

# Hedge Fund Issues: Foreign Taxes

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It is not uncommon for investors in a domestic hedge fund to earn income from non-U.S. securities and interest bearing instruments. Accordingly, a portion of their taxable income as reported on their U.S. Schedule K-1 may consist of foreign interest, dividends and tax expense. Generally, the foreign taxes withheld are allowed as a dollar for dollar credit on the U.S. tax return. Based on our experiences, many investors and fund managers may not be aware that in some cases, a portion of the taxes paid on foreign source income is not eligible for the foreign tax credit allowable under Internal Revenue Code (IRC) section 901.

In general, a non-U.S. country will withhold tax on investment income earned by an investor that is not a resident or citizen of that country. Unfortunately, the foreign withholding agent has no knowledge of the underlying partners of a fund, and will treat the fund as a single tax entity for withholding purposes. As a result, the foreign withholding agent generally will withhold on the applicable amount of income earned by the fund at the highest marginal rate, without regard to how each investor in the fund would be treated if they had simply invested in the income producing asset directly. The members of the fund, however, may actually be entitled, because of their residency and status, to a much lower taxation rate.

An individual taxpayer is allowed to take an amount as a credit on their U.S. income tax return equal to the amount of income tax withheld by the foreign country pursuant to IRC 901, subject to certain limitations and adjustments. To claim the credit, the U.S. taxpayer will prepare U.S. Form 1116, Foreign Tax Credit, and report their proportionate share of foreign source income, foreign deductions and foreign taxes withheld as shown on the investor's Schedule K-1. If, after preparing the Form 1116, the investor has foreign withholding in an amount that exceeds the allowable amount for the current tax year, the excess may be carried back one year and forward ten years.

Although a U.S. tax credit is allowed for foreign taxes paid, there are often circumstances where a foreign government withholds more tax than the individual investor legally owes. Foreign governments generally withhold at the highest marginal rate because they view the fund as a single tax entity, while ignoring the effects on the individual investor. In reality, the investor's foreign tax liability should be computed using the applicable treaty rate, which has been agreed upon by the foreign country and the United States. Consequently, a hedge fund investor may not be aware that the foreign tax expense reflected on their U.S. Schedule K-1 may not be eligible to be claimed fully as a credit. In this situation, "legally owed" is defined as the taxpayer's liability under applicable foreign law.

The following example from the instructions to U.S. Form 1116, Foreign Tax Credit provides an illustration of such a situation:

- Country X withholds \$100 of tax from source dividend income earned in Country X. Under the income tax treaty between the United States and Country X, the fund owes only \$75 and can claim a refund from Country X for the remaining \$25. However, only the \$75 is eligible for the foreign tax credit, whether or not the fund applies for a refund.

In order to alleviate the loss of the U.S. credit on the amount of foreign taxes paid that exceed the amount legally owed, individuals may be able to apply to the foreign country for a refund of the excess tax withheld. However, this can be a difficult task for several reasons. The forms to be filed to claim for the refund of over-withholding must be first identified and then obtained from the appropriate tax authorities. Furthermore, unless the taxpayer or their CPA has prior experience with foreign tax filings, extensive research may be required to file accurate forms. It also is very possible that English is not the native language in the country in question. The combination of corresponding with foreign tax authorities, overcoming the language barrier, and incurring professional fees and shipping costs to file with the foreign authorities could prove to be very costly as well.

Tax reclamation is a complex issue that should be handled by a professional that is experienced in foreign taxation and reclamation. Thankfully, there are organizations in the industry that have expertise in worldwide tax reclamation, and can be engaged to aid in the recovery of the foreign taxes withheld in excess of liability. They may also be able to alleviate

the need to waste unnecessary time and resources pursuing refunds, which can ultimately result in cost savings. If you feel that you may benefit from the services of such an outfit, please contact your tax advisor.

As you can imagine, an investor in a fund that earned income from foreign sources would need detailed information to determine the appropriate amount of foreign taxes to claim as a credit, but also to be able to file for refunds of amounts over-withheld. Accordingly, the fund manager should ensure that detail of all foreign income, expense and tax activity is made available so the necessary information can be provided to the investor. Too often foreign income and expense details are lumped together and reported as "various," which does not provide individual investors with enough information to comply with the U.S. or foreign taxation principles.

As the hedge fund industry continues to grow, it is likely that incidence of investors demanding accurate foreign tax data is likely to increase. In addition, the IRS matching program is

becoming more sophisticated with each passing year, and it is conceivable that this issue could begin to cause investors to receive notices from the IRS claiming that their foreign tax credit was calculated incorrectly. Accordingly, it is likely that the issues described above will continue to become more important to the hedge fund industry for investor and fund manager alike.

The above is intended as a general overview of the tax issues associated with the disallowance of the foreign tax credit in certain situations where the withholding rate exceeds the treaty rate in a foreign country. Due to the intricacies inherent to foreign tax provisions, we recommend that you consult a tax advisor with experience in tax reclamation to assist you with your particular facts and circumstances.

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