Understanding Master Feeder Accounting
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Introduction

Accounting for master feeder funds has once again come to the forefront of the hedge fund industry (if it ever left). In general, depending on the objectives of the fund and the target market(s), the advantages of setting up a hedge fund with a master feeder structure can outweigh the disadvantages. So, what is a master feeder?

💡 Before the attributes of a master feeder are explained, which inherently uses industry jargon, here are a couple of tips that will help your understanding as you read through the rest of the guide:

💨 A feeder fund is generally where the capital investing begins; capital (i.e. cash or securities) flows into the feeders from the investors, which in turn invests all or a portion of the capital into the master fund. The master fund then uses that infusion of capital to generate P&L (i.e. invests in securities, receives income/loss). The P&L generated from the master fund then needs to be “allocated” to all of its constituent feeders. (From the master’s point of view, each feeder can be viewed as an investor).

💡 When you think of a feeder fund investing in a master fund, think of it as a fund buying any other “security”. For example, the feeder fund (where all the limited partner / shareholder capital resides) buys “shares” of a master fund, in the same vein as it buys shares of IBM common stock. (For purposes of this article, a “limited partner” is a US taxable limited partner, and a “shareholder” is a non-US or tax-exempt investor). One significant operational difference between the two is that when a share of common stock is purchased, the underlying income attributes of a corporate stock is not “peered into”; rather, the total return of the stock only comprises price appreciation and dividend income distributions. On the other hand, when you buy a share of a master fund, you’re buying into an investment partnership, and thus all the different income attributes that the master fund generates are passed through to the feeder fund (i.e. dividends, interest, gains, tax adjustments, etc.).
**Master Feeder Funds - Background**

A common type of hedge fund structure is called a “master feeder”. A master feeder fund is (most commonly) a two-tiered investment structure in which investors deposit capital in a “feeder” fund, which in turn invests in a “master” fund that is managed by the same investment advisor. The master fund is the entity that invests in the market as proscribed by the partnership agreement.

A typical master feeder setup has one master fund with one U.S. (or onshore) feeder and one Non-U.S. (or offshore) feeder. The benefit of this organization is that it doesn’t restrict the investing fund to just one type of investor (that is, tax-exempt versus U.S. taxable).

Feeder funds under the same master can differ in their investor types, investment minimums, fee structure, net asset values, and other operational features. Said another way, feeder funds are not tied to a particular master fund, but rather are their own legal entity. As such, they are their own partnerships, and can invest in any number of master funds. The reverse is also true; a master fund is not tied to a feeder, and can accept investments from any number of feeders.

A master fund, being its own legal entity, is typically an offshore corporation. An offshore corporation can “check the box” and elect to be taxed as a partnership for U.S. tax purposes. By investing in an offshore master feeder fund taxed as a U.S. partnership, the onshore feeder will receive “pass-through” treatment for its share of the master fund’s P&L. The investment managers or general partners of offshore funds can be offshore corporations owned substantially by the fund manager or the manager’s U.S. entity. The business structure of a master feeder fund with onshore and offshore feeders is shown below:

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Advantages of a master feeder structure

- Reduces trading costs because there is no need to “split” tax lots (i.e. trading in portfolios designed to mirror each other).
- It eases the administrative burden of maintaining multiple portfolios (a.k.a. pari passu).
- The general partner’s performance fee will be able to maintain the underlying tax attributes from onshore feeders.
- The fund’s combined assets can be used to obtain greater financing benefits (for example, greater leverage or lower interest rates on borrowed securities).

Disadvantages of a master feeder structure

- An offshore fund is generally subject to 30% withholding tax on U.S. dividends. If a fund tries to avoid such transactions, it incurs increased costs that it otherwise would not experience.
- Investing strategies may not offer advantages to all investors at all times. For example, long-term capital gains are beneficial for U.S. limited partners, but taxes are not a concern for offshore investors, so if the master fund holds a security longer to receive favorable tax treatment it may create strategy conflicts.
- Some investment types, such as REITS and mutual funds, are not appropriate for offshore investors due to various regional restrictions, but can be appropriate for U.S. investors.
- Uneven allocations of P&L (such as hot issue versus non-hot issue) and tax accounting can become cumbersome, negating the time and/or cost savings gained from easier trade administration.

