

## Memo Master-Feeder Structures

*Updated October 2008, post the Emergency Economic Stabilization Act of 2008 ("EESA").*

### General

Master-feeder structures are commonly used as a mechanism for simplifying portfolio management when multiple funds are managed in an identical style. A single investment portfolio can eliminate performance differences between funds plus reduce the management challenges associated with alignment of positions. However, the structure can also be used to improve after-tax results for the managers of certain offshore funds. This motivation is especially germane now that EESA has effectively eliminated the practice of deferring income in offshore funds.

In a nutshell, the issue is that offshore funds are almost universally formed as corporations and the investment manager is a service provider to the fund. Conversely, most domestic funds are limited partnerships (or LLCs with similar tax effects), with the fund manager acting as general partner. In the offshore structure, the fund manager is paid fees taxed at ordinary income rates; in a partnership, incentive compensation can come through as an allocation of a share of portfolio income. If that portfolio income includes significant capital gains, qualified dividends or current-year unrealized gains, it can make a difference, after-tax, to the manager.

Prior to EESA, many fund managers would enter into deferral agreements with the expectation that the power of tax deferral and compounding returns would be a better alternative than paying current taxes on portfolio income, regardless of its composition. With that option now off the table, we would expect many fund managers to review how some of their brethren have been earning allocations rather than fees in offshore funds.

For a number of years, some managers have eschewed deferral, expecting that paying taxes now at lower rates (versus later at higher rates) often seemed preferable, especially considering that deferred fees were inaccessible for long periods of time. The method has been the "memorandum master-feeder" structure.

The following discussion addresses the generalities plus some of the structural considerations for memorandum master feeders. The structure is applicable for both multiple feeder funds and stand-alone offshore funds. This

latter type of fund is sometimes called a "mini-master" or "mini-master-feeder."

We will also spend just a short amount of time setting forth the basics of master-feeders.

### Other Considerations

*Note that this discussion is limited to administration issues and investor perceptions. There may be other considerations relevant to the structure of any fund, such as the existence of other manager-affiliated funds plus the legal implications of commingling of assets in the master fund. These are issues beyond the scope of this material and should be discussed with counsel.*

## The Basics

### Parallel Funds or a Master-Feeder?

At its simplest, a master-feeder is a structural separation of the investment portfolio from the investors. A single portfolio is maintained in a master fund and its participants are feeder funds – funds that hold the investors and "feed" capital to the master. Feeders are defined by their investors, most often with a US limited partnership feeder for taxable domestic investors, plus the offshore corporation feeder for non-US and perhaps non-taxable US investors.

Of course, parallel funds – two separate funds managed identically – despite the portfolio challenges, are sometimes preferable. Due to the different tax concerns of offshore and domestic investors, some managers embrace the opportunity to manage the domestic fund with taxes in mind while ignoring taxes on the offshore fund. For example, in a domestic fund filled with taxable investors, there is good reason to hold an enormous gain about to go long-term, even if it has become less attractive on a technical or fundamental basis. In an offshore fund filled with non-taxable and non-US taxpayers, that consideration doesn't exist.

### Parallel Funds or a Master-Feeder? *continued*

The conundrum is that portfolio alignment won't exist when one fund is managed for taxes. On the one hand, investors generally like to see identical performance from identically-managed funds. On the other, when only one portfolio is managed for tax considerations, results will differ.

The decision to structure parallel or master feeder is based primarily on the level of difficulty associated with alignment of two portfolios when there are varying cash flows, plus trying to gauge investor expectations. The decision to structure as parallel funds or in a master-feeder structure is one that should be discussed with counsel, taking into consideration portfolio characteristics and expected investor composition.

### The Basics of "Conventional" Versus "Memorandum" Master-Feeders

*"Conventional" master-feeder.* This structure contains at least 2 feeders, one of which is an offshore entity (typically a corporation) and one that is a domestic entity (usually a limited partnership). The master fund is simply a portfolio with a minimal number of common expenses; all fees and incentive compensation plus most of the expenses are accounted for at the feeder level. The offshore fund, as a corporation, uses classes of shares plus series within each class issued over time to divide up capital and performance among the investors.

*"Memorandum" master-feeder.* Again, 2 feeders (or a single offshore feeder in a "mini-master"); however, there is a tracking process at the master level — the memorandum accounts — for feeder participants. While the investors do own shares in the offshore corporation, those shares track memorandum accounts in the master, and incentives are charged as allocations at the master level versus fees at the feeder level. The memorandum accounts are required so that incentives at the master fund properly track participant performance at the feeder level. If the master fund simply charged on aggregate feeder fund performance, there would be inequities for both investors and manager.

### A Master-Feeder Decision Matrix

The following are intended as prompts when contemplating fund structure. The primary considerations are three: the level of difficulty in the portfolio; expected US tax characteristics; and offshore investor expectations. The prompts below are ones that should be carefully considered with the assistance of counsel, keeping in mind that there may be additional considerations. The assumption is that two funds are to be formed; one domestic; one offshore.

