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Taxes:
Looking Back, Looking Ahead

By Mary Ho, CPA

By the time this issue goes into publication, for many, a New Year's resolution will have been made, broken or forgotten. Tax regulations, however, as much as we would wish, do not work the same way. As we gear up for another tax filing season, there are some noteworthy items to highlight. We have published alerts or articles on these topics during the past year and links are provided if you need a refresher on the details.

NEW YORK CHANGES THE DEFINITION OF INVESTMENT CAPITAL

2015 was a year for states to assert themselves; particularly New York and California, two of the highest income tax states in the nation. Late September saw a flurry of activity as funds busied to identify the assets in their portfolios for investment to meet New York's new investment capital definition for corporate tax purposes. Why does this affect funds that are generally partnerships? Because any corporation that is invested in a partnership and uses the aggregate method to compute its tax can treat the proportionate share of the partnership's assets as investment assets only if the investment capital requirement is met at the partnership level.

The October 1 timeline to identify assets for investment only applies to pre-existing assets. Identification after this date for any new assets purchased must be done by the end of the date of acquisition. All investment partnerships should have a mechanism in place to identify assets as held for investment — even if they do not have any corporate partners at present — in the event that a corporate investor comes on board sometime in the future.

http://www.eisneramper.com/investment-capital-corporations-obligation-0915.aspx

CALIFORNIA MARKET-BASED SOURCING LEGISLATION

California raised some buzz in early 2014 when it drafted amendments to have its receipts factor to include market-based sourcing concepts as they relate to asset management firms. Management firms that receive management fees from its residents amounting to approximately $529,000 will have a filing requirement in the state even though there is no traditional physical nexus. Although the original regulation for market based sourcing rule was in place since 2013, the California Department of Revenue had indicated that it would not start enforcing the amendments for asset management firms until 2015.

Late September saw a flurry of activity as funds busied to identify the assets in their portfolios for investment to meet New York's new investment capital definition for corporate tax purposes.

In January of this year, California removed certain subsection examples from the proposed regulations that were the key indicators of the rule's applicability to asset management firms. We will closely monitor future developments in this area.

http://www.eisneramper.com/Asset_Management_Insights/state-income-taxation-cross-boarder-0515.aspx

TAX EXTENDER – LEASEHOLD IMPROVEMENTS

I've been paying close attention to the tax extenders for one item that affects a lot of clients who want to see their capital improvements have a bigger write-off than over 39.5 years and am happy to report that the 15-year

Each year, we like to remind our clients to review their portfolio for stocks that are maybe worthless and to keep in mind the tax criteria. It is not enough that the book value of the stock is being written down to zero; in the tax world, there is usually an event that establishes the worthlessness status, whether it is cessation of business or liquidation of assets.

qualified asset treatment for leasehold improvements have been made permanent though there were some minor changes in the taxpayers favor as to what defines qualified leasehold improvements.

TAX SAVINGS CONSIDERATIONS

QSBS

Qualified Small Business Stock ("QSBS") has been around for a long time but that does not diminish its importance when it comes to tax treatment. QSBS rules may apply if you have made investments in corporations that have less than $50 million in assets, among other requirements, and have held the stock for more than 5 years. With proper handling, you and your investors may qualify for reduced tax rates on these investments upon sale. Remember to properly footnote those sales if you are the investment partnership with gains from QSBS in 2015 or, if you are holding such stock, to be careful in your planning. Another important note is that losses from QSBS stock have preferential treatment as well.

Worthless Stocks

Each year, we like to remind our clients to review their portfolio for stocks that are maybe worthless and to keep in mind the tax criteria. It is not enough that the book value of the stock is being written down to zero; in the tax world, there is usually an event that establishes the worthlessness status, whether it is cessation of business or liquidation of assets. Generally speaking, a security is worthless for tax purposes only if both liquidation value and potential value have disappeared. Potential value relates to the effects of future operations while liquidation value is the solvency of the corporation. Potential value may not be as easy to determine as liquidation value, which can be the cause of the nebulous determination when the loss can be taken as a deduction.