It may appear at first glance that the advantages are vastly diminished by the disadvantages; that’s only partially true, and fund dependent. Meaning, not all the items on the above list apply to every fund, so each must be evaluated on a case-by-case basis to determine if any obstacles are likely to present themselves.

Difference Between a Master Feeder and a Fund of Funds (External and Internal)

This is a common question from those trying to differentiate these structures from an operational perspective (as opposed to a legal perspective, where there much more clear delineations). The primary operational difference is timing of the transparency of the information at the different levels. A master feeder, where the feeder buys shares of the master, is getting all of the underlying characteristics of the P&L of the master, all the time (or as frequent as investor reporting is performed). For instance, if what was earned at the master level includes realized gain/loss, unrealized gain/loss, taxable interest, tax-free interest, etc., then all that flows through during the allocation to the feeder.

In a typical externally managed fund of funds investment, the manager is investing in funds that he/she doesn’t manage directly. (Remember that in a master feeder environment the feeder fund and the master fund are managed by the same investment adviser). The “fund of fund” (i.e. investor fund) doesn’t receive underlying detail of the P&L of the investee funds on a periodic basis, but rather just receives a change in NAV or performance figure for which it records as an estimated “appreciation” figure each break period. At the end of the year, the fund of fund receives Schedule K-1s from all the investee funds, and then essentially “restates” the entire year’s P&L into its proper tax components. So, the major difference between the two is timing of when the actual attributes of the income is known to the manager.

Note: Internally managed fund of funds (which is essentially an asset allocation tool used by an investment adviser to diversify by manager within the firm) can peer into the attributes of the P&L on a periodic basis, so that operationally it can work like a master feeder. That said, there are other considerations, such as reporting, that can differ, but just note that if the partnership system can support an internal fund of fund, it can likely do a master feeder as well.
General Accounting Procedures and Workflow for a Master Feeder

Capital Flows

Feeder Capital Flows

Contributions of capital begin at the feeder fund, as that’s where the partners’/shareholders’ capital resides. The feeder then turns around with the capital it has, and may decide to invest all or part in a master fund. So, tracking this contribution has the effect of not only determining each partner’s capital ownership percentage in the feeder fund, but also goes into the equation of what percentage the feeder fund owns of the master fund.

Master Capital Flows

When the feeder invests in the master, from the master’s perspective, it looks like capital (i.e. typically cash) coming into the fund from one of its investors. So, at the master, the net capital flow of all the investors is what’s entered. For example, if a feeder invests $1,000,000 into the master (which is some or all of, say, 5 different investors’ contributions of $200,000 each), then the master can just record a net contribution of $1,000,000. That’s the capital the master has to work with to generate P&L.

Generation of P&L

At the Master Fund

Once the master has recorded the net capital flows it has to work with, it then has a pooled trading account for which it can then generate all P&L. All buys, sells, dividends, interest, etc. are initially accounted for at this level. At an interval that reports need to be generated, it then needs to “allocate” the P&L components back down to the feeder funds that invested in it generally based on their relative capital (economic) percentages.

At the Feeder Fund

Again, feeders are their own partnership (legal entity). They can decide to invest in a master fund, as well as anything else allowed by the partnership agreement. Thus there often times two sources of P&L for a feeder – results from the master, and feeder-specific P&L. Feeder-specific P&L is what you’d expect it to be; P&L related only to things that that feeder invests in (i.e. stocks, bonds, etc.), having nothing to do with the P&L from other feeder(s) or P&L from the master fund. In addition, the feeders carry certain expenses of their own such as management and performance fees. Since each level of the master feeder structure (i.e. corporation / partnership) is a legal entity, full books and records for financial and tax reporting must be maintained for each.

