Using Derivatives to Enhance After-Tax Hedge Fund Returns

By Kevin McGrath

Kevin McGrath (mcgrathk@bellsouth.net) is of counsel to The Saylor Law Firm LLP, and director of specialized tax services for Stillpoint Advisors, Inc., in Atlanta.

Hedge funds, while often generating above-market returns, typically are tax inefficient. It is well understood that hedge funds generate an inordinate amount of ordinary income, and significant creative energy is spent in an attempt to convert that income to capital gains. Section 1260 was enacted in 1999 to combat some attempts to convert ordinary income to long-term capital gain through derivative contracts, referred to by section 1260 as constructive ownership transactions (COTs).

Although section 1260 was aimed at taxpayers’ attempts at converting ordinary income to capital gain, hedge funds have at least three other negative attributes worth curtailing. One sneaky problem involves the interplay of section 67 (2 percent floor on miscellaneous itemized deductions), section 68 (phaseout of itemized deductions), and the alternative minimum tax, the combination of which can significantly reduce the after-tax return of some hedge funds. A second problem is that, while generating substantial taxable income for their owners, hedge funds often make no cash distributions, creating potential cash flow problems. A third burden—some element of hedge funds, not reflected by increased taxes but by increased tax preparation fees, is their propensity to generate an inordinate number of forms, whether it be the innumerable federal forms generated by the hedge fund’s investments, multistate filing requirements, or the growing tax shelter disclosure burden.

The use of COTs can eliminate some of those problems and accordingly result in substantial tax benefits while eliminating the cash flow problems and tax compliance burdens often associated with hedge funds.

Section 1260

Section 1260 applies to COTs. In general, a COT refers to some derivative contracts with respect to specified pass-through entities (a hedge fund, which is typically taxed as a partnership for income tax purposes, is one such pass-through entity). For example, if a taxpayer enters into a forward contract to purchase an interest in a hedge fund, the forward contract is a COT. Before enactment of section 1260, the forward contract, if held for more than one year and terminated at a gain, would have resulted in long-term capital gain.

Today, if a derivative is a COT, section 1260 operates to (i) recharacterize the long-term gain as ordinary income, to the extent that the gain would not have been long-term gain had the taxpayer held the interest directly; and (ii) impose an interest charge on the ordinary income, which compensates the government for the deferral of tax that owning a derivative contract allows.

Example: On July 1, 2005, Taxpayer enters into a forward contract to purchase interest in ABC hedge fund. The contract expires on July 2, 2006. On July 2, 2006, the value of the forward contract has increased by $100,000, and Taxpayer cash-settles the forward contract by receiving $100,000 from the counterparty to the forward contract. If Taxpayer would have directly owned the interest in ABC hedge fund, Taxpayer would have had $10,000 of long-term capital gain and $90,000 of ordinary income.

Absent section 1260, Taxpayer would have a $100,000 long-term capital gain, which would have been reported on his 2006 tax return. Section 1260 operates to convert the gain that would not have been long-term gain ($90,000) to ordinary income. Additionally, because Taxpayer reports the income on his 2006 tax return (the year the contract was settled), Taxpayer will owe interest on the portion of the 2005 gain that is deemed ordinary income.

While there are ways to structure derivative contracts to fall outside the scope of section 1260, the purpose of this article is to illuminate ways in which derivative contracts, whether or not subject to section 1260, can enhance the return of, and reduce some burdens with respect to, specific hedge funds. Accordingly, the-operative provisions of section 1260 are not further explored in this article.

Sections 67 and 68 and AMT

Section 67 limits the deductibility of some miscellaneous itemized deductions. Miscellaneous itemized deductions are allowed only to the extent they exceed 2 percent of adjusted gross income, and are added back into income for purposes of computing AMT. Section 68 phases out itemized deductions for AGI in excess of a threshold amount. The amount of the phaseout is 3 percent of AGI in excess of the threshold amount. The phaseout is limited to 80 percent of itemized deductions.

6Note, however, that section 1260(e) provides that the underlying long-term capital gain will be treated as zero unless the amount thereof is established by clear and convincing evidence. Because the counterparty will presumably own the hedge fund interest to hedge its risk on the derivative, the counterparty should be in a position to supply the taxpayer with sufficient information regarding the underlying long-term capital gain.