ADMINISTRATIVE ITEMS

Partnerships are required to issue K-1s to their partners on a timely basis. Failure to make delivery will subject the partnership to penalties. Beginning in 2012, the IRS set guidelines for partnerships to follow in order for electronic K-1 delivery to be considered a valid form of timely K-1 delivery. Remember: Even if you already have handled consent notifications for your existing investors, you must still obtain consent for electronic K-1 delivery from any new investors going forward.

http://www.eisneramper.com/guidelines-delivery-partnership-k-1-0212.aspx ■

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The Common Reporting Standard

By Cormac Doyle

The introduction of the Common Reporting Standard ("CRS"), the result of an Organization for Economic Cooperation and Development ("OECD") initiative for the Automatic Exchange of Information ("AEOI"), will affect Irish domiciled funds in 2016 and beyond.

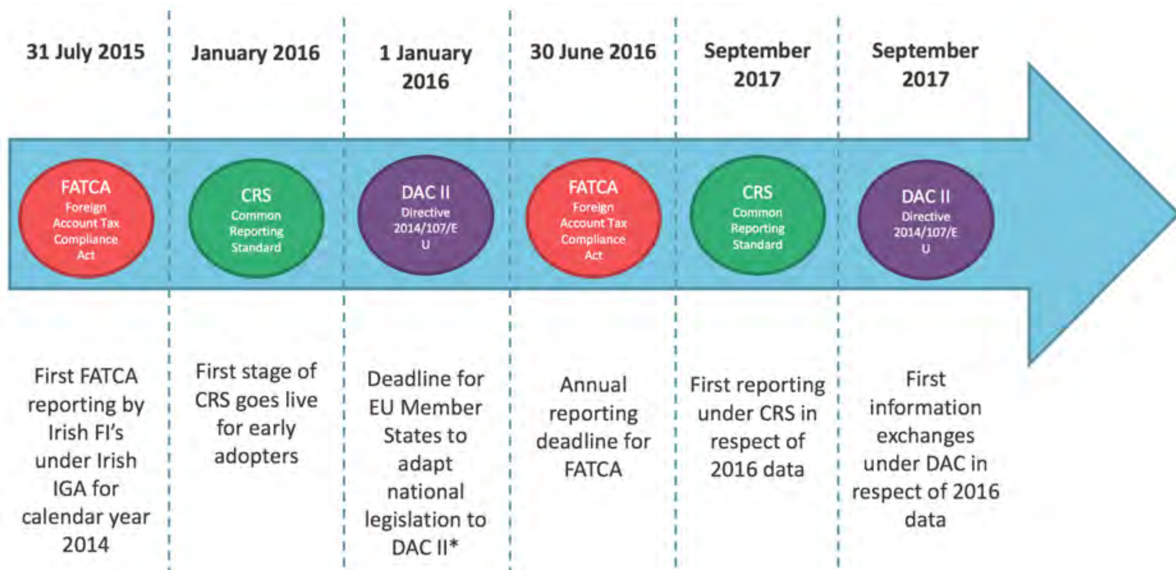
What is the CRS?

Any fans of the old Star Trek series and movies might remember a line from the associated Star Trekkin' song with the words: "It's life, Jim, but not as we know it." Well it could be said that the CRS is simply FATCA, but not as we know it.

FATCA and the CRS are both part of an ever more popular move towards more AEOI between jurisdictions.

These reporting requirements join with a further EU regulation referred to as Directive on Administrative Cooperation in Tax Matters ("DAC2"), which will replace a previous regulation governing the exchange of certain savings information between financial institutions and other jurisdictions. The requirements of all 3 have been illustrated below.

Timeline



*Applicable from January 1, 2017

FATCA is a regime aimed at U.S. citizens with offshore accounts and investments. In Ireland, FATCA was implemented through a Model 1 IGA with the U.S. and also domestic legislation which lead to the first set of reporting in June 2015.

The CRS effectively applies the principles of FATCA on a global scale. The OECD has agreed on the format of an information standard which will be implemented by its various member jurisdictions. It is a global approach to require the disclosure of income earned by individuals and corporate entities with a view of preventing tax evasion and improving compliance. The CRS came into effect for Irish domiciled funds and investment entities from 1 January 2016, with the first reporting required in June 2017. Ireland has introduced domestic legislation and regulations which will require financial institutions to comply with the reporting requirements. Fifty-six countries have committed to exchanging information in 2017.

