

How fees can trigger stealth taxes

Tax rules treat investment fees in a variety of ways, which might affect portfolios

By Robert N. Gordon

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Since the tax laws are so complex, and often inconsistent, it's no wonder that the tax treatment of investment management fees varies widely.

Consider investment management fees paid by a trust. The Supreme Court recently ruled that these costs are deductible only once the fees exceed 2% of the trust's adjusted gross income. This is because investment management fees are miscellaneous itemized deductions.

Overriding limits on deductibility — such as the rules for the management fees paid by a trust — often are referred to as stealth taxes because what otherwise would be a perfectly acceptable deduction somehow becomes limited. Other examples of stealth taxes are medical costs, which are deductible only if they exceed 7% of your AGI, and the alternative minimum tax, of which we're all too aware.

Exploring the various ways fees are treated for tax purposes and how that tax treatment affects our clients is an enlightening exercise.

Let's look at advisory fees. The after-tax cost of advisory fees rises 50% if they are caught by the 2% limitation. For most of our clients, miscellaneous itemized deductions are rendered worthless by that limitation. All investment management fees are miscellaneous itemized deductions, whether paid by a trust or by an individual.

Advisers should explore whether their clients will be able to deduct their fees. If the fees are not deductible, there are a few alternatives. For example, ownership of a portfolio through a derivative could be useful. The goal is for your client to earn returns net of fees rather than the fees' being "broken out." The offshore version of your favorite hedge fund also might alleviate any concerns on this score.

Mutual funds have a distinct advantage over managed accounts because of the limitations of deductibility. Mutual funds are allowed to deduct management fees without limit against their profits before they arrive at taxable income. If a client hires a money manager that produces 8% after a 1% fee, it is quite possible that the investor will pay tax on 9% even though they earned only 8%. If that same money were in a mutual fund run by the same manager, taxes would be levied only on the 8% net earnings.

Marrying flow-through entities such as limited partnerships with the rules about miscellaneous itemized deductions creates a host of problems.

Take a typical fund of hedge funds charging a 1% base fee and a 10% performance fee. Let's assume that the hedge fund portfolio earns 11%. Take away the base fee, and we're at 10%; deduct the performance fee, and the investor earns 9%. But if everyone is not careful or aware of the tax issue, the investors could pay tax on 11% when they are earning only 9%.

There is nothing an adviser can do to change the limits on the base fee. It is believed that if the performance fee is not a cash payment to the manager but instead is taken as a percentage of profits participation, the performance fee need not be reported separately on the investor's K1 form, which will not create phantom income. It might be wise in your due diligence, therefore, to look at previous years' K1 forms and inquire about how the manager is paid.

There are now many mutual fund companies that offer hedge fund strategies — long/short investing, for example, as well as a few funds that specialize in risk arbitrage funds and convertible arbitrage. Due to their corporate structure, these mutual funds enjoy the benefits of not creating phantom income. Hedgelike mutual funds have other advantages over true hedge funds in that they offer daily, not monthly or quarterly, liquidity and they are not constrained by lockup provisions. Best of all, mutual funds don't charge 20% performance fees.

The only thing that mutual funds don't have these days is cachet, so the trick is getting our clients to brag about the tax advantages of mutual funds at their next cocktail party.

Or maybe this new wave of cloning hedge fund returns without the manager will prove out. I wouldn't bet on either.

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