Section 1234A.

The interest is calculated using the underpayment rate in effect under section 6601, and is applied to the underpayment that would have resulted had the taxpayer included the ordinary income in income during the year in which it accrued. Section 1260(b)(2).

In 2005 the threshold is $145,950.
The section 68 phaseout does not apply to a few enumerated deductions, including investment interest expense.\(^7\) Sections 67 and 68 create a less visible problem for some hedge funds, which often produce substantial income and deductions. Income generated by the funds has the effect of increasing itemized deduction phaseouts and increasing the 2 percent floor for miscellaneous itemized deductions. That means that some portion of the deductions flowing out of the fund will be lost.

Additionally, not only are some deductions lost due to phaseouts but some deductions generated by the hedge fund are subject to the 2 percent floor, which means they are added back in income for purposes of computing AMT. Finally, some deductions, for example, investment interest expense, could be a problem if, due to other tax-exempt income of the taxpayer, they become in part nondeductible. The section 68 phaseout will itself gradually be phased out beginning in 2006, only to reappear in 2011. That does not help the hypothetical taxpayer here because the increase in allowable itemized deductions are added back into income for AMT purposes, resulting in the same tax liability.

That problem is best illustrated by an example of a hedge fund investment.

Example: Before any hedge fund investments, Taxpayer has $600,000 of AGI and $142,000 in itemized deductions, as illustrated in Table 1. Taxpayer loses $12,000 in miscellaneous itemized deductions due to the 2 percent floor (2 percent of $600,000) and $13,622 of remaining itemized deductions due to the section 68 phaseout (3 percent). Additionally, like many high-income taxpayers, Taxpayer is subject to the AMT.

<table>
<thead>
<tr>
<th>Table 1</th>
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<tbody>
<tr>
<td>Income Before Hedge Fund Investment</td>
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<tr>
<td>AGI</td>
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<tr>
<td>Itemized deductions</td>
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<tr>
<td>State taxes</td>
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<tr>
<td>Investment interest expense</td>
</tr>
<tr>
<td>Charitable deductions</td>
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<tr>
<td>2 percent deductions</td>
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<tr>
<td>2 percent floor</td>
</tr>
<tr>
<td>Total deductions</td>
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<tr>
<td>Phased out</td>
</tr>
<tr>
<td>Allowable deductions</td>
</tr>
<tr>
<td>Taxable income</td>
</tr>
<tr>
<td>Tax liability</td>
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<tr>
<td>AMT</td>
</tr>
<tr>
<td>Total tax</td>
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</table>

Next, a hedge fund investment is added to illustrate the marginal effect of the income and deductions of the hedge fund. At year-end, Taxpayer’s interest in the hedge fund has increased in value by $100,000. The following year, Taxpayer receives a Form K-1 from the hedge fund reporting Taxpayer’s items of income, deductions, and so on. For the sake of illustrating the tax problem in a simple manner, it will be assumed that the K-1 reports only the following: $20,000 of long-term capital gain, $180,000 of ordinary income, and $100,000 of deductions. Of the deductions, $25,000 relates to portfolio expenses (subject to the 2 percent floor) and $75,000 relates to investment interest expense. Because of the increase in income, the hedge fund results in $5,000 of additional state income tax.

As shown in Table 2, the hedge fund income and deductions increase Taxpayer’s tax liability from $150,500 to $182,900. Notably, the additional $200,000 in gross income results in a phaseout of an additional $6,000 in itemized deductions. While the $75,000 in investment interest expense is not subject to the phaseout, the phaseout simply wipes out other deductions that are subject to the phaseout. Similarly, the additional gross income increases the 2 percent floor threshold by $4,000. Thus, $10,000 of the $105,000 in additional itemized deductions is immediately lost. Finally, the added state tax and the added portfolio expenses are subject to the AMT.