The type of financial institutions which come within the scope of the CRS, and indeed the type of information which must be gathered and reported, is very similar to the requirements under FATCA, including investor details, and account balances.

It all sounds very like FATCA. So what are the differences you might ask? One of the significant differences is that the CRS will operate on a "carrot" approach only, without the "stick" element of FATCA, namely withholding tax. Non-compliance with the CRS will not result in the imposition of withholding tax by any financial institutions.

The other principal differences are illustrated here:

CONCEPT	FATCA	CRS
Withholding tax?	Yes	No
De minimis threshold for individual account holders?	Yes	No
Country specific entity/product carve outs?	Yes	Yes
Driven by citizenship?	Yes	No
Reporting exemption for certain debt/equity interests regularly traded on an established security market?	Yes	No

CONCLUSION

An Irish-domiciled fund or other financial institution will now have to apply the broad principles of FATCA to global investors. It will be required to continually report under FATCA for U.S. citizens, and report under the CRS for investors in any other jurisdiction which has signed up to implement the CRS.

As can be seen from the above there is a significantly increased scope with respect to due diligence and reporting requirements under CRS and all relevant institutions should now examine their systems and processes to ensure that all relevant information on investors is captured for both FATCA and CRS purposes. ■

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Enforcement Actions by the SEC — Cases from 2015 Provide Guidance for Private Fund Advisers

By Ira Kustin, Partner, Akin Gump Strauss Hauer & Feld LLP

During 2015, actions brought by the SEC's Division of Enforcement highlighted a number of themes of importance to managers of private investment funds. Among those numerous themes, this article discusses a subset relating to the following: (1) disclosure requirements in fund offering and governing documents, (2) the duties of a registered investments adviser's chief compliance officer ("CCO") and (3) cybersecurity requirements.

In some instances, enforcement actions seemed to coincide with pronouncements by the SEC's staff or the focus of examinations by the SEC's Office of Compliance Inspections and Examinations ("OCIE").

DEFICIENCIES RELATING TO REQUIRED DISCLOSURES IN FUND OFFERING AND GOVERNING DOCUMENTS

Enforcement cases during 2015 included those where advisers to private funds were found to have had inadequate disclosures in their funds' offering materials and governing documents relating to fees and expenses.

Nevertheless, advisers themselves have been the target of enforcement action in recent years and 2015 was no exception.

In one highly publicized case, the SEC found that an adviser failed to disclose to its investors that it would be entitled to payment of certain monitoring fees earned in connection with fund investments and that the adviser was entitled to certain discounts from third-party service providers when such discounts were not given to the funds. The adviser was deemed by the SEC to have breached its fiduciary duty to the funds and violated Advisers Act Rule 206(4)-8.

In a relatively minor case, the SEC found that an adviser violated the Advisers Act by charging to its client funds, without proper disclosure, the cost of the Adviser's registration with the SEC, the expense of complying with Advisers Act requirements and legal expenses in connection with an examination by the SEC.

These types of enforcement cases have caused many private fund advisers to revisit their disclosure documents (including advertising materials, private placement memoranda, governing documentation such as partnership agreements and the advisers' Form ADV and the brochure relating thereto). Advisers should confirm that the disclosure describing the fees which they may earn, and the expenses which the funds will bear, is in line with current market practice in light of these recent enforcement cases and adequate given facts applicable to the funds.

ENFORCEMENT ACTIONS RELATING TO CHIEF COMPLIANCE OFFICERS

In a public statement issued in June 2015, SEC Commissioner Luis Aguilar said "it has been my experience that the Commission does not bring enforcement actions against CCOs who take their jobs seriously and do their jobs competently, diligently, and in good faith to protect investors. I do not believe that these CCOs should fear the SEC." Commissioner Aguilar noted that most cases brought by the SEC against private fund CCOs were in connection with CCOs who wear "more than one hat" in connection with their employer (for example, a CCO who is also a portfolio manager).

Nevertheless, advisers themselves have been the target of enforcement action in recent years and 2015 was no exception. One case focused on an adviser's deficient compliance procedures caused by the CCO having inadequate compliance experience, inadequate support personnel and additional non-compliance responsibilities which resulted in the CCO being able to devote only 10%-20% of his business time on compliance activities. The

CEO of the adviser was found to have ordered the CCO to focus more on investment research than on compliance duties. The SEC took action against the CEO and the adviser in this instance (not the CCO), requiring, among other things, that the adviser take remedial action such as working with outside compliance counsel.

