IN FOCUS

Providing industry insight into market trends, best practices, and service solutions

APPLYING A HOLISTIC APPROACH TO RIC TAX ADMINISTRATION

INTEGRATING PEOPLE, PROCESSES, AND TECHNOLOGY TO ADMINISTER COMPLIANCE IN A COMPLEX AND EVOLVING INVESTMENT ENVIRONMENT.

SPRING 2011

All of us serving you™

usbancorp®
Fund Services, LLC

ABOUT THE AUTHORS

MIKE MCMASTER

As director of tax, Michael McMaster is responsible for the oversight of all fund administration, fund accounting, and alternative investment product tax matters. Mr. McMaster oversees the tax support and services provided to fund administration clients on IRS compliance issues, tax filing requirements, and mutual fund and investment partnership tax laws. Mr. McMaster served as the director of Fund Administration at Jackson National Asset Management, LLC, from 2006 to 2007 where he was responsible for all tax and financial reporting matters for Jackson's mutual funds and third party administrative services for investment entities including investment partnerships. Mr. McMaster was a tax manager in the financial services practice of PricewaterhouseCoopers LLP from 2003 to 2006 where he coordinated tax services to registered mutual funds, private investment funds, and investment advisers. He was also active in the firm's national and industry specific tax and financial reporting training programs. From 2000 to 2003, Michael was a mutual fund and hedge fund tax manager in the financial services practice of KPMG, LLP. Prior to that, Mr. McMaster worked at Northern Trust Company from 1994 to 2000 where his responsibilities included financial reporting and managing the tax team overseeing all of the bank's mutual funds.

BOB KERN

Bob Kern began his career with U.S. Bancorp in 1982 and has served as a manager within the fund services subsidiary since 1984. From 1984 to 1994, Mr. Kern managed business development efforts as well as the mutual fund Transfer Agent operation including the Investor Services group, Account Services, Legal Compliance, Document Processing, and Systems Support divisions. During that time, Mr. Kern assisted in the management and implementation of both services and technologies related to Transfer Agent and shareholder services, Fund Accounting, Fund Administration, literature fulfillment, and fund Distribution services. Mr. Kern serves as a board member of U.S. Bancorp Fund Services, LLC and Quasar Distributors, LLC.

ABOUT US

For more than 40 years, U.S. Bancorp Fund Services, LLC has leveraged the specialized niches of experience across our organization to provide seamless services for our clients regardless of the complexity and depth of their products. We know the foundation for strong relationships is built on open communication, trust, and accountability. Our managers and professionals do what it takes every day to deliver the support, guidance, and insight into the market to help our clients be successful.

As investment companies incorporate more complex vehicles such as commodities, futures, short sales, and master feeders into their portfolio investment strategies, it is crucial that service providers have the infrastructure in place to help anticipate any tax, accounting, legal, and compliance risks these securities and complex structures could pose to the fund. Many back-office approaches rely primarily on technology applications to monitor exceptions, but systems alone may not provide the additional insight and oversight needed to catch errors before they significantly impact the fund.

As security types and regulatory requirements continue to evolve, a formal process for addressing issues combined with well-trained, expert professionals may help mitigate and eliminate risks. Comprehensive project management and planning across all functional areas help investment companies and third party service providers to:

- Proactively and efficiently identify any potential issues.
- Pool together talent and specialized expertise to test, create, and analyze potential solutions.
- Develop technology tailored to address the requirements of increasingly complex investment vehicles from a regulatory and compliance perspective.
- Educate the entire staff.
- Implement and update processes and procedures.

> "PFICs are very difficult to identify and funds that invest in foreign equities are always at risk of incurring a tax liability. Having the right system and talent in place is paramount to accurately researching and identifying a security's PFIC status."
>
> *Lance Baker, Chief Financial Officer*
> *Hatteras Investment Partners*

This white paper covers several complex investment vehicles and strategies that can pose risks to your funds if not treated and monitored effectively, efficiently, and continuously.

PASSIVE FOREIGN INVESTMENT COMPANIES (PFIC)

PFICs present unique tax challenges and considerable risk and liability with respect to tax return compliance reporting. In recent years, the IRS has focused considerably more attention in this area and, as a result, there are much more stringent tax reporting requirements and substantial penalties for failure to properly disclose PFIC investments on U.S. taxpayer tax returns, including Regulated Investment Company (RIC) returns. Currently, failure to properly report and identify each PFIC investment on a RIC's annual income tax return on Form 8621 can result in significant penalties and may require tax returns to be amended and re-filed as a result.

