cause allocations of income, gain, loss and deduction, as determined for federal income tax purposes to achieve this result so that liquidating distributions will in all cases be made in accordance with the positive lower-case capital account balances.

As a result of maintaining both a "Capital Account" and a lower-case "capital account," the fund investor can receive statements showing his or her interest in the fund as would be reported for financial reporting purposes, and the fund can maintain capital accounts that comply with the capital account maintenance rules.

CONCLUSION

Many times, organizational and marketing documents are compiled using precedents that may not be the best models when certain facts differ. With a hedge fund partnership agreement, one form does not fit all. When preparing a hedge fund partnership agreement, it is important to understand what the investment structure is intended to be. Without this knowledge and an understanding of the capital account maintenance rules, the partnership agreement may be providing something it cannot deliver. By assuming that the fund is complying with the capital account maintenance rules when it may not be, the fund risks having its allocations of profits and losses not being respected and having the allocations determined by the IRS under PIP, which could differ from what the investors expect. ●