Hedge Funds and the Taxable Investor

By Robert N. Gordon

Taxable investors in hedge funds should take great care in the types of hedge funds they choose. High-income taxpayers in investor hedge funds can be paying hundreds of basis points of tax on phantom income. There are possible solutions to this problem but none are without some baggage.

The Trouble with Flow-through Tax Treatment

Like mutual funds, hedge funds immediately pass through any income they recognize to investors. Unlike mutual funds that make cash distributions of their net gains, hedge funds send no money—just a K-1 stating the amount of taxable income on which the investor must pay tax.

Many popular strategies throw off income taxed at the highest rate. Worse yet, many investors in funds of funds and “investor” hedge funds find themselves paying tax on more profit than they have actually made. Investors in “trader” hedge funds should face less of a problem. Only “trader” hedge funds can net fees against profits under IRC Section 162. What constitutes a trader is not very clear and may turn out to be a very large issue for domestic investors if the Internal Revenue Service (IRS) follows the guidelines laid out in its hedge fund audit manual.

These problems arise because the funds are set up using flow-through vehicles. This flow-through structure is utilized to accomplish the goal of not having a tax to pay at the entity level. Instead the taxation is only at the holder level. Unfortunately, this flow-through nature has a nasty side effect: Before flowing through on a K-1, expenses are not netted against income unless you are in a “trader” investment fund.

Rather, the gross return is shown on a K-1 and is taxable to the investor while the base management fees and expenses are shown separately as miscellaneous itemized deductions to be limited by IRC Section 212. Herein is the problem: Most high-income taxpayers cannot utilize miscellaneous itemized deductions. Investors who must pay the alternative minimum tax (AMT) also can be disadvantaged by this outcome. Depending on how any performance fees are paid could determine whether the performance fees are also miscellaneous itemized deductions.

Friedenberg (2012) reports that “tax authorities have stepped up their efforts to audit Alternative Investment funds ... the distinction between trader and investor has been at the center of recent audit activity...” There is an IRS audit manual for hedge funds. It instructs field agents to request the offering materials for the fund. The manual states: “Taxpayers who mention capital appreciation or even conservation of capital do not prevail. Significant long-term capital gains, and even dividends and interest, are strong indications of an investor and not a trader.”

Gordon (2005; 2012) offer more information on this topic.

Paying Tax on Phantom Income

The limitation on miscellaneous deductions makes investors pay tax on more than they earn. If a hedge fund had a gross return of 11 percent and a net return of 9 percent after fees, it is possible that investors will be forced to pay tax on 11 percent when they made only 9 percent. This limitation under IRC Section 212 is true with all investment management fees (except those charged to a mutual fund); it’s just more of an issue here because of the combination of a high level of fees being paid in a flow-through vehicle.

For many taxpayers, the most tax-efficient way to access hedge fund investing would be one that captures returns in a form that nets expenses against income before they flow through. This approach should assure that the investor pays tax only on the profits actually earned.

Gross Income States Magnify the Injustice

There are nine “gross income tax states”: Connecticut, Illinois, Indiana, Michigan, New Jersey, Ohio, Pennsylvania, Rhode Island, and West Virginia. These states allow no deductions. It seems unfair to tax income but not allow a deduction for the costs incurred in producing that income. In addition, Massachusetts denies any deductions for interest or fees and New York limits most deductions for high-income taxpayers. Imagine a hedge fund that is both long and short stocks: Any dividends received will be taxable in the state; any dividend expenses from being short will be denied.

The Basics

A domestic fund is usually set up as a flow-through vehicle such as a limited partnership (LP) or a limited liability company (LLC). There is no tax at the entity level with these structures. All recognized items of income are passed through annually on a K-1 form, to be included with the investor’s tax return. These flow-through tax items...
can contain capital gains, capital losses, interest income, interest expense, dividends, and expenses and fees. These taxable items come with no distributions in cash.

Most hedge fund strategies produce short-term gains and/or interest taxed at the highest tax rate. These profits are taxed each year to the investor whether the investor took any action with the fund or not. Because the profits are taxed annually and at the highest rate, hedge funds are not considered particularly tax friendly to individual investors.

**Funds of Funds**

Investors sometimes will employ a manager to pick their hedge funds. A fund-of-funds manager sets up its own entity to commingle investor funds. The fund-of-funds manager then invests this upper-tier entity in various hedge funds that it deems attractive investments. This upper-tier fund of funds charges its own set of management and performance fees. In Revenue Ruling 2008-39 (http://www.irs.gov/irb/2008-31_IRB/ar01.html) the government made clear that a fund-of-funds management fee is a miscellaneous itemized deduction.

