INVESTMENTS & WEALTH MONITOR

A reprinted article from May/June 2019

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A Perfect Storm Ahead

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INVESTMENTS & WEALTH INSTITUTE®
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The Tax Cuts and Jobs Act of 2017 (TCJA) has created a perfect storm for taxable investors in hedge funds. There are multiple problems that I will first summarize and then later get into with more detail.

First, as predicted in "Hedge Funds and the Taxable Investor" (Gordon 2012), the government eliminated many deductions—including the deduction for investment management fees. This can dramatically impact the after-tax returns from investing in hedge fund partnerships where the base management fees can be hundreds of basis points.[1] The problem could be even larger if managers of the funds attempt to lower their own tax bills now that the benefits of carried interest have been severely limited by the TCJA (Gordon 2015).

This problem affects "investor" funds and is not an issue for "trader" funds.[2] But as we've written before, in our reading of the relevant court cases, many funds that claim trader status are in reality investor funds (Gordon 2005). The second storm we see was created by the TCJA when it established a mechanism for the Internal Revenue Service (IRS) to start auditing hedge funds. The difference between these two types of funds will become apparent as the government starts auditing hedge funds. A third problem created by the TCJA is that investor funds that use swaps also became less attractive because the taxation of swaps is now a classic tax whipsaw of tails they win, heads you lose (Fichtenbaum and Gordon 2018).

This provision[3] can cause tax havoc on highly leveraged funds and those that utilize short sales and or swaps. Thus, this fourth problem means that the TCJA is negatively affecting all hedge fund partnerships.

Also in the law is a provision that will affect funds that actually are traders by limiting the amount of interest a trader fund can deduct. This provision[3] can cause tax havoc on highly leveraged funds and those that utilize short sales and or swaps. Thus, this fourth problem means that the TCJA is negatively affecting all hedge fund partnerships.

There is a solution to all of these problems, but it requires that investors change the way they invest when accessing hedge fund strategies.

NO MORE MISCELLANEOUS DEDUCTIONS

Investment management fees are one of the many deductions eliminated in the TCJA. An investor hedge fund that earns 8 percent on its portfolio and has a 2-percent base management fee will issue a K-1 showing 8 percent in taxable income even though the investor earned only 6 percent. The non-deductibility of the management fee created phantom income of 2 percent.

Unfortunately, swap losses are also a miscellaneous itemized deduction for individuals and investor hedge funds. Most unfair is the fact that swap profits are still totally taxable and that swap gains and losses are not netted before arriving at taxable income. Thus an investor fund that has a $100 profit on one swap and a $100 loss on a different swap will have $100 of taxable income.

If a performance fee is paid rather than taken as a profits allocation (also known as a carried interest) then the phantom income could become huge. Up until now, most fund managers liked to take a profits allocation rather than a cash performance fee because through the allocation, the managers' income took the nature of the portfolio's profits. Thus the manager possibly could earn part or all of its performance fee as preferentially taxed long-term gain rather than as ordinary income. The TCJA sought to reduce the benefits of managers' carried interest by only treating gains longer than three years as long-term for the manager to get this tax break. As of now, gains of less than three years are taxed as short-term gains to the managers. It has not been lost on managers that short-term gains are investment income that are liable for the 3.8-percent Medicare Tax whereas ordinary income is not. Thus a manager who switched from a carried interest to a cash management fee will reduce taxes from a maximum of 40.8 percent to 37 percent. But taxpayers in an investor hedge fund would wind up with that fee becoming a non-deductible item creating more phantom income.

TRADER OR INVESTOR

The non-deductibility of miscellaneous deductions is not a problem for hedge funds that are traders for tax purposes. However, the line demarking which is which is not so clear. Until 2008, fund-of-funds investment partnerships took the position that they were traders for these purposes. Revenue Ruling 2008-39 reversed the long-standing practice of claiming that funds of funds were trader funds.

The TCJA created a regime in order for the IRS to start auditing hedge funds beginning in 2019. It may be wise to take a clue from the IRS's "Audit Technique Guide to Partnerships" released in 2003.[4] Chapter 12 deals with hedge fund issues. This chapter specifically instructs IRS agents to challenge trader status. The IRS Audit Manual tells its agents that one factor to consider is the "nature of the income from the activity—only short-term gains qualify as trading income … significant long-term capital gains, and even dividends and interest, are strong indications of an investor and not a trader." The manual also instructs agents to examine a fund's offering document to determine whether it uses the terms "capital appreciation" or "conservation of capital" as an objective, and it contends that "objectives other than taking advantage of short-term market movements negate securities trader status."

EVEN TRADER FUNDS CAN NOW THROW OFF PHANTOM INCOME

Under Section 163(j) of the TCJA, a trader fund can only deduct as interest a maximum of 30 percent of its gross income. Interest for these purposes encompasses not just interest expense from borrowing but also short sale expenses, the interest component of swap expenses, and substitute payments of both dividends and interest. If a trader fund had $100 of taxable profits and $40 of these expenses, the net profit would be $60, but because of the Section 163(j) limitation, there would be $70 of taxable income on the investor's K-1. This is because Section 163(j) would limit the deduction to 30 percent of the gross profits of $100 thus allowing only a $30 deduction of the $40 of actual expense. With more leverage comes more phantom taxable income. An extreme example might be a fund that breaks even (or even loses money) pretax but still flows through taxable income to its partners' K-1s. An example would be a fund with $100 of income and $100 of these expenses—there would be no pretax profit but $70 of taxable income after the 30-percent disallowance. The disallowed deductions can be carried forward and possibly utilized under a very complex set of circumstances.

> *All the solutions advise against investing in the domestic limited partner or limited liability company.*

SOLUTIONS

These solutions will negate the elucidated above tax problems of both investor and trader funds. All the solutions advise against investing in the domestic limited partner or limited liability company.

One could invest in the offshore version of the hedge fund; these are corporate vehicles that will be taxed as a passive foreign investment company (PFIC). A U.S. taxpayer investing in a PFIC can either elect to be taxed as a qualified electing fund PFIC that annually flows through income including preferential long-term gains (if realized) or not make such an election and have all the income deferred as ordinary income. This deferral comes with an interest charge but also, as it turns out, can have some state income tax benefits (Gross 2004).

Alternatively, an investor can invest in a mutual fund or exchange-traded fund (ETF) that provides exposure to hedge fund strategies. Mutual funds and ETFs are allowed to take the deductions individual investors cannot take. There are also those that invest through a private placement life insurance contract whose return is linked to a hedge fund's net return after taking in all expenses.

Clearly, the TCJA has shifted the dynamic for taxable investors who might find it wise to start to navigate around the storm if they have not already done so.

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ENDNOTES

1. This also should affect one's choice between separately managed accounts versus mutual funds or exchange-traded funds.
2. By definition, a "trader" fund is one that trades solely for short swings in the market.
3. TCJA Section 163(j)1.
4. See http://www.twenty-first.com/pdf/audit_technique_guide_to_partnerships_092002.pdf.

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