



Considerations for U.S. Hedge Fund Managers Regarding Withholding Requirements for Non-U.S. Investors

As U.S. hedge funds continue to seek out new capital, a common solution is to pursue non-U.S. investors and/or offer an offshore investment vehicle – often utilized for non-U.S. investors and tax-exempt investors. When adding an offshore component to a fund structure or the fund’s investor group, additional fund filing requirements and withholding requirements may apply. The following is a discussion, in broad terms, of a fund manager’s responsibility and common withholding issues related to U.S. based portfolio income.

General Withholding Requirements

A non-U.S. investor in a hedge fund is generally subject to U.S. tax withholding on certain types of U.S. income. Since the range of various withholding requirements is broad, the focus of this discussion is on portfolio-type income (i.e. interest, dividends, capital gains, etc.) derived by a typical hedge fund. Also assumed is that the fund and its foreign investors are compliant with FATCA (Foreign Account Tax Compliance Act).

Portfolio-type income subject to withholding is often known as FDAP (Fixed or Determinable Annual, Periodical) income. FDAP withholding rates can range from 0% to 30%, depending on the treaty agreement between the U.S. and non-U.S. person’s resident country. For common offshore fund tax haven domiciles (Cayman Islands and British Virgin Islands), the withholding rate is generally 30% because no treaty rate applies.

For a hedge fund, FDAP income subject to withholding is most often required on interest and dividend income; however, not all interest and dividend income is subject to withholding. It is also important to note that FDAP income does not include capital gains, which when realized by a hedge fund and allocated offshore, are not generally subject to withholding.

Interest income is subject to withholding if the interest is derived from U.S. sources; however, the IRS has allowed a very generous exemption that many fund managers and their offshore investors enjoy, namely the portfolio interest exemption. When interest meets the portfolio interest exemption, as outlined in IRS Publication 519, such portfolio interest is not subject to withholding. This is a great win to hedge funds because most often the interest related to bonds and other interest-bearing securitized products traded by funds will meet the portfolio interest exemption. As a result, interest income is not a common source of withholdable income when allocated offshore.

On the other hand, dividend income does not enjoy such an exemption. Dividend income is generally subject to withholding if the dividend is from a U.S. company. It is important to note that dividends from non-U.S. companies are often not subject to withholding.

Fund managers should consult their tax advisors regarding the withholding requirements for interest and dividend income.

Withholding Agent

In addition to understanding the types of income subject to withholding, a fund manager should also understand the responsible person for withholding and filing withholding forms (Form 1042 and 1042-S) with the IRS – referred to as the withholding agent. A withholding agent is the last U.S. person/entity who pays or allocates to a non-U.S. person any amount subject to withholding. A payment is made to a person if that person realizes income, whether or not there is an actual transfer of cash or other property. The withholding agent must also withhold on the gross amount, meaning it cannot reduce the amount to be withheld by any deduction.

For typical fund structures, if the non-U.S. investor or offshore investment vehicle (i.e. in a mini-master fund structure) is invested in a U.S. partnership, the withholding agent is the fund and the responsibility for withholding falls on the fund manager. On the other hand, if the non-U.S. investor is invested in an offshore entity (i.e. a typical master-feeder structure with an offshore master fund), the withholding agent is the U.S. broker for the fund and the responsibility for withholding falls on the U.S. broker.

Residency Certification Forms

Along with identifying the withholding agent, it is imperative for a fund manager to receive residency certification forms from its investors. These forms are required whether or not the fund has non-U.S. investors. Without such forms, the IRS rules require the payer to perform backup withholding, even for a U.S. investor. The most common required certification forms are:

- **Form W-9** (Request for Taxpayer Identification Number and Certification)
- **Form W-8BEN** (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting [Individuals])
- **Form W-8BEN-E** (Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting [Entities])
- **Form W-8IMY** (Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting)

Each form has its own purpose. Generally:

- **Form W-9** is used to certify U.S. residency
- **Form W-8BEN** is used to certify foreign residency for an individual
- **Form W-8BEN-E** is used to certify foreign residency for entities
- **Form W-8IMY** is used to certify foreign residency for flow-thru and intermediary entities
- Both **W-8BEN** and **W-8BEN-E** are also used to certify treaty benefits

Common Required Hedge Fund Residency Certification Forms

Just as a fund manager needs to receive residency certification forms from its investors, the fund's banks, brokers, and custodians need residency certification forms from the fund. A few common hedge fund structures and required forms include:

Stand-alone onshore fund structure: Typically the fund will provide a W-9 to its broker. The fund should request and receive residency certification forms from all of its investors. For withholding purposes, the onshore fund would be the withholding agent and would withhold on any investor who provides Form W-8BEN and Form W-8BEN-E.

Stand-alone offshore fund structure where the fund is a corporation and does not elect to be treated as a partnership: Typically the fund will provide a W-8BEN-E to its broker. As part of FATCA compliance, the fund should request and receive residency certification forms from all of its investors. For withholding purposes, the fund's U.S. broker would be the withholding agent. Assuming FATCA compliance by the fund and its investors, the offshore fund would not generally have its own additional withholding requirement.

Mini-master structure: Typically the hedge fund is set up onshore as a partnership and has both U.S. investors as well as an offshore feeder vehicle organized as a corporation for non-U.S. and tax-exempt investors. The fund should request and receive residency certification forms from all investors in each entity in the structure; the offshore fund should request these forms as part of FATCA compliance similar to the stand-alone offshore fund structure. For withholding purposes, the onshore fund would be the withholding agent and would provide a W-9 for the onshore fund to the broker, and would prepare Form W-8BEN-E for the offshore feeder and use that form to dictate the offshore fund's withholding.

Master-feeder structure: The hedge fund is typically set up with an offshore master fund that is treated as a partnership for U.S. tax purposes. The partners of the offshore master fund include an onshore feeder organized as a partnership and an offshore feeder organized as a corporation. The fund should request and receive residency certification forms from all investors in each entity in the structure; the offshore fund should request these forms as part of FATCA compliance similar to the stand-alone offshore fund structure. For withholding purposes, the U.S. broker would be the withholding agent and the offshore master fund would provide a W-8IMY to the broker along with a W-9 for the onshore feeder and a Form W-8BEN-E for the offshore feeder. The fund would also provide a withholding statement to the U.S. broker showing the offshore vs. onshore ownership percentage of the offshore master. This withholding statement would generally be updated each time the ownership changes. The purpose for these forms is so that the U.S. broker can look through the offshore master fund and withhold only on the offshore feeder fund ownership.

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