#### Is portfolio alignment between the two funds both difficult and important?

**Yes** Are long-term gains and/or qualifying dividends significant?

**Yes** Consider a memorandum master-feeder.

**No** Consider a conventional master-feeder (also, consider a 475(f) election<sup>1</sup>).

**No** Are long-term gains and/or qualifying dividends significant?

**Yes** Do offshore investors prefer that US tax considerations be ignored in trading decisions?

**Yes** Consider parallel.

**No** Consider a memorandum master-feeder.

**No** Consider a conventional master-feeder (also, consider a 475(f) election<sup>1</sup>).

*Note that if a 475(f) election is warranted, the structure should likely be a conventional master-feeder. In a 475(f) fund, there would be little or no tax advantage for a memorandum master-feeder, plus the implied level of portfolio activity would best be managed in a single master account.*

<sup>(1)</sup> A 475(f) election marks the portfolio to market at year-end, with all income being considered "ordinary" in character. Its principal advantage is that it eliminates wash sale issues, which can be troublesome in high turnover funds.

### Structural Details

While the master fund in a “conventional” master-feeder has just two participants to track – the two feeders, a “memo-master” has multiple accounts used for tracking underlying investments at the feeders. This may be in the form of (a) “memorandum accounts” at the master level reflecting each feeder participant or (b) separate capital accounts at the master for each feeder series. The feeder, in turn, links each of these accounts at the master to an individual investor or to one of its series. Since manager compensation (and hopefully expenses – more on that below) are accounted for at the master level, the master’s net “memorandum accounts” become the feeder’s net values for the relevant participants or series. Since the master entity is a partnership, incentive compensation occurs as an allocation of portfolio income.

There are two important structural elements for a memorandum master-feeder: expense mechanics and whether the master fund tracks participants or calendar series.

#### Expenses

*Location.* One added promise of a memorandum master-feeder is simplicity. When all the expenses and allocations occur at the master level, then two important things occur:

- The incentive calculation will be on true net gains. (Conversely, any expenses occurring at the feeder level would be post-incentive.)
- The master “memorandum” or series capital accounts are directly convertible into participant or series capital in the feeder.

Conversely, if expenses were paid or reserved at the feeder level, the feeder would have its own accrued payables plus possible cash balances to facilitate payment, which would mean that the master memorandum accounts won’t directly translate into feeder valuations. Accordingly, documentation should provide that feeder expenses be handled in one of the following ways:

- At the master fund as an obligation of the master fund;
- Nominally at the feeder level, but administered by agreement at the master level, so as to

provide for proper incentive computation and eliminate separate feeder assets and liabilities;

*Allocation.* Expenses may be shared pro rata at the master fund level or allocated differentially among the feeder funds.

- Pro rata. While some expenses may relate more to one feeder than another, both feeders are often considered inseparable parts of a common business enterprise. Increased capital, regardless of source, generally helps to reduce the performance effect of third-party expenses and can make operations more efficient. Pro rata sharing is simpler administratively and will usually decrease accounting costs.
- Allocated by feeder association. If some expenses are to be attributed to one feeder and not the other, such an allocation can be made at the master fund level to the memorandum accounts associated with the relevant feeder.

These allocation decisions may differ depending on the type of expense (formation costs, audit, administration, RTA if separate, offshore directors, and ongoing legal).

*APM Observation: The simplest and least expensive structure is for expenses to be shared pro rata at the master fund level.*

#### The Tracking Choice

*The master fund can track the offshore feeder’s individual participants or its calendar series. Note that the master fund always tracks participants in the domestic feeder. While familiarity may suggest using the calendar-based series seen in conventional offshore funds, there are several advantages of tracking participants:*

- Each participant has its own aggregate high-water mark. In a “conventional” offshore fund, the series shares, not the investor, have the high water marks, so one series may pay an incentive while other series held by that investor are

### The Tracking Choice continued

below high-water. The investor's realization that "If I add money, I may pay an incentive even if I haven't made money overall" can stall added contributions during bad patches. Conversely, an aggregate high-water mark can encourage capital additions – which also help the manager by reducing the percentage gains needed to get back to incentive territory.

- Series roll-ups and the associated paperwork and potential confusion are eliminated.
- Investor reporting is less confusing. Instead of multiple calendar series accounts for multiple capital additions, investors see just one aggregate account.

*APM Observation: The simplest and least expensive structure is for the master fund to track offshore feeder participants rather than calendar series.*

## Memorandum Master Feeder Parameter Table

**Fund:** \_\_\_\_\_

**A. Tracking Choice** Offshore: Memo accounts track offshore  participants  calendar series  
 Domestic: Memo accounts track domestic participants.

### B. Expense Treatment

- Location:  At the master fund as defined obligations of the master fund  
 Nominally at the feeder level, but administered by agreement at the master, for proper incentive computation and to eliminate separate feeder assets and liabilities

### Allocation choices:

Formation costs	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA
Audit	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA
Administration	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA
RTA (if separate)	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA
Offshore Directors	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA
Ongoing legal	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA

### C. Management

- Fees:  At master level  
 Nominally at offshore feeder level, but administered by agreement at the master level, so as to provide for proper incentive computation.

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