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IRS Limits Deductions
Rules that Funds of Funds' Management Fees are Not Deductible as Business Expenses

In Revenue Ruling 2008-39 ("Ruling"), issued July 3, 2008, the Internal Revenue Service ("IRS") ruled that (1) management fees paid by a lower tier partnership ("LTP") constitute a business expense under §162 of the Internal Revenue Code ("Code"), and (2) management fees paid by an upper tier partnership ("UTP"), often referred to as a "fund of funds," must be treated as an investment expense under §212 of the Code. Therefore, the Ruling limits the deductibility by U.S. individual investors of expenses paid or incurred by funds of funds in connection with certain investment activities.

Background and the Ruling

Generally, U.S. individual taxpayers are entitled to a deduction for (1) ordinary and necessary expenses paid or incurred during the taxable year in connection with a trade or business, which expenses are deductible in full under Code §162; or (2) ordinary and necessary expenses paid or incurred during the taxable year (i) for the production of income, (ii) for the management, conservation or maintenance of property held for the production of income, or (iii) in connection with the determination, collection, or refund of any tax, which expenses are only deductible under Code §212 to the extent that they, together with other miscellaneous itemized deductions, exceed 2% of a taxpayer's adjusted gross income (the "2% floor"). **[1]** In the context of investment funds that are taxed as partnerships, if a fund's activities qualify as a trade or business, then an investor may deduct expenses incurred in that activity as a business expense under Code §162. If, however, such a fund's activities do not qualify as a trade or business, then the expenses incurred will constitute expenses under §212 of the Code and will be subject to the 2% floor.

The Ruling addresses how management fees incurred by LTPs and UTPs may be taken into account by a U.S. taxpayer who owns a limited partnership interest in a UTP which in turn owns limited partnership interests in several LTPs. UTPs and LTPs pay annual management fees to their managers, computed in each case as a specified percentage of the value of the net assets owned by the UTP or LTP. The Ruling notes that UTPs' activities consist solely of acquiring, holding and disposing of interests in LTPs and that LTPs are engaged in the business of trading in securities. Starting from these premises, the IRS determined that the management fee paid or incurred by an LTP is an ordinary and necessary business expense within the meaning of Code §162 in carrying on its trade or business, but the management fee paid by a UTP, which engages in the passive activity of holding limited partnership interests for the production of income, constitutes an expense under

§212 of the Code and is not properly characterized as an ordinary and necessary business expense under Code §162.

Although LTPs generally deduct the management fees paid to their managers as §162 business expenses in computing their taxable income or loss, there has been less uniformity with UTPs. Some UTPS have taken the position that a fund of funds derives its business activity from that of the LTPs in which it invests and accordingly treat the management fees paid as business expenses not subject to the 2% floor. The Ruling cites precedent mandating that the character of deductions incurred by a partnership must be resolved at the partnership level. Under the Ruling, a UTP must treat the management fee paid or incurred by it as an expense under §212 and may not take that expense into account in computing its taxable income.

The Ruling is significant because it clarifies an issue as to which there was previously no general consensus. Furthermore, the deductibility of items of pass-through expense is typically a significant consideration for investors in hedge funds.

What Should Funds Do Now?

1. Evaluate your fund structure to determine the proper characterization of the deduction for management fees.
2. Review your offering memorandum to ensure that the discussion of deductibility of management fees in the tax section properly reflects the current law and interpretations. If appropriate, supplement the memorandum to disclose that deductions claimed to date are inconsistent with the Ruling and that, in the event of a fund audit and an adjustment, investors may be required to file amended tax returns to reflect any such adjustments.
3. If you intend to change your historical practices for reporting the deduction of management fees, consider informing your existing investors of the change in advance.

For more information about the Ruling, please feel free to contact your Butzel attorney, the authors listed below, other attorneys of the Investment Management Practice Group, or the attorneys of our Tax Strategies & Resolutions Practice Group.

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Footnotes

[1] The 2% floor is further subject to a reduction equal to the lesser of (i) 3% of the excess of adjusted gross income over the applicable amount ($159,959 for 2008), or (ii) 80% of the amount of the itemized deductions otherwise allowable for such taxable year.
