

REQUEST LETTER

06-007

March 30, 2006

NAME

ADDRESS

Re: Request for Advisory Opinion – Utah Taxation of COMPANY Client’s and Customers

The following information is the formal request for an advisory opinion on the matter we recently discussed via telephone. As per our discussion, we are submitting this written request but feel that an actual meeting to discuss this issue with commission members and staff would be of significant value. It is my understanding that Commission Marc Johnson will be coordinating the advisory opinion process. As such, we will work with him on scheduling a meeting after the commission and staff have had the opportunity to initially review this request.

The matter at hand concerns COMPANY, a Utah corporation located in CITY, STATE. As more fully disclosed below, COMPANY provides administrative (back office) services to unrelated offshore hedge funds. For federal income tax purposes prior to the Taxpayer Relief Act of 1997 (“1997 Act”), an unrelated offshore hedge fund could be subjected to United States (federal) income taxation simply by engaging an unrelated U.S. company to provide administrative services similar to the services provided by COMPANY. The 1997 Act revised the law eliminating this possibility for federal income tax purposes.

Although the issue of federal tax liability has been addressed via federal legislation, COMPANY is concerned about the possibility of Utah state income tax being imposed on offshore hedge funds simply because they chose to utilize COMPANY administrative services. As such, pursuant to Rule 861-1A-34 of the Utah Administrative Code, COMPANY hereby submits this Request for an advisory opinion from the Utah State Tax Commission (“Commission”) confirming that unrelated offshore funds that otherwise have no nexus in the State of Utah are not subject to Utah income taxation simply by engaging COMPANY to provide administrative services.

STATEMENT OF FACTS

A. Taxpayer Information

COMPANY is a long-standing S Corporation domiciled in the State of Utah. All income generated by COMPANY is treated as Utah income. Each of the shareholders is a Utah resident. As such, all income generated by COMPANY is subject to Utah income taxation.

COMPANY provides administrative services to hedge funds, both domestic and foreign (trading stocks and securities on its own behalf). Such hedge funds are not related to COMPANY.

COMPANY is not owned nor does it (or its shareholders) have any ownership in any of the funds serviced. Each of these funds is assessed an administrative fee on a quarterly basis. The quarterly fee is calculated as a percentage of the fund's net asset value under management subject to various minimum fees. The amount of such quarterly fee is consistent with similar fees charged by competitors throughout the industry.

The administrative services rendered by COMPANY consist of the following:

1. Provide private placement memorandums and subscription agreements to potential fund investors as directed by the fund's investment manager.
2. Maintain private placement memorandum log as required by Securities and Exchange regulations.
3. Receive completed subscription agreements from each investor. Review agreements for completeness and match agreement amounts to incoming funds.
4. Perform anti-money-laundering procedures on incoming wire transfers.
5. Complete treasury functions by notifying investment manager of available funds received and transferring available funds to investment manager's prime broker account(s).
6. Admit shareholders into the fund and enter them into the shareholder registry. Note that shareholders are either foreign investors or US non-taxable investors.
7. Account for and reconcile all investment manager trades to all clearing and custodial brokerage accounts.
8. Obtain approval from the fund and draw upon the bank accounts of the fund to pay and discharge all properly due charges, documented costs, expenses and liabilities of the fund that become due and payable.
9. Value the fund's assets and liabilities on a monthly basis and calculate the net asset value.
10. Provide the fund's financial statements and portfolios to the investment manager.
11. Report the net asset value to shareholders via email, fax, or hard copy.
12. Provide other necessary and requested reports to the investment manager and shareholders.

13. Coordinate and oversee the annual audits of the fund with external auditors.
14. Provide corporate secretarial services to the fund.
15. Conduct on-going anti-money-laundering procedures.
16. Act as may be required from time-to-time by the company as proxy agent in connection with the holding of shareholder meetings, receiving and tabulating votes cast by proxy and communicating to the fund results of such tabulation, accompanied by appropriate certificates.

The funds in question are offshore hedge funds. Such funds are not required to and do not file U.S. federal income tax returns. They do not have any employees, property or sales within the State of Utah. Their sole affiliation with the state is the engagement of an unrelated service provider COMPANY to provide the above-mentioned administrative services.

B. Background/Change in Internal Revenue Code

Prior to the 1997 Act, Internal Revenue Code (IRC) §864(b) provided that a foreign taxpayer trading in stocks or securities for the taxpayer's own account would not be treated as engaging in a "trade or business within the United States" unless (a) the taxpayer was a dealer in securities or a corporation whose principal business was trading in stocks or securities for its own account and (b) its principal office was in the United States. As such, if a foreign corporation did not have its principal office in the United States and solely traded in stock and securities for its own account, such a corporation would not be subject to taxation within the United States.