OUR SOLUTION TO MITIGATE RISKS

Comprehensive PFIC identification and reporting for RICs is crucial. Mutual fund tax experts should consider this a very high risk area and take specific steps to reduce risks by leveraging best-in-class technology tools and adopting consistent, formal internal control policies and procedures. PFICs are defined by reference to certain gross income and asset tests pertaining to individual securities and because of this, they can be very difficult to identify. Our senior managers leverage their more than 18 years of industry experience to develop comprehensive internal processes that identify and track PFICs in our client's investments. We also implemented automated software that exclusively streams PFIC data into our fund accounting system on a quarterly basis. Our approach allows us to accurately identify and help mitigate potential tax risks associated with investments in PFICs.

RESULTS FROM OUR APPROACH

Our commitment to accuracy has resulted in 100 percent compliance for our clients' initial tax return and annual report filings. Several outside audit and tax firms have also been impressed with the overall efficiencies of our PFIC reporting processes and we've received positive comments with respect to the processes that support our tax return and annual report filings.

COMMODITY INVESTMENTS

In recent years, commodity investments have become a very popular investment option for RICs given today's current economic and market conditions. However, they present definite challenges from a tax reporting perspective due to a RIC's stringent investment limitations in these investment products per the current Investment Company Act of 1940 and the Internal Revenue Code current guidelines. Direct investments in commodities by RICs generate non-qualifying income and jeopardize a RIC's ability to flow taxable income to the underlying shareholders without incurring an income tax liability at the Fund entity level. If more than 10 percent of gross income is earned by a RIC in any given fiscal year from "non-qualifying" sources such as commodities, a tax liability may be incurred by the RIC. This requires Fund management and their fund administrator to ensure this threshold level of income earned from "non-qualifying sources" does not exceed the 10 percent threshold in any given year.

"Experience and continual education are integral to administrators being able to consult with clients on the tax implications of their investment strategies and product structures."

Debra McGinty-Poteet, President
Brandes Investment Partners L.P.

OUR SOLUTION TO MITIGATE RISKS

Income earned by RICs from direct commodity investments is monitored quarterly by our Tax department. This review process is primarily based upon an automated software program that monitors investment purchases generating "non-qualifying" sourced income. The information generated from this automated process is documented for each RIC by our Fund Administration and Tax departments and then followed up on with discussions that include the RIC's fund management to ensure purchases of "non-qualifying" assets can be monitored and controlled going forward. Any RIC that is classified by the quarterly review processes as investing in "non-qualifying" assets is then reviewed via the automated software program monthly.

RESULTS FROM OUR APPROACH

Our commitment to accuracy has resulted in 100 percent compliance for our clients' initial tax return and annual report filings. Integrating a proactive approach within Tax and Fund Administration departments will lead to early detection of "non-qualifying" income earned. Early, frequent identification on a monthly basis helps our teams address and monitor any potential issues that may result in a taxable liability at the fund entity level.

QUALIFIED PUBLICLY TRADED PARTNERSHIPS (QPTPS)

In recent years, investments in master limited partnerships, often referred to as QPTPs, have become a very popular investment option for RICs with investment holdings pertaining to oil and gas exploratory companies. However, QPTP investments present a unique challenge from a tax reporting perspective given a RIC's stringent investment limitations in these investment products per the current Investment Company Act of 1940 and Internal Revenue Code guidelines. Direct investments in QPTPs are limited to twenty-five percent of a RIC's gross asset value. If the cumulative QPTP investment percentage is greater than twenty-five percent, a fund entity's status as a RIC could be jeopardized and potentially create an income tax liability at the Fund level. If this happens, it prevents a RIC from flowing taxable income to the underlying shareholders without incurring a tax at the fund level.

OUR SOLUTION TO MITIGATE RISKS

Fund management and their administrators must monitor QPTP ownership levels to ensure this twenty-five percent threshold level is not exceeded during any given fiscal quarter-end. At U.S. Bancorp Fund Services, the review process is primarily based upon an automated software program that monitors investment purchases of QPTPs. Any RIC that is classified as investing in QPTPs is generally reviewed monthly and the information generated from this automated process is documented for each RIC by our Fund Administration and Tax departments. We then work directly with our clients' investment management teams to ensure purchases of QPTPs are monitored and controlled.