<table>
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<th>Table 2</th>
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<tr>
<td>Income With Hedge Fund</td>
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<tr>
<td>AGI</td>
</tr>
<tr>
<td>Itemized deductions</td>
</tr>
<tr>
<td>State taxes</td>
</tr>
<tr>
<td>Investment interest expense</td>
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<tr>
<td>Charitable deductions</td>
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<tr>
<td>2 percent deductions</td>
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<tr>
<td>2 percent floor</td>
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<tr>
<td>Allowable 2 percent deductions</td>
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<tr>
<td>Total deductions</td>
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<tr>
<td>Phased out</td>
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<tr>
<td>Allowable deductions</td>
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<tr>
<td>Taxable income</td>
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<td>Tax liability</td>
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<tr>
<td>AMT</td>
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<tr>
<td>Total tax</td>
</tr>
</tbody>
</table>

The hedge fund income is subject to a 32.4 percent effective tax rate ($32,400 additional federal tax divided by $100,000 economic growth in the hedge fund).

If instead, Taxpayer invested in the hedge fund through a COT, the numbers look better. Instead of owning an interest in a hedge fund, Taxpayer owns a derivative contract (for example, a forward contract). The value of the contract will have increased by $100,000. Sometime the following year (after Taxpayer has attained a one-year holding period), Taxpayer settles the forward and receives $100,000 in cash.

Absent section 1260, settling the forward contract in that manner would generate $100,000 of long-term capital gain. Because long-term gain would otherwise result, section 1260 applies and partially recharacterizes the income. The first $20,000 — the amount that would have been long-term gain if the taxpayer held the hedge fund.
directly — retains its long-term gain characterization. The remaining $80,000 will be recharacterized as ordinary income.

For comparison purposes, the $100,000 in section 1260 income is added to Taxpayer’s income to illustrate how the total tax paid changes. (In reality, as described below, an added benefit of structuring the investment through a COT is that the income recognition is delayed a year, with a partial interest charge.) By owning the hedge fund through a COT, AGI is increased by only $100,000. That means deductions are phased out to a lesser degree than they would be with direct ownership of the hedge fund ($5,000 instead of $6,000), and the effect of the 2 percent floor is minimized ($2,000 increase in threshold as opposed to $4,000). Finally, AMT is reduced because income has increased, without the burden of the $25,000 in additional portfolio expenses.

<table>
<thead>
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<th>Table 3</th>
<th>Income With COT</th>
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<tbody>
<tr>
<td>AGI</td>
<td>700,000</td>
</tr>
<tr>
<td>Itemized deductions</td>
<td></td>
</tr>
<tr>
<td>State taxes</td>
<td>72,000</td>
</tr>
<tr>
<td>Investment interest expense</td>
<td>40,000</td>
</tr>
<tr>
<td>Charitable deductions</td>
<td>10,000</td>
</tr>
<tr>
<td>2 percent deductions</td>
<td>25,000</td>
</tr>
<tr>
<td>2 percent floor</td>
<td>(14,000)</td>
</tr>
<tr>
<td>Allowable 2 percent deductions</td>
<td>11,000</td>
</tr>
<tr>
<td>Total deductions</td>
<td>133,000</td>
</tr>
<tr>
<td>Phaseout</td>
<td>(16,622)</td>
</tr>
<tr>
<td>Allowable deductions</td>
<td>116,378</td>
</tr>
<tr>
<td>Taxable income</td>
<td>583,622</td>
</tr>
<tr>
<td>Tax liability</td>
<td>174,330</td>
</tr>
<tr>
<td>AMT</td>
<td>1,570</td>
</tr>
<tr>
<td>Total tax</td>
<td>175,900</td>
</tr>
</tbody>
</table>

The result is a total tax liability of $175,900. Here, the tax savings resulting from structuring the hedge fund purchase as a constructive ownership transaction is $7,000. That represents 7 percent of the $100,000 economic income, or a 7 percent reduction in the effective tax rate to 25.4 percent ($25,400 in additional tax divided by the $100,000 economic growth of the hedge fund).

Much of the savings is AMT related. Increasing AGI, without corresponding deductions, has the effect of minimizing the effect of AMT, as illustrated by the drop in AMT liability from $6,620 to $1,570. Furthermore, if the assumptions regarding the hedge fund’s deductions were reversed, that is, the hedge fund generated $75,000 of 2 percent floor deductions and $25,000 of other itemized deductions, the savings are dramatically higher. With actual ownership of the hedge fund, Taxpayer’s total tax liability goes up to $196,900. In that case, a constructive ownership transaction would save $21,000, or 21 percent.