In September 2015, the SEC fined a registered adviser which it found did not have written policies and procedures reasonably designed to protect customer records and information (resulting in the disclosure of personally identifiable information of 100,000 individuals) and ordered the adviser to take certain remedial action.

REQUIREMENTS RELATING TO CYBERSECURITY

During 2015, OCIE published the results of a "Cybersecurity Examination Sweep" in which it examined 49 registered investment advisers (and 57 registered broker-dealers) in connection with cybersecurity issues. The SEC published guidance for investment advisers stating that "funds and advisers should identify their respective compliance obligations under the federal securities laws and take into account these obligations when assessing their ability to prevent, detect and respond to cyber-attacks. Funds and advisers could also mitigate exposure to any compliance risk associated with cyber threats through compliance policies and procedures that are reasonably designed to prevent violations of the federal securities laws."

In September 2015, the SEC fined a registered adviser which it found did not have written policies and procedures reasonably designed to protect customer records and information (resulting in the disclosure of personally identifiable information of 100,000 individuals) and ordered the adviser to take certain remedial action. Registered advisers should, therefore, review the SEC's guidance on the topic of cybersecurity to ensure compliance with applicable rules and the SEC's current expectations.

LOOKING AHEAD TO 2016

OCIE has already announced selected examination priorities for 2016 relating to private advisers, which include, among other topics, (1) a continued focus on cybersecurity, (2) fees and expenses and (3) controls and disclosure associated with side-by-side management of accounts with performance-based vs. asset-based compensation. OCIE indicated this is far from an exhaustive list, but rather simply a suggestion for areas which may require an even greater degree of attention for registered advisers, their principals and their compliance staff. ■

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Reminder: New ASU 2014-11 Disclosures Effective for Calendar Year-End 2015 Funds with Repo Lending Accounted for as a Secured Borrowing

By Ari Samuel, CPA and Melissa Miro, CPA

In June 2014, the Financial Accounting Standards Board issued an amendment to Topic 860 – *Transfers and Servicing, Accounting Standards Update No. 2014-11 Repurchase-to-Maturity Transactions, Repurchase Financings and Disclosures* (the "ASU"). Although many of the provisions of this ASU are not applicable to funds, the ASU does require certain additional financial statement disclosures for funds that enter into repo lending transactions. These new disclosure requirements are effective for private entities for annual periods beginning after December 15, 2014.

The main provisions of the ASU changes the accounting for repurchase-to-maturity transactions and repurchase financing agreements executed contemporaneously with a repurchase agreement with the same counterparty. Previously, these transactions were accounted for as a sale with a forward repurchase commitment. Under the ASU, these types of transactions should be accounted for as secured borrowings.

As funds account for repurchase agreements as secured borrowings, these provisions will generally not have an impact on funds. However, the ASU does require additional disclosures for all repurchase agreements and security lending transactions, as follows:

- A disaggregation of the gross obligation by the class of collateral pledged
- The remaining contractual time to maturity of the agreements
- A discussion of the potential risks associated with the agreements and the related collateral pledged, and how those risks are managed.

The following is an example of the quantitative disclosure included in the ASU:

Repurchase Agreements, Securities Lending Transactions, and Repurchase-to-Maturity Transactions Accounted for as Secured Borrowings *(Dollars in Millions)*