RESULTS FROM OUR APPROACH

Our commitment to accuracy has resulted in 100 percent compliance for our clients' initial tax return and annual report filings. Integrating a proactive approach within tax and fund administration teams helps lead to early detection of "non-qualifying" income earned. Automated monthly monitoring and analysis also helps ensures any potential issues that may result in a taxable liability at the fund entity level are efficiently identified and addressed.

"The industry is only getting more complex. Investment managers and their funds need providers with the expertise and capacity to support even the most complicated tax issues."

Matt Mead, Principal
Chickasaw Capital Management, LLC

CONTINUOUS TRAINING TO EMBRACE CHANGE

Our educational philosophy is strategically aligned with our core value of employing passionate, talented, and engaged people. By making an organizational commitment to lifelong learning, our employees and clients benefit from a highly knowledgeable and dedicated workforce. In addition to our corporate-wide training, all our divisions maintain dedicated training teams responsible for the initial and ongoing development of new associates. Our employees regularly attend comprehensive training programs that help them master job specific skills as well as interpret changes occurring in our dynamic industry. We continue to invest in each employee through training and development and devote resources to continuously improve training experiences.

As members of the Investment Company Institute RIC National Tax Committee, the American Institute of Certified Public Accountants, and the National Investment Company Service Association, our Tax department maintains a current perspective on all tax issues impacting the financial services industry. In order to ensure their knowledge is shared across our company and helps our entire client base, our Tax department holds training sessions on a quarterly and semi-annual basis. These training sessions are shared throughout our Fund Accounting, Fund Administration, and Alternative Investment divisions to ensure tax-related topics such as client-specific issues and requirements, trends in the industry, and tax treatment of complex instruments such as PFICs, commodity investments, and QPTPs are communicated and discussed in substantial detail. Consistent training allows professionals across our company to understand the impact current, pending, and recently implemented tax legislation has on our clients and internal processes.

PARTING THOUGHTS

A pivotal element of a successful service provider is bringing the right expertise together with sophisticated technology to identify gaps among regulatory guidance and then develop and incorporate a solution into existing processes and daily operations. Our experience has shown that a highly tenured base of professionals, combined with comprehensive procedures, robust training, and integrated technology, helps service providers anticipate and support clients with any regulatory, legal, or tax requirement that may affect their funds.

"A provider with the capacity and experience to walk you through how pending legislation will impact your funds is critical."

Ron Redell, CEO
DoubleLine Capital LP

Our extensive internal training and participation in several national investment company and investment partnership accounting and tax training seminars allow us to develop processes and procedures that positively impact our clients. For example, our Tax department documented all PFIC and QPTP identification, income measurement, and reporting procedures within the FIN 48 documentation that we provide on behalf of our clients. This documentation is also presented to outside audit firms as part of the annual report preparation process. We pool our experience together and share our insights on recent tax developments and current hot topic issues with clients during quarterly client conference calls.

Our specialized Tax department works with every client to develop tax planning strategies specific to their needs. We provide tax consulting services relating to the tax treatment of complex derivative securities and debt instruments, defaulted securities, and an array of tax strategies for specialized transactions including fund mergers and in-kind contributions and redemptions.

U.S. BANK AND ITS REPRESENTATIVES DO NOT PROVIDE TAX OR LEGAL ADVICE. EACH ORGANIZATION'S TAX AND FINANCIAL SITUATION IS UNIQUE AND ORGANIZATIONS SHOULD CONSULT THEIR TAX AND/OR LEGAL ADVISERS FOR ADVICE AND INFORMATION CONCERNING THEIR SPECIFIC SITUATION.

Visit www.casestudies.usbfs.com for additional white papers and case studies or call 800.300.3863.

Headquartered in Milwaukee since 1969, U.S. Bancorp Fund Services, LLC currently provides services to more than 289 mutual fund and alternative investment clients with 1,657 portfolios and aggregate assets of $452 billion. U.S. Bancorp Fund Services' clients include mutual funds, investment partnerships, hedge funds, separately managed accounts, fund-of-funds, and offshore funds. It is a subsidiary of U.S. Bancorp, the fifth largest bank in the United States with assets of $311 billion, NOTED IN THE FIRST QUARTER 2011 CORPORATE PROFILE. U.S. Bank is not affiliated with Hatteras Investment Partners, Brandes Investment Partners L.P., Chickasaw Capital Management, LLC, DoubleLine Capital LP, or any other organization mentioned. U.S. Bank is not responsible for, and does not guarantee the products, services, or performance of its affiliates or third-party providers.

All of us serving you™

usbancorp
Fund Services, LLC