The following activities typically occur solely at the feeder level:

- Cash – kept on hand for miscellaneous feeder-specific expenses and fees
- Capital contributions and redemptions of the investors
- Direct investments in securities and short positions
- Feeder level expenses including management fees and performance fees
- Other liabilities
- Organization costs

So, after the master P&L has been distributed to its respective feeders, all the feeder-specific P&L is entered; then, finally, allocation down to the investors can occur.
Allocation of P&L

Master Fund Economic Allocations

Again, feeders are a partnership (or offshore corporation) and hold all the investors' capital. The master is also a partnership (or an offshore corporation). From the feeders' perspective, it buys shares of the master, and that's an investment it has decided to make. From the master’s perspective, it (typically) has only 2 partners it in, the onshore and offshore feeders. (Think about the master being a partnership with 2 partners in it).

As is true with any partnership that has a U.S. taxable entity invested in it (i.e. the onshore feeder) it needs to “allocate” gains and losses to its investors on both an economic and a tax basis. That is, the P&L for the current period is first allocated based on each feeder's capital (economic) ownership percentage in the master. Exceptions to this will be covered in the Advanced Topics section.

Master Fund Tax Allocations

The reason a tax allocation also needs to occur at the master is for the same reason a standalone U.S. partnership has to do a tax allocation: timing. Cash flows by the different partners (in this case the 2 different feeders) can skew current period economic allocations for tax purposes; remember, the master fund has 2 investors, which can (at least in theory) have varying cash flows.

For example (which is extreme to show the mechanics of the concept), let's say that in Period 1, the onshore feeder invests $1,000,000 into the master fund, while the offshore feeder's investment won't begin until period 2. If the master earns $50,000 of unrealized gain, the onshore feeder receives 100% of it. In Period 2, the offshore feeder invests $1,050,000 to become a 50% owner of the master, and there's no more appreciation of the securities, and the securities are sold (creating $50,000 of realized gain). Economically, each feeder fund will receive $25,000 of realized gain (50% of the $50,000 realized gain).

Presuming that the master fund has elected to use the aggregate realized gain allocation method (with book gains, full netting), for tax purposes, though, the onshore feeder has an unrealized memo account balance (a.k.a. revalue account) of $50,000 from period 1; during the tax allocation in period 2, the onshore feeder will actually receive all $50,000 of the realized gain, and the offshore feeder will receive $0. Essentially, aggregate allocation has the impact of looking at each feeder's (i.e. investor's) historical participation in the unrealized gain to determine how much taxable realized gain it should receive. Although U.S. taxes do not usually apply to the shareholders in the offshore feeder, they do to the limited partners in the onshore feeder. For more information on how aggregate allocation works, see Understanding Partnership Accounting, 2nd Edition.

Additionally, as you are now aware, the master fund is itself a partnership, and thus needs to produce a Form 1065 and deliver Schedule K-1s to all of its investors. Thus, the master fund must have completed all tax adjustments as they relate to its investors (i.e. wash sales, constructive sales, other M1 adjustments, etc.)

Important Note: Timing of these calculations is not being considered here. For instance, it is plausible (and possibly even encouraged) to only produce tax allocations for the master entity at year end. That way there’s not excessive operational overhead all year long for producing figures that only apply (theoretically) to the onshore feeder fund that’s invested in the master fund.
Feeder Fund Economic Allocations

Now that each of the feeders have split all the unrealized and realized gains appropriately (as well as all other income), allocations now have to occur to the partners/shareholders. The feeders, by design, are to receive their allocation inputs from the master fund’s 1065 Schedule K-1 (see above). This is the tax return for the master fund, so it assumes all tax accounting and M-1 adjustments are already complete (i.e. wash sales, etc.) So, essentially, the results of the tax allocation at the master become the inputs to the economic allocations for the feeders. The feeder fund then allocates the P&L based on capital (or some other formula-based) percentages.

Feeder Fund Tax Allocations

Remember, a feeder is its own partnership, thus must also fairly distribute taxable income based on historic participation. So, for the onshore feeder only, a tax allocation (i.e. aggregate allocation) must occur again (remember that an aggregate allocation already occurred at the master fund level). The offshore feeder is not required to perform a tax allocation, as offshore investors are not generally subject to U.S. taxes.

Management Fees

Management fees typically occur only at the feeder fund. Each feeder or class of investors within a feeder has a standard rate, but then each investor may be able to negotiate his/her own rate as well (depending on the partnership agreement). Because these expenses occur at the feeder, the feeder may retain some “cash” to pay expenses that only impact it, and thus may not invest 100% of its capital in the master. If there is not enough cash retained at the feeder to pay for the management fees, a withdrawal of capital from the master occurs to make up for it.