Moreover, the ruling made clear that a fund of funds can’t take the position it is a trader or that a proportionate amount of its management fee can be treated as an ordinary expense if some of the underlying funds are traders. This is different from what the industry had done in practice.

**One Possible Solution: The Offshore Fund**

Most hedge funds have a domestic fund and an offshore fund. The domestic fund is set up for U.S. individuals. Offshore funds historically have been for U.S. tax-exempt and non-U.S. entities.

**Offshore Funds**

Most offshore funds are set up as corporations, not flow-through entities. U.S. tax exempts (pension plans, foundations, etc.) try to avoid unrelated business taxable income (UBTI) by investing in the offshore fund rather than the domestic flow-through entity. UBTI tax is levied on profits that come from leveraged investments. If a U.S. tax exempt invested in the domestic flow-through vehicle and the hedge fund used leverage, the profits would be taxable.

The corporate form acts as a blocker (not a flow-through) and thus the U.S. tax exempt is free from UBTI on any profits. These offshore corporations usually are headquartered in a tax haven so that there is no corporate tax.

These offshore funds usually would be classified as passive foreign investment companies (PFICs). Although PFICs are not traditionally thought of as good places for U.S. investors, there are possible federal and state tax benefits to U.S. investors that invest in offshore funds. For example, no miscellaneous itemized deductions result from investing in a PFIC because returns are realized on a net basis.

There are two ways that U.S. investors can choose between how they would like to be taxed on their PFICs.

1. The qualified electing fund (QEF) investor has all the net income of the hedge fund flow-through to the taxable U.S. investor, even long-term gains stay long-term gains.
2. A non-QEF investor also will realize income only on a net basis, when the offshore fund is sold. The non-QEF investor opts into a government-sanctioned deferral. This deferral on the federal level comes at a cost. All income is taxed at the highest rate and interest is charged at a non-deductible rate on the taxes that should have been paid.

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**Risks and Costs of Investing in a PFIC**

Investing in a PFIC has its drawbacks. Capital losses do not flow through a PFIC and there is no step-up in basis at death. If an offshore fund receives a U.S. dividend it will be reduced by the withholding tax. Although derivatives can be used to reduce the effect of withholding, there is a cost to employing the derivatives. Debate exists as to what types of investing can be done in these offshore funds without incurring U.S. tax. If the strategy of the fund rises to a level of doing business in the United States, the offshore fund can get caught in the U.S. tax system. Hedge funds that lend money to U.S. concerns may be found to be receiving effectively connected income.

**IRC Section 1260**

Wall Street noticed the tax drag problem of hedge funds years ago and thus suggested investors invest in their favorite hedge funds through derivatives. Utilizing a forward, a combination of options, or a swap, investors sought to achieve both the deferral of any tax and the conversion of any income into long-term capital gains. Washington responded with IRC Section 1260, the Constructive Ownership Rules, which charged interest for the deferral and recharacterized any mischaracterized income.

**IMPORTANT UPDATE:** The treasury has promulgated regulations with respect to the 3.8% net investment tax. It was originally thought that income generated from a passive foreign investment company (“PFIC”) would not be subject to the tax. The regulations make it clear that income derived from an investment in a PFIC will be subject to the tax.

Gross (2004) observed that taxpayers may be better off in offshore funds. More recently Miller (2011) concluded that there are many benefits to the offshore vehicle, not the least of which is his opinion that the incoming 3.8-percent Medicare tax would not be levied on income from a PFIC.
long-term gain back into ordinary income.

McGrath (2006) points out that investing through a derivative may still be useful. The derivative will be taxed on only net income and will be available for a step-up in basis at death. Counterbalancing any benefit is the manufacturing cost of the derivative and the fact the investor is now forced to take on counterparty risk.

It May Get Worse

Numerous tax proposals in Washington would impact the after-tax returns on hedge funds. In my opinion, none would have a more dramatic effect than the proposals to limit deductions. President Barack Obama’s budgets have consistently included the notion that a dollar of deduction shouldn’t be worth more to a rich person than to the average taxpayer; thus the proposal to allow a maximum 28-cent benefit for a dollar deduction. Feldstein et al. (2011) suggests denying all deductions that exceed 5 percent of a taxpayer’s adjusted gross income.

These types of stealth tax increases might be what Congress settles on when push comes to shove after the 2012 election. The Democrats will be loath to deny any deductions to all (such as mortgage interest) and the Republicans will be loath to raise tax rates. A decoupling of tax rates on income and expense will magnify

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References


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