

Tax Alert

Hedge Funds

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IRS INITIATIVE REQUIRING GREATER TRANSPARENCY CONTINUES

By Howard Leventhal and David Racich

On December 20, 2005 the IRS introduced the new draft Schedule M-3 (“M-3”) for qualifying partnerships filing a tax return on or after December 31, 2006. The draft M-3, *Net Income (Loss) Reconciliation for Certain Partnerships*, will provide the IRS additional transparency with respect to the increasing number of partnership vehicles that are filing tax returns, which includes the vast and growing number of hedge funds in the marketplace. This initiative for partnerships follows the release of Schedule M-3 for corporations. The medium of reconciling financial accounting income to taxable income currently exists for partnerships in the form of the Schedule M-1 on Form 1065, but the draft M-3 is a much more detailed version of this current reconciliation.

IRS Initiative

With the M-3, the IRS brings the application of increased reporting compliance and establishes a framework for more uniform tax accounting and reporting principles. The proliferation of partnerships has prompted the IRS to better assess compliance risk and aid in the efficiency of audit examinations. The IRS has indicated that by having these uniform reporting requirements in place, they will be better served to increase the number of examinations with respect to partnerships. Through electronic matching procedures, recent disclosure initiatives, its audit manual for partnerships including hedge funds, as well as the planned M-3, the IRS continues to bolster its audit tools for partnerships.

Entities Impacted

Most hedge funds will be required to file the M-3 for their tax year ending on or after December 31, 2006 since most will meet one of the following criteria. In general, if assets computed under two alternative tests exceed \$10 million at the end of the tax year or if the partnership has total receipts in excess of \$35 million, then the partnership will be required to file the M-3. In addition, if the partnership has a “reportable entity partner,” which in general is any partner who owns or is deemed to own, directly or indirectly, a 50 percent or greater interest in the income, loss or capital of the partnership on or after July 1, 2006, and was also required to complete the M-3, then the partnership itself has to complete the M-3.

The management company and/or general partner of the hedge fund complex could also be required to file the M-3 and should test the applicability of the exceptions on a case by case basis. It should also be noted that a disregarded entity for U.S. Federal tax purposes (either within the fund structure or management company structure) does not need to separately report its activity on the M-3 since all activity of the disregarded entity should be reported as part of its ultimate

owner. Foreign partnerships and entities that are treated as partnerships for U.S. Federal tax purposes (ie, “check the box” entities) are subject to the M-3 reporting requirements as well, should they meet any one of the respective criteria. This would include a foreign master fund formed as a corporation that has “checked the box” for U.S. Federal tax purposes to be treated as a partnership.

Industry Items

A sample of items on the M-3 which are of interest to fund managers and call for separately stated information both for financial statement as well as taxable income purposes are as follows: mark to market gains or losses under IRC Section 475, hedging transactions, original issue discount, Subpart F income inclusions, QEF income inclusions, deferred compensation, reserves and contingent liabilities, syndication costs and organizational costs. For dividend income, there is additional reporting required for a fund that owns (directly or indirectly) greater than 10% of the voting stock a corporation who is the payer of a dividend (this would be more applicable to a private equity fund complex). In addition, detail of worthless stock losses as well as gross capital gains and gross

capital losses reportable for tax purposes need to be provided. The related income statement gain/loss amounts for these categories need to be presented as well.

The tax shelter regulations continue to be relevant with respect to partnership reporting since the draft instructions for the M-3 require that any amounts attributable to certain reportable transactions must be separately stated. These amounts are required to be reported even if there is no difference between the financial statement amount and the taxable income amount. Hence, additional reporting over and above the existing tax shelter reporting regime will soon exist.

Fund of fund complexes will also experience the additional reporting burden since partnerships will be required to provide additional details relating to the name, EIN, and the end of year profit/loss-sharing percentage (if applicable) of any partnership (both domestic and foreign) or “pass-through” interests they hold.

Consistent with corporations filing the their own version of the M-3 for the first time, certain parts of the form will be optional the first year that partnerships are required to file. If a partnership does not meet any of the criteria for reporting on the M-3 during a given taxable year, then Schedule M-1 must be filled out accordingly. It should also be noted that since the IRS is allowing ample time for partnerships to prepare themselves for having to report this additional detail, an extension of the effective date is probably unlikely.

Implications

The IRS is seeking comments regarding the draft M-3 and instructions by February 21, 2006 and will be meeting with certain stakeholders in the near future for further discussion. Hedge fund managers should be aware of the draft M-3 and the detail that the IRS is seeking in their drive towards greater transparency.

Howard Leventhal, *Co-National Director of Ernst & Young's Asset Management Tax Practice*, is a partner in Ernst & Young's Global Hedge Fund Practice and is based in the firm's New York Financial Services Office.

David Racich, is a senior manager in Ernst & Young's Global Hedge Fund Practice and is based in the firm's New York Financial Services Office.

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