Performance Fees

Performance fees typically occur at the feeder fund only. After all the capital has been entered, and all the P&L from the master and from feeder-specific investments have been entered, then performance fees per partner can be calculated and allocated. In the onshore feeder, it will be a reallocation of profit to the general partner, reinforcing the necessity to get all the tax characteristics correct, as these will ultimately flow through to the general partner’s capital account. The offshore feeder, the performance fee is calculated per series (for multiseries funds) or against the feeder and subsequently “equalized” using to true up investor balances with fees paid. Equalization to be discussed later.
Advanced Topics

Classes

There are normally only 2 main types of investment classes in a master feeder environment: hot issue securities and non-hot issue securities. Other types exist (such as currency hedges), but to keep it simple let’s focus on the two. Additionally, various investor classes exist as well, but typically they surround a partners’ or shareholders’ attributes (i.e. differing fees, etc.) as opposed to actual investment classes. The distinction is being made because allocation of hot issue gains can sometimes not be so straightforward, where other items allocated based on class are fairly intuitive (i.e. if Class A pays a 1% fee and Class B pays a 2% fee, that’s pretty clear).

Hot Issues - “Pro Rata” and “Look Through”

When trying to determine how to allocate P&L to the feeders invested in the master, it’s pretty clear-cut when all investors can receive all P&L. For economic purposes, you can just take the percentage that the feeders own of the master fund, and for tax purposes, you can just use an aggregate allocation method.

But when there’s hot issue gains at the master, allocation to the feeders can become a little more intricate. Essentially, there are 3 main methods for allocating hot issue P&L to the feeders: the “pro rata” by feeder method, the “look through investment” method, and the “look through capital” method.

The “pro rata” by feeder method allocates hot issue income the same as all other income, i.e. no distinction is made. This is common practice for many firms because either 1) there’s not a material difference in the proportion of hot issue capital coming from each feeder; 2) there’s not a material difference in the amount of hot issue income generated in the master, or 3) it’s too difficult to implement.

The “look through investment” method drills down into each investor’s capital available to receive hot issue income. This is best understood by a simple example:
Notice that although each feeder invested 50% each, hot issue allocation is based on “looking through” to each investor’s capital balance and realigning them to 100%. This method would produce a 60/40 split of hot issue income between the 2 feeders.

A variation of this is called the “look through capital” method. The main difference occurs when the feeders do not invest 100% into the master, but actually keep some capital down at the feeder, best viewed by an example:

Notice here that the Offshore feeder only invested 50% of its capital, and some of the capital that remained behind is available to participate in hot issue income unrelated to the master fund. In that case, it really is a 75/25 split, and could be a reasonable way for how the master should split hot issue income.

In summary, the main things to recognize is whether hot issue income is going to be split by feeder or by investor ratios, and whether the feeders invest 100% in the master.

**Multiple Masters/Multiple Feeders**

As a feeder is a partnership that can invest in any investment that it chooses, it’s not limited to invest only in a single master fund. In fact, a feeder can invest in any number of master funds. The subsequent P&L allocations of the master fund back to the feeder may become more difficult to determine. For example, if a feeder is invested in 3 master funds, with different ownership percentages in each, and earns realized gains from each, determining the amount of realized gain to record for both book and tax may become a bit more complicated.

On the other hand (and/or at the same time), a master may have more than 2 feeders invest in it. Any particular master fund may have any number of investee feeders. The equation to determine allocation of P&L now must be extended to include all the feeders, each which may have different investment classes and attributes to consider (see Hot Issues section above).
Direct Investments By Limited Partners

The reason a master fund might be set up as a U.S. limited partnership (as opposed to an offshore corporation) would be to allow a particular investor to invest directly into the master fund without having to set up another feeder. In this case the investor would be charged a management fee and a performance fee at the master fund level, while the other feeder funds would be charged their fees at the feeder level. In addition, the master fund would require a general partner as one of the partners and/or classes of shares and each direct investor would have a limited partnership account or a class/series of shares. It is important to have separate mechanisms for calculating and allocating management fees and performance fees as these are not always allocated evenly across all investors.