Because of the wide disparity in benefits to a COT based on a taxpayer and hedge fund’s individual at-

tributes, the examples here are offered to prove that a constructive ownership transaction can save money, not to prove the scope of the savings. The magnitude of the savings is both taxpayer and hedge fund specific.

Matching Cash Flow With Tax Liability

Another problem with hedge funds is the mismatching between cash flow and the tax liability generated from owning the hedge fund. For example, if Taxpayer owns the hedge fund in 2005, and the hedge fund generates the income described above, the tax resulting from the income will be due by April 15, 2006. The hedge fund, however, may not make any cash distributions to Taxpayer by that time.

If Taxpayer instead invested through a COT, the increased income described above would be reported on his 2006 return (or the year in which the forward contract is settled). That results in one benefit, and possibly two. First, tax will not be due until cash flow is generated. Thus, there is no mismatching between cash flow and the tax liability generated by fund. Second, to the extent the income is characterized as capital gain, income will have been deferred. The interest charge imposed by section 1260 is only for deferred ordinary income, and not capital gain. Accordingly, the $20,000 capital gain would be reported on the 2005 return in a direct ownership transaction whereas it is reported on the 2006 return in a COT.

Burdensome Reporting

Aside from tax inefficiencies, the proliferation of tax shelter disclosure statements generated by hedge funds and the tendency of some funds to produce income reportable in multiple states may have the effect of significantly increasing tax compliance costs. For example, some hedge funds producing real estate income report income in multiple states, sometimes requiring a tax-filing obligation in multiple states. Many hedge funds, out of an abundance of caution or otherwise, disclose reportable (and sometimes many) transactions on Form 8886. While those disclosures are almost always labeled “protective,” they are no less burdensome to file, and many taxpayers may cringe at the unwelcome attention their returns subsequently receive.

Reporting in multiple states and reporting tax shelters increases the complexity of tax preparation, which in turn increases costs to the taxpayer. Ownership of a hedge fund through a derivative will be unlikely to subject a taxpayer to the tax shelter reporting or disclosure requirements generated by the hedge fund investments.

Footnote continued on next page.

8That includes $20,205 of AMT.

The tax shelter reporting requirements are described in Treas. reg. section 1.6011-4(c)(3), and apply to taxpayers who participate in a reportable transaction. For each type of reportable transaction (for example, listed transaction, confidential transaction, loss transaction, and so on), the rules separately delineate who a participant is. The only type of transaction engaged in by a hedge fund that could give rise to a reporting requirement by a holder of a derivative contract with respect to the hedge fund is a listed transaction, and then only if the derivative holder’s tax return reflects the tax benefits of a listed transaction. Because a derivative holder’s return will, at most, reflect only the ordinary income and capital gain of the fund, the only probable way that a derivative holder’s tax return will...
(unless the derivative itself constitutes a reportable transaction under the disclosure rules), and would most likely avoid the requirement to file tax returns in any state in which the taxpayer is not a resident. Accordingly, in addition to the dollar savings that a COT potentially provides, taxpayers could enjoy significantly less complex tax returns.

Other Considerations

Basis step-up at death. If the owner of a COT dies before its termination, the derivative will receive a step-up in basis. If the derivative is settled shortly thereafter, there should be no (or little) gain to report. Because there is no gain to report, there is no gain to recharacterize as ordinary income, and no gain on which to impose an interest charge. If a taxpayer desires long-term exposure to hedge funds, a long-term derivative contract could provide substantial benefits if kept open until the taxpayer’s death: elimination (not conversion) of income.

Conversion if assets fall in value. If the hedge fund goes down in value, a COT has the potential to convert ordinary losses (particularly if a fund invests in foreign currency) to capital losses, or to defer capital losses from one year to the next.

No direct ownership. A COT gives Taxpayer no direct ownership in the hedge fund. That means Taxpayer has no right to inspect the books of the hedge fund partnership, no voting rights, and no right to obtain an accounting. The COT also exposes Taxpayer to the credit risk of the counterparty to the derivatives.

reflect the tax benefits of a listed transaction is if some portion of the hedge fund’s capital gains were achieved through a listed transaction.

