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No More Miscellaneous Itemized Deductions?

Avoid swaps--Funds get an edge over managed accounts

The effect of the new tax law is rippling through the economy and taxable investors need to be aware of one of the most impactful revisions to the code; the elimination of a deduction for miscellaneous itemized expenses. This change will cause investors to pay tax on income that they will never earn- a tax on "phantom income". Included in the miscellaneous deduction category are investment management fees and swap expenses.

Funds vs. Managed Account

As an example; if a taxpayer has a managed account that earns 9% in taxable income/gains and pays a 1% management fee- that investor will now pay tax on 9% even though they only earned 8% after fees. The same monies invested in a Regulated Investment Company (RICs include ETFs as well as open and closed end mutual funds) would only pay tax on the net return of 8% because the fund IS allowed a deduction for the management fee.

A 60% Tax?

This problem can be magnified when one invests in a high fee flow through vehicle like the typical hedge fund limited partnership. A 12% gross return becomes an 8% net return after a 2 and 20 management fee is charged. The investor could be paying tax on $12 while only making $8. Applying a 40% tax rate on that $12 creates a tax of $4.80- $3.20 of tax on income they earned and $1.60 of tax on "phantom income" they will never earn. The effect is a 60% tax on the net hedge fund profits.

Hedge fund investors could alternatively explore investing in the RICs that employ hedge fund strategies or in the offshore version of the hedge fund. The key is to capture the returns net and to pay tax on only the monies actually earned.

SWAPS- the worst of all worlds

The hedge fund problem can be even worse if your fund utilizes swaps. Swap payments received are taxed at the highest rate while, under the new law, swap payments made will not be deductible. Heads they win- tails you lose.

Funds or families utilizing swaps should switch to using other investment tools like options where the taxation regime is more equitable. Investors who do not make the change could explore possible relief in the netting of swap payments or might try to manage the swap portfolio to avoid making any swap payments. For a more detailed analysis of the tax issues surrounding swaps click here.