	20XX Remaining Contractual Maturity of the Agreements				
	Overnight and Continuous	Up to 30 days	30-90 days	Greater Than 90 days	Total
Repurchase agreements and Repurchase-to-maturity transactions					
U.S. Treasury and agent securities	$ XXX	$ XXX	$ XXX	$ XXX	$ XXX
State and municipal securities	XXX	XXX	XXX	XXX	XXX
Asset-backed securities	XXX	XXX	XXX	XXX	XXX
Corporate securities	XXX	XXX	XXX	XXX	XXX
Equity securities	XXX	XXX	XXX	XXX	XXX
Non-U.S. sovereign debt	XXX	XXX	XXX	XXX	XXX
Loans	XXX	XXX	XXX	XXX	XXX
Other	XXX	XXX	XXX	XXX	XXX
Total	XXX	XXX	XXX	XXX	XXX
Securities lending transactions					
U.S. Treasury and agency securities	$ XXX	$ XXX	$ XXX	$ XXX	$ XXX
State and municipal securities	XXX	XXX	XXX	XXX	XXX
Corporate securities	XXX	XXX	XXX	XXX	XXX
Equity securities	XXX	XXX	XXX	XXX	XXX
Non-U.S. sovereign debt	XXX	XXX	XXX	XXX	XXX
Loans	XXX	XXX	XXX	XXX	XXX
Other	XXX	XXX	XXX	XXX	XXX
Total	XXX	XXX	XXX	XXX	XXX
Total Borrowings	**$ XXX**	**$ XXX**	**$ XXX**	**$ XXX**	**$ XXX**
Gross amount of recognized liabilities for repurchase agreements and securities lending in footnote					**$ XXX**
Amounts related to agreements not included in offsetting disclosure in footnote					**$ XXX**

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Alternative Investment Industry Outlook for Q1 and Beyond in 2016

By Elana Margulies Snyderman

2015 will go down as one of the worst years on record for the hedge fund industry, with a handful of the biggest names to experience their first-ever negative year and prompting mass investor redemptions and firms to shut down. Both allocators and managers looking ahead to 2016 are concerned about the liquidity problem due to uncertainty around the Federal Reserve's interest rate hike along with worries about China's economy. Hence, many investors are anticipated to rotate out of the larger managers — all crowded in the same positions — into smaller and medium-sized managers who are more nimble and therefore better able to navigate the choppy marketers. On the strategy front, mean-reversion strategies are expected to shine, including global macro managers and CTAs with their ability to capitalize on the volatility. On the other hand, managers slated to struggle include those investing in some of the emerging markets countries, particularly China, along with distressed debt offerings since the pool of money trying to take advantage of those investments will be too big.

Both allocators and managers looking ahead to 2016 are concerned about the liquidity problem due to uncertainty around the Federal Reserve's interest rate hike along with worries about China's economy.

Additionally, non-investment trends anticipated for 2016 such as long/short equity hedge fund strategies will be the most popular new launches, although new offerings in the private equity and credit space will debut with the most money. Asset raising will still be challenging as institutional investors, pensions in particular, consolidate their number of underlying managers. Finally, the debate on fee reduction will continue.

INVESTOR DEBATE: SMALL VS. LARGE MANAGERS

Investors in general are slated to pay more attention this year to smaller-to-medium-sized managers, independent of their strategy given their ability to be nimble and navigate the volatile markets better than the larger funds.

"If you look at the top 20-to-25 funds, a lot of them didn't do well," said Robert Discolo, Executive Vice President, Permal Group. "They struggled since a lot of them had the same trades on and same ideas."

However, some of the biggest investors, pensions in particular, will continue to prefer managers with over $1 billion in assets under management.

STRATEGY OUTLOOK

On the heels of volatility, mean-reversion strategies are expected to shine, including global macro and CTAs.

"Allocators are going to be looking for strategies that are mean-reverting in nature, much different than what we have seen over the last 6-7 years where beta was really the way to make money," said Michael Beattie, Chief Investment Officer, Tradex Global Advisors, a Connecticut-based alternative asset manager. "I think smart beta and negatively correlated hedge funds are going to be in favor for what institutions need to survive."

On the other hand, the general consensus is distressed debt managers will face challenges since the pool of money pursing the same opportunity sets will be too large. Additionally, portfolios exposed to some of the emerging markets countries will get hurt, especially those connected to China because of its economic growth slowdown.

NON-INVESTMENT TRENDS

Fund Launch Activity

Long/short equity hedge funds have been and are expected to continue to be the most popular strategy to

On the strategy front, mean-reversion strategies are expected to shine, including global macro managers and CTAs with their ability to capitalize on the volatility. On the other hand, managers slated to struggle include those investing in some of the emerging markets countries, particularly China, along with distressed debt offerings since the pool of money trying to take advantage of those investments will be too big.

launch, although their launch size will be a lot smaller than the new offerings in private equity and credit: $30 million to $50 million on average vs. $100 million.

"Although there has been a great deal of volatility in the equity markets, long/short equity is still the most popular strategy that is attempting to launch," said Frank Napolitani, Director in EisnerAmper's Financial Services Group." The recent volatility may cause some of these firms to rethink their plans due to their investors wanting to de-risk."