However, it is conceivable that there are states that have their own set of constructive ownership rules that would impose a filing requirement on the holder of the derivative contract as if the derivative owner owned the underlying property directly.

While section 1014 operates to step up or step down an asset’s value to fair market value, its application in the case of derivatives depends on the nature of the derivative. If, for example, the derivative is a forward contract, the forward contract represents both the right and the obligation to purchase the underlying asset at a set price at a specified date. If the forward contract is “in the money” (that is, the hedge fund is worth more than the present value of the forward price), the forward contract will represent a right, a right that has value, and should accordingly receive a step-up in basis (that is, the basis in the asset will be stepped up to the FMV of the right). If the forward contract is “out of the money,” it will represent an obligation to purchase the underlying asset at a price above its discounted FMV. In that case, section 1260 would be inapplicable (because there is no long-term gain at that time) and section 1014 would be irrelevant (the contract is not an “asset”). The same analysis should apply in the case of a prepaid forward. The effect of section 1014 on different types of derivatives will vary.

Section 1014. However, the basis step-up rules may have a limited life. Under current law, the basis provisions of current section 1014 are set to expire in 2010. Current law sunsets in 2011, which means the existing basis rules of section 1014 will reappear at that time unless Congress acts to extend current law.

Avoiding section 1260 by terminating the contract before attainment of one-year holding period. The benefits described here by using a COT are achievable whether or not the COT meets the requirements of section 1260. It is owning a derivative investment, rather than actual ownership, that avoids the negative friction caused by income and deductions, the cash flow problems, and substantial filing requirements resulting from the hedge fund’s investments.

The benefit of having section 1260 apply to the COT is the retention of long-term capital gain characterization of fund investments. If the hedge fund has substantial long-term capital gains (including qualified dividends), Taxpayer will not get the benefit of long-term gain treatment unless the derivative is held for more than one year (section 1260 is only invoked if the COT otherwise would have resulted in long-term gain), or as described below, if the transaction is outside the technical scope of section 1260.

With qualified dividends obtaining long-term capital gain treatment, many hedge funds will have some long-term gain. In those funds, it is more important that section 1260 applies to the transaction, so that items of income taxed as long-term gains retain that characterization.

On the other hand, in some circumstances it may be beneficial to avoid section 1260. The benefit of avoiding application of section 1260 is avoidance of the interest charge applicable to deferred ordinary income. Application of section 1260 can be avoided by terminating the derivative before a one-year holding period is attained. For example, if the hedge fund has no or limited long-term gains so that only ordinary income is present in the underlying hedge fund investment, there is no real benefit to characterization of the derivative as a COT.

In such a circumstance, avoiding section 1260 has the effect of avoiding the interest charge. Thus, returning to our example, Taxpayer could, for example, enter into the derivative on May 1, 2005, and settle the derivative on April 1, 2006. Because, due to the 11-month holding period, the contract would not result in long-term gain absent section 1260, section 1260 is inapplicable. Although the gain on settling the COT will be short term, it will not be reported until the 2006 return is filed. In a direct ownership transaction, some of the income would have been reported on the 2005 return.

Structuring COT to Fall Outside Section 1260

Finally, it would be most beneficial to structure the COT to fall outside section 1260, yet retain long-term gain treatment. For example, if the derivative is held for more than one year and does not meet section 1260’s technical definition of a constructive ownership transaction, section 1234A will apply, and settlement of the derivative should result in capital gain treatment. Such a transaction would convert all ordinary income to long-term gain. While an attempt to structure a derivative to fall outside the confines of section 1260 may introduce an element of tax risk, the tax risk may be worth taking because even if section 1260 is held to apply to the derivative, all of the other benefits described herein would nevertheless be
obtained. How to avoid section 1260’s technical definition of a constructive ownership transaction is beyond the scope of this article.

Conclusion

Although section 1260 prevents taxpayers from converting ordinary income to long-term capital gain through constructive ownership transactions, constructive ownership transactions nevertheless may provide substantial benefits. For hedge funds that produce substantial income and deductions, a constructive ownership transaction will significantly increase after-tax returns for taxpayers who have miscellaneous itemized deductions exceeding the 2 percent floor, are experiencing phaseout of itemized deductions, and are subject to, or close to being subject to, the AMT.