



PRIVATE INVESTMENT FORUM

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FAQ Regarding New York State Sales And Use Tax Audits of Hedge Fund Management Companies

David Seiden, CPA and Camille Mule

NEW YORK STATE has recently initiated an extensive program to audit hedge fund management companies for sales and use taxes. The purpose of the audits is to determine whether there is a filing requirement and whether sales and use taxes should have been paid. The FAQ below discusses the implications of this project.

Q. I heard another hedge fund management company ("HFMC") was notified that they have been selected for a New York State Sales and Use Tax Audit. What's going on?

A. Over the last few months, several of our HFMC clients have received sales and use tax audit notices from New York State. This appears to be a new "special project" being conducted by the Tax Department. In the past the Department found audits of this type of business to be both productive and a quick and easy way to raise much needed tax revenue since tax, penalties, and interest found due is typically paid in full at the conclusion of the audit.

Q. I thought HFMC services were exempt from sales tax. What kind of exposure could I possibly have?

A. The common misunderstanding among HFMC is that since HFMC revenue is exempt from sales tax, no sales/use tax returns are required to be filled. The reality is New York State is among the many states that assesses a use tax on taxable goods and services used or consumed in their state and will assess use tax when sales tax is not paid at the time

of purchase. Examples of taxable goods and services include but are not limited to; antiques, art work, jewelry, furs, photographic and electronic equipment, computers, software, information services, private aircraft, office furniture, and collectibles. Examples of use tax situations include: purchases of tangible personal property purchased out of state, tax unpaid; purchases made through the Internet without the payment of sales tax; sales of taxable goods or services where a New York retailer fails to collect sales tax; purchases from out-of-state mail-order companies, television shopping channels, etc. where a sales tax has not been paid. Use tax is paid on a regularly filed sales/use tax return (depending on magnitude of tax due, returns can be due monthly, quarterly or annually).

Q. How far back can the Department audit?

A. Once identified and contacted for audit, an unregistered sales tax business typically faces a six year audit period rather than the normal three year audit cycle. Technically there is no statute of limitations if returns were never filed and therefore the Department could issue an assessment beginning from the time the Taxpayer began business in New York. In reality, the Department has adopted an audit period policy on unregistered sales tax businesses of six years.

Q. What can I expect during a sales and use tax audit? What type of records will I be required to show the auditor?

A. When you are selected for audit, an auditor

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SAVE THE DATE

Hedge Fund Sales Tax Teleconference

JULY 12TH at 9:00 AM

OR

JULY 26TH at 5:00 PM

For call-in information, Contact Jennifer Alessi at (T) 631-414-4042 (Email) jalessi@mkllp.com

Foreign Withholding Taxes: How Much Money Are You Leaving On The Table?

Len A. Lipton

HEDGE FUNDS, like many other investment vehicles invest a portion of their assets cross border. In this context, cross-border means that the country where the income is generated (i.e. invested) is different from the country of residence of the underlying partners/investors in the fund. Hedge funds by and large are viewed by the various tax authorities as an entity that passes through all profits, dividends, etc. This separation of the fund as an entity, from its members is called the “transparency” principle (look-through principle) and creates a problem which has led many hedge funds to lose out entirely on recovering excess withholding tax, to which they are entitled.

The reason that a portion of the withholding tax may be **reclaimable** is that the governments largely understand that the investor is being taxed on the income payment in the country where the investment is made and then being taxed again in their home country. As a result, pairs of countries (there are thousands of combinations) have entered into treaties with one another to alleviate some of this tax burden and to entice foreign investment into their markets. Investors can generally reclaim the difference between the statutory withholding rate and the treaty rate.

The problem for hedge funds is that income on cross border investments is taxed in the country where the income is generated, based on the level of knowledge that the tax authority has about the ultimate beneficial owners of the income. Foreign tax authorities generally have no knowledge of the underlying partners so they tax the whole of the income at their (high) statutory withholding rate, even though the

members of the fund may actually be entitled to a lower rate of taxation, because of their residency and status. A typical international portfolio will add an average of 20 to 30 basis points in performance by reclaiming their entitlements (source: Globe Tax Services Inc.).


The table below shows the scale of the issue for the major developed markets regarding how much a US hedge fund would normally receive and what it should actually receive if it files reclaims to recover its tax.

In addition to the recoverable tax from the foreign government, the entitlement can sometimes be enhanced by additional tax credits. As hedge funds often take large concentrated positions in securities, the absolute value of this recoverable can be quite substantial.

Due to recent changes in the dividend tax rate it is often more beneficial to file the reclaim than to employ other strategies like using SWAPs or other synthetic vehicles to mitigate this issue. However, the primary reason that most hedge funds ignore the issue is that neither the hedge funds nor their administrators maintain the experience, the extensive expertise or research to effectively file reclaims on behalf of their partners.

The final hurdle is maintaining the confidentiality of the partners in the fund. This can be achieved by using a reputable and knowledgeable

agent to act as the go between from the fund to the prime broker and the tax authorities. Typically, the prime broker has no knowledge of the underlying partners of its hedge fund clients and so, does not have the information needed to calculate and file the reclaims. The prime brokers are however, critical to the process as they are the custodians of the assets and maintain the official income payment records necessary to prove both payment and withholding. As the hedge fund industry matures and becomes subject to further regulation (as is happening with forced registration by the SEC) this issue will be increasingly viewed as one of fiduciary responsibility and best practice.

There’s one final piece of good news! Each tax authority sets a Statute of Limitation on tax reclaims. So, in many cases, a hedge fund (or their tax reclaim agent) is able to go back, often over several years, and recover excess withholding tax on previous years’ income – a windfall benefit. 

GlobeTax is the pre-eminent provider of withholding tax services in the world. GlobeTax works on contingency and maintains strategic alliances with all major prime brokerage firms going back many years. Len A. Lipton is Vice President of Marketing for GlobeTax. For more information or analysis of the potential benefit of filing foreign tax reclaims for your fund please contact Mr. Lipton; 212-747-9100 or len_lipton@globetax.com or, Mr. Ross McGill, GlobeTax’s Director of Marketing at; 44 (0)20 7618 6692 or ross_mcgill@globetax.com.

Country	Dividend	Taxes Withheld (%)	Dividend Received %	Recoverable Taxes (%)	Statute	Dividend Received (%)
Australia	100	30	70	15 or 30	No deadline	85-100
Austria	100	25	75	10	5 yrs	85
Canada	100	25	75	10 or 25	2 yrs	85-100
Finland	100	28	72	13 or 28	5 yrs	85-100
France	100	25	75	10	2 yrs	85
Germany	100	21.1	78.9	6.10 or 21.1	4 yrs	85-100
Italy	100	27	73	12	4 yrs	85
Netherlands	100	25	75	10 or 25	3 yrs	85-100
New Zealand	100	30	70	15 or 30	8 yrs	85-100
Sweden	100	30	70	15 or 30	5 yrs	85-100
Switzerland	100	35	65	20 or 35	3 yrs	85-100