A U.S. partnership acts like a typical U.S. hedge fund whose portfolio holdings is its investment in the master fund. Although the feeder owns shares of the master fund, it picks up its economic share of book and tax income from the master fund as it was reported through the master K-1 to the feeder. Generally, tax is done using a form of aggregate allocation, although some funds use the lot layering method as well.

Currency Hedges

Feeders which are based in a currency that is different then the master fund’s base currency may require special currency hedges to protect the foreign currency NAV. These hedges can be done at the applicable feeder level as an investment by the feeder, though some funds will put on these hedges at the master fund level and specially allocate the trade and the related P&L to a specific partner.

Sidepocket Classes at the Master and/or Feeder

Sidepockets are often set up as their own investment class. These investments can disrupt the processing of the structure due to all the specially handling they require…from calculation of capital account ownership percentages after the investment in the sidepocket, to the different treatments of realized/unrealized income that is generated from the investment, (and how that amount impacts capital account percentages), to whether the investment should be included in the calculation of management fees, to how the investment impacts performance fee calculations, etc. Additionally, treatment of the sidepocket may depend on whether it resides in the master or at the feeder level.

Performance Fees/Management Fees at the Master

As stated above with regard to direct investors, in some funds the management fees and/or performance fees are charged at the master fund level. When a direct investor is involved, there then needs to be a general partner at the level as well (to receive the performance fee).

Performance Fees for Offshore Feeders

Offshore funds calculate and charge performance fees differently from U.S. limited partnerships. Typically, an offshore fund is set up as a corporation. Therefore, it charges performance fees at the “company” or “fund” level, and applies the fee to all the shareholders as an expense based on units held, irrespective of the investor’s entry into the fund. This method, however, can result in unfair charges to shareholders that were not in the fund for the entire performance fee period or for those that have carryforward losses. This imbalance occurs because the strategy of allocating performance fee based on shares held fails to account for three important factors:

- The timing of each shareholder’s entry (or subsequent subscription) into the fund.
- Changes in the fund’s net asset value (NAV) over time
- Carryforward losses.

To ensure fair distribution of performance fees, the fund can make adjustments. The process of making these adjustments is generically called “equalization.”
Said another way, without an equalization method, investors who purchase shares at an NAV that is at a premium to the highwater NAV would be charged a performance fee in excess of the earnings on their shares. An equalization methodology would “make whole” this overpayment of performance fee to those investors, either with providing them additional shares, giving a credit, etc.

There is no one standard form of equalization the way there are standards for performing U.S. performance fee accounting. Thus, the number of methods that exist have and continue to increase, each with a different “flavor” of one that already existed. The form that is most similar to U.S. partnership accounting is called the multiseries shares method. Essentially, it tracks each investor’s subscription in a separate tranche, or series, with each one receiving its own highwater mark. Contributions that are profitable are charged a performance fee and then collapsed, or rolled up, at year-end, to avoid a proliferation of shares over time. Contributions that are not charged a fee are rolled into the next year and exist separately until such time they are charged at the next performance fee interval.

**Bid/Ask NAV**

There are funds that allow (require) investors to purchase shares of the fund at the “asked” NAV (that is adjusted for a type of sales charge) and redeem shares at the “bid” NAV. The partnership agreement will determine how this spread is allocated within the fund or paid out to the consultant/sales agent.

**Conclusion**

Again, this document was to familiarize the reader with master feeder funds, such as what they are, how they work, and what are some issues to consider when picking a partnership accounting system that can handle these structures. Because each firm’s requirements are different, a deep systems evaluation should be performed prior to purchase for 2 main reasons: 1) To ensure that the system is implemented to your exact specifications, and 2) to ensure you don’t trade in one set of workflow/accounting problems for a different one.
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About Understanding Partnership Accounting, 2nd Edition
Co-authored by American Express Tax & Business Services and Advent Software, Inc., it has quickly become an industry standard resource. It is now available on either www.amazon.com or www.barnesandnoble.com. Advent’s portion of the proceeds goes to Hedge Funds Care, a non-profit organization dedicated to the prevention of child abuse (www.hedgefundscare.com).

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