

IN FOCUS

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

APPLYING A HOLISTIC APPROACH TO TAX ADMINISTRATION

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

SPRING 2011

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 the past 40 years, U.S. Bancorp Fund Services, LLC has leveraged the specialized niches of experience across our organization to provide seamless service solutions for our clients regardless of the complexity and depth of their products. With client relationships lasting since our inception 40 years ago, we know the foundation for strong relationships is built on open communication, trust, and accountability. Our managers and professionals will deliver the amount of support, guidance, and insight into the market our clients need to 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 anticipate any tax, accounting, legal, and compliance risks these securities and complex structures could have to the fund. Many back-office approaches rely primarily on technology applications to monitor exceptions, but systems alone cannot 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 can help mitigate and eliminate risks. Comprehensive project management and planning across all functional areas allows 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 entire staff.
- Update processes and procedures.

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 COMPANY (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 applicable penalties for failure to properly disclose PFIC investments on U.S. taxpayer tax returns, including Regulated Investment Company returns. Currently, failure to properly report and identify each PFIC investment on a Regulated Investment Company's annual income tax return on a Form 8621 can result in significant penalties and may require tax returns to be amended and re-filed as a result.

SOLUTION TO MITIGATE RISKS

Tax departments should create and identify PFIC reporting for Regulated Investment Companies as a very high risk area and take specific steps to minimize this risk by augmenting technology and adopting internal control policies and procedures. U.S. Bancorp Fund Services has incorporated PFIC identification software provided by Ernst and Young as a component of our PFIC identification process. On a quarterly basis, PFIC data streams into our fund accounting system to help identify new PFICs for each of our clients' Funds.

RESULTS FROM OUR APPROACH

Regulated Investment Company clients that leverage our Tax services have never restated or re-filed their tax returns due to inaccurate PFIC reporting issues to date. Outside audit and tax firms have often commented on the overall efficiencies of our PFIC reporting processes with respect to tax return and Annual Report filing processes. We have also been able to leverage a considerable fee reduction from Ernst and Young based on the extensive volume of PFICs reviewed through the use of their software, as well as from the strong working relationship between our firms. These savings reductions are passed on to our fund administration clients. Our Tax department also supplements the data software process by conducting manual reviews throughout the identification process.

“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.”

*Client Name, Title
Company Name*

COMMODITY INVESTMENTS

In recent years, commodity investments have become a very popular investment option for Regulated Investment Companies given today's current economic and market conditions. However, they present definite challenges from a tax reporting perspective due to a Regulated Investment Company'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 Regulated Investment Companies generate non-qualifying income and jeopardize a Regulated Investment Company'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 Regulated Investment Company in any given fiscal year from "non-qualifying" sources such as commodities, a tax liability may be incurred by the Regulated Investment Company. 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.

SOLUTION TO MITIGATE RISKS

Income earned by Regulated Investment Companies from direct commodity investments is monitored quarterly by our Tax Team. This review process is primarily based upon an automated software program that monitors investment purchases by Regulated Investment Companies that generate "non-qualifying" sourced income. The information generated from this automated process is documented for each Regulated Investment Company by the fund administration and tax teams, and then followed up on with discussions that include the Regulated Investment Company's Investment Fund Management Teams to ensure purchases of "non-qualifying" assets can be monitored and controlled going forward. Any Regulated Investment Company that is classified by the quarterly review processes as investing in "non-qualifying" assets is then reviewed via the automated software program on a monthly versus quarterly basis.

RESULTS FROM OUR APPROACH

Clients using our tax preparation and compliance services have not had to restate or re-file tax returns due to the inaccurate disclosure of taxable income from "non-qualifying" asset sources. Integrating a proactive approach within tax and fund administration teams will lead to early detection of "non-qualifying" income earned. It will also identify and allow teams to address and monitor any potential issues that may result in a taxable liability at the fund entity level on a monthly basis.

QUALIFIED PUBLICLY TRADED PARTNERSHIPS (QPTPS)

In recent years, investments in master limited partnerships, often referred to as qualified publicly traded partnerships or QPTPs, have become a very popular investment option for Regulated Investment Companies with investment holdings pertaining to oil and gas exploratory companies. However, QPTP investments present a unique challenge from a tax reporting perspective given a Regulated Investment Company's stringent investment limitations in these investment products per the current Investment Company Act of 1940 and Internal Revenue Code current guidelines. Direct investments in QPTPs are currently limited to twenty-five percent of a Regulated Investment Company's gross asset value. If a Regulated Investment Company's cumulative QPTP investment percentage is greater than twenty-five percent, a fund entity's status as a Regulated Investment Company could be jeopardized and potentially create an income tax liability at the Fund level. This would prevent a Regulated Investment Company from flowing taxable income to the underlying shareholders and would force an income tax liability at the Fund entity level. Fund Management and their administrators must monitor QPTP ownership levels by Regulated Investment Companies to ensure this twenty-five percent threshold level is not exceeded during any given fiscal 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."

*Client Name, Title
Company Name*

SOLUTION TO MITIGATE RISKS

Income earned by Regulated Investment Companies from QPTPs should be monitored quarterly. At U.S. Bancorp Fund Services, the review process is primarily based upon an automated software program that monitors investment purchases of QPTPs by Regulated Investment Companies. The information generated from this automated process is documented for each Regulated Investment Company by our Fund Administration and Tax departments. We communicate with our clients' investment management teams to ensure purchases of QPTPs are monitored and controlled going forward. Any Regulated Investment Company that is classified as investing in QPTPs is reviewed via our automated software program on a monthly versus quarterly basis.

RESULTS FROM OUR APPROACH

Clients using our tax preparation and compliance services have not had to restate or re-file tax returns due to the inaccurate disclosure of taxable income from QPTP investments to date. Integrating a proactive approach within tax and fund administration teams will lead to early detection of "non-qualifying" income earned. It will also identify and allow teams to address and monitor any potential issues that may result in a taxable liability at the fund entity level on a monthly basis.

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's Regulated Investment Company National Tax Committee, the American Institute of Certified Public Accountants, and the National Investment Company Service Association, our Tax team maintains a current perspective on all tax issues impacting the financial services industry. Our Tax team also provides services to our alternative investment fund clients. In order to ensure their knowledge is shared across our company and benefits our entire clients base, our tax team holds training sessions on a quarterly and semi-annual basis for our the entire department where they discuss, in substantial detail, on all tax reporting aspects related to client-specific issues and requirements, trends in the industry, and complex instruments such as PFICs, commodity investments, and QPTPs. Consistent training allows our professionals to understand the impact current, pending, and recently implemented and how they can impact our clients.

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

*Client Name, Title
Company Name*

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 issues may arise from one or more of the following:

- Inadequate procedures.
- Inadequate technology.
- Inadequate training.

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 in our FIN 48 documentation. This documentation is presented to all outside audit firms when our clients' Annual Reports are prepared. We also pool this experience together to share our processes and to discuss 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.

This document is for general information purposes only and should not be used as a substitute for consultation with professional advisers.

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

*Client Name, Title
Company Name*

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 290 mutual fund and alternative investment clients with 1,658 portfolios and aggregate assets of \$625 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 \$283 billion, NOTED IN THE SECOND QUARTER 2010 CORPORATE PROFILE.

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