The U.S. Treasury Department promulgated regulations (Reg. §1.864-2(c)) outlining what constitutes a "principal office." These regulations referenced ten administrative functions. The location where these ten functions were performed determines the location of the principal office; regardless of whether the functions are performed by corporate employees or agents appointed by the corporation. These ten administrative functions became known euphemistically as the "Ten Commandments." Hence, under prior law, an offshore hedge fund which engaged in a firm similar to COMPANY to perform the administrative functions listed above would be subject to U.S. taxation since the performance of these administrative functions by COMPANY would constitute a "principal office" for the offshore fund.

Over a period of years, the impact of the "Ten Commandments" led to the elimination of numerous jobs within the U.S. as hedge funds simply moved their administrative work offshore. In response, the Clinton administration moved to address this situation with the result that the "principal office" requirement and thus the "Ten Commandments" were repealed as part of the 1997 Act. The expectation was that over time many of these jobs would migrate back to the U.S. Simply put, following the 1997 Act, an offshore fund with no activity in the U.S. could engage COMPANY to perform its administrative functions without the fund creating a U.S. tax liability.

The 1997 Act eliminated the concern of offshore funds around U.S. taxation but didn't completely eliminate the concern around state taxation. The lingering concern is whether an offshore fund outsourcing its administrative functions to a U.S. service provider inadvertently creates nexus in a given state such that the Fund becomes taxable in that state even though it is not subject to U.S. taxation. Several states such as Connecticut and New York have is actively changed or clarified their respective laws to eliminate any nexus concerns on the part of these offshore funds. No such change or clarification has occurred in the State of Utah.

II. RULING REQUEST

Based on the facts presented in this Request, the taxpayer asks the Commission to issue an advisory opinion finding that unrelated offshore fund clients and customers of COMPANY are not subject to taxation within the State of Utah simply by outsourcing the fund's administrative functions to COMPANY. It is understood that these off-shore funds do not otherwise have nexus within the State of Utah.

III. STATEMENT OF LAW AND ANALYSIS

The following information outlines the underlying rationale as to why we believe that there is no basis for imposing the state corporate tax on the off-shore hedge fund clients of COMPANY.

Attribution

As with many other states, Utah adopts most of the provisions contained within the Internal Revenue Code. The Utah Code does not contain a provision similar to IRC § 864 nor does it contain any provision eliminating the impact of the 1997 Act changes on IRC § 864. As such, there is no basis by which the activity of COMPANY would be attributed to the offshore hedge fund.

Unitary Group

Likewise, COMPANY and the fund do not constitute a unitary group. Utah Code Ann. §59-7-101(28) (a) (1996) defines a unitary group as "a group of corporations that:

- (i) are related through common ownership; and
- (ii) by a preponderance of the evidence as determined by a court of competent jurisdiction or the commission, are economically interdependent with one another as demonstrated by the following factors:
 - a. centralized management
 - b. functional integrations; and
 - c. economies of scale."

Given that there is no common ownership between the fund and COMPANY, by definition, these two entities do not form a unitary group.

Hedge Fund Taxable on Stand-Alone Basis

The following analysis focuses on whether the offshore hedge fund is subject to Utah taxation on a stand-alone basis. In calculating income subject to tax within the State of Utah, the starting point is unadjusted income as defined in Utah Code Ann §59-7-101(27)(1996). “Unadjusted income” means federal taxable income as determined by the Internal Revenue Code, before the net operating loss deduction and special deductions for dividends received.” Unadjusted income is modified by additions and subtractions outlined in Utah Code Ann §§59-7-105 and 59-7-106 (1996) respectively. It appears that none of the additions and subtractions would modify the unadjusted income of an offshore hedge fund not filing a US federal income tax return. Adjusting the unadjusted income with the additions and subtractions drives “adjusted income” as defined in Utah Code Ann. §59-7-101(1)(1996).

Adjusted income is then increased by non-business income as defined in Utah Code Ann. §59-7-302. Such definition states that “non-business income” means all income other than business income.” Utah Code Ann. §59-7-306 indicates that certain non-business income (such as capital gains, interest, and dividends) “shall be allocated as provided in Sections 59-7-307 through 59-7-310.” These sections state the following as it would apply to an offshore hedge fund:

1. Capital gains and losses from sales of intangible personal property (i.e., stocks, bonds, etc.) are allocable to Utah if the hedge fund’s commercial domicile is Utah.
2. Interest and dividends are allocable to Utah if the hedge fund’s commercial domicile is Utah.

As stated in the facts above, the offshore hedge fund’s only affiliation with the state of Utah is COMPANY. Since there is no statutory basis for attributing the activities of COMPANY to the fund, the fund has no activity within the state and consequently is clearly not domiciled within the state.

“Apportionable income” is defined as adjusted income less non-business income net of related expenses, to the extent included in adjusted income (Utah Code Ann. §Ann. 59-7-101 (1996)). Such income is then apportioned between various jurisdictions based on a three-factor formula as provided in Utah Code Ann. §59-7-311 (1996). Finally, Utah taxable income is the sum of (1) “apportioned income” apportioned to Utah and (2) “non-business income” allocated to the state.