Of the new launch candidates that EisnerAmper's Financial Services Group has met since September, the majority of them (60%) have been long/short equity managers, followed by funds of hedge funds (8.89%) and finally, credit (6.67%).

Fundraising Challenges/Fee Debate

Finally, funds are going to run into more barriers raising money this year as investors, pensions especially, consolidate their number of underlying managers; and the debate on fee reduction will continue. The best-performing managers won't lower their fees and despite investors' most favored nation clauses in place, which deter funds from dropping their terms, there will be ways funds can circumvent this and reduce them if they create different structures outside the LP structure for allocators such as separately managed accounts. ■

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Compliance and Regulatory Services ("CARS") Hot Topics for January 2016

By Carmine Angone

For this month, we thought to highlight some of the SEC's regulatory initiatives for the past year. In 2015, the SEC was very active with an aggressive agenda that resulted in many new regulations and rule proposals that will be sure to prove to be challenging to implement for many advisers, especially the medium-to-smaller advisers that are already have a difficult time with the cost of compliance. It appears as though the route the SEC has taken will make it extremely difficult for many smaller advisers to operate because of the cost of implementing some of these regulations and proposed rules, if and when they are adopted.

As new regulations are adopted the costs for new resources, including additional staffing, technology and software, are accretive to fixed costs. This adds to the overall operational expenses of managing an advisory firm, and may cause smaller advisers to either go back in-house or sell out to larger asset managers. There just does not seem to be any real easy solution for asset managers in this regulatory environment. To provide a sense of what management firms are facing these days, consider some of the following:

For asset managers of mutual funds, including liquid alts, and business development companies, the SEC has proposed 2 regulations that will add to the already onerous reporting and ongoing compliance requirements for 1940 Act registered investment companies.

- The first is a liquidity management regulatory rule proposal. This would require the implementation of a liquidity risk management program and enhanced disclosures directly related to fund liquidity and redemption practices. One of the elements of the risk program requires, among other things, classifying assets into various buckets based on the amount of time an asset would be able to be converted to cash without market impact, ongoing assessment and management of liquidity, establishing a 3-day liquid asset minimum, and board review and approval.   This proposed regulation also codifies the 15% illiquid asset limit in terms of reporting. To read further, please click here: *Liquidity Management Rules for Mutual Funds and ETFs*

- The second impacts the use of derivatives. If adopted as proposed, it would limit the degree to which managers of mutual funds and ETFs can use derivatives and would also require them to implement a derivative risk management program administered by a derivatives risk manager. This program would also involve segregating assets to limit exposure to certain predetermined thresholds by offsetting the derivative exposure relative to assets. Please click here for overview of the new derivatives proposal: *Derivative Rules for Registered Funds and Business Development Companies*

There is also the SEC's Form ADV proposal that will amend Part 1 to capture and report more information on separately management accounts, derivatives, notional exposure, metrics for determining a relying adviser and more supervisory oversight of branch locations.

This is in addition to the SEC's cyber security risk alert that makes clear that the SEC is expecting registered advisers to develop a cybersecurity framework administered by a CTO or CISO.

If that wasn't enough, there is also the FinCEN proposal that would make registered investment advisers subject to the BSA and Patriot Act of 2011 anti-money laundering ("AML) requirements, which will be overseen by the SEC. Historically, advisers would rely on an administrator and pretty much almost ignore AML. It seems as though the adoption of this rule will be a game changer to the current modus operandi.

The above is not even close to an exhaustive list of SEC and related regulatory agencies 2015 initiatives and to do so would in and of itself be too exhausting to list.

Compliance and Regulatory Services ("CARS") Hot Topics for January 2016

Our Take: The SEC is on a tear and it doesn't look like it is going to slow down anytime soon. All one can do is be prepared to address the onslaught of new regulations and have the SEC's questions answered before they are asked. This is a relatively easy task with the right resources, dedication and commitment to implement the fundament elements of these initiatives in the form of procedures and controls designed to reasonably ensure compliance. During the process, smaller advisers may be left behind, forced to find a way to meet these initiatives, or become part of a larger organization with more extensive resources. At this pace, we may be seeing the end of the mid- to small-investment adviser. ■

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