As it relates to an offshore hedge fund with no Utah nexus and limited affiliation (through engaging COMPANY to provide administrative services) to the state, it appears that both “apportioned income” and “non-business income” would be zero. The same would apply for (a) apportioned income since the hedge fund has no federal taxable income and does not file a federal return; and (b) non-business income since the offshore hedge fund is not domiciled in the state.

As such, it appears the hedge fund on a stand-alone basis is not taxable in the state of Utah.

IV. PROCEDURAL MATTER

A. Representation under Rule 861-1A-34.A.2 of the Utah Administrative Code that this Request Does not Duplicate Facts or Matters already before the Commission.

To the best knowledge of the Taxpayer and the Taxpayer's representatives, the issues presented in this request for an advisory opinion are not regarding facts raised pending before the Commission in an audit assessment, refund request, or other agency action, or are not regarding matters that are pending before the court on judicial review of a Commission decision.

B. Administrative

1. The Taxpayer requests that following receipt of this information that a follow-up meeting be scheduled to address any outstanding issues and provide clarification of any issues.
2. The Taxpayer requests that the Commission send the advisory opinion via facsimile transmission to NAME at PHONE and OTHER NAME at PHONE, their authorized representatives. The Taxpayer expressly waives any disclosure violations resulting from the fax transmission of the advisory opinion.
3. In the event the Commission determines that a favorable ruling will not be issued, the privilege of a telephone conference is requested.

Thank you very much for your assistance in this matter.

Very Truly Yours

NAME
TITLE

RESPONSE LETTER

September 1, 2006

NAME
ADDRESS

Re: Private Letter Ruling 06-007
Utah Taxation of COMPANY Clients and Customers

Dear NAME,

This is in response to your letter dated March 30, 2006 in which you requested an Advisory Opinion regarding certain activities of COMPANY. Your question is whether the activities performed in Utah, providing administrative services to unrelated offshore hedge funds, create nexus in Utah for these entities and their owners/members/partners (“members”). The clients of COMPANY comprise both domestic and foreign funds that trade stocks and securities on their own behalf. You have indicated that these clients, consisting of both ‘hedge funds’ and ‘fund of funds’, are generally organized as partnerships and LLC’s and that their members are either foreign or U.S. (non-taxable) investors. We subsequently met with you, representatives from both COMPANY as well as OTHER COMPANY on DATE. At that meeting your inquiry was further explained and a number of questions addressed.

As explained in your letter, there is a history with the Internal Revenue Service in connection with the former attribution of the income of offshore hedge funds as U.S. source income, based on ‘back office’ activities performed within the United States by a service provider performing activities similar to those performed by COMPANY for its clients. Former IRC Section 864(b) and IRC Regulation 1.864-2(c) governed this area and provided guidelines under which certain activities, regardless of by whom performed (i.e. whether related or unrelated parties), formerly constituted a “principal office” of the hedge fund, resulting in the determination that the back office activities provided by the unrelated service provider, generated income for the unrelated offshore fund that was effectively connected with the United States.

As explained, these Federal provisions were repealed in 1997 such that the types of activities performed by COMPANY and similar service providers for their unrelated offshore fund clients no longer constitute income effectively connected with the U.S. (or U.S. source income). Although, the 1997 Federal legislation addressed concerns regarding Federal taxation of this income to the hedge funds and their members, you explained that few states have passed

legislation or issued guidelines in this area. Your question concerns the taxability of the unrelated offshore hedge fund clients of COMPANY only and not the taxability of the income of COMPANY itself. You have acknowledged that the income of COMPANY and/or its owners is subject to Utah tax because services provided by COMPANY are performed in the state of Utah.

The March 30, 2006 request letter identified sixteen administrative services that are provided by COMPANY. You have characterized these activities as “back office functions” for its unrelated offshore hedge fund clients. Many of these functions are similar to those frequently provided to clients by accounting firms.

It was emphasized that COMPANY does not have authority to act and does not act in any manner as an agent for or on behalf of its offshore hedge fund clients in the course of providing administrative services to such clients. Specifically, COMPANY does not become involved in making investment decisions or soliciting investors on behalf of the unrelated offshore hedge fund client. Such investment and solicitation services are performed by hedge fund staff at the location of the hedge fund domicile and/or by advisors in other states, and none of which are performed in Utah.

Based upon the information provided in your letter dated DATE and during the meeting held on DATE, we have determined that the activities of COMPANY will not create Utah nexus or taxability for the unrelated offshore hedge fund clients of COMPANY and their owners for purposes of the Utah corporation franchise tax and Utah individual income tax. However, this advisory opinion is not to be construed to exempt any client or member of an offshore fund from Utah taxation that is domiciled in or a resident of the state of Utah, or that otherwise has nexus with Utah.

Our analysis is based on the assumption that the facts as you have represented them are correct. Should the conditions or circumstances be other than as you have represented, our conclusions may differ. If you have any other questions, please contact us.

For the Commission,

Marc B. Johnson
Commissioner

PLR 06-007