

IRS ruling likely to nix options tactic

Instead of deferring gain, hedge fund investors will have to pay tax at short-term rate

By Robert N. Gordon

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In light of a recent IRS decision that took some by surprise, there's one options strategy we're not likely to see anymore.

The strategy involved a contract between a British investment bank and a U.S. hedge fund that both parties documented as an option written on an underlying basket of long and short securities. The securities were to continue to be managed by the general partner of the hedge fund, and all profit and loss from price movement and dividends were to be credited to the portfolio; all associated costs were to be debited to the portfolio. These costs included brokerage commissions on trading and interest expense.

The Internal Revenue Service disregarded the option (AM 2010-005) and deemed the hedge fund the owner of the portfolio.

Here's the background: The hedge fund bought the option for 10% of the portfolio's value. Under the contract's terms, the option would expire immediately if the reference value fell to 90% of the starting value. Although those terms seem to describe a knockout option, the IRS concluded that this contract was not being priced like an option at all, but instead was more akin to a loan. The IRS noted that interest expense was debited from the reference value for the other 90% not funded by the 10% down payment/option purchase price.

The hedge fund hoped that the option would be respected so that all underlying trading would have no immediate tax effects to the fund. Further, if the option were respected, it could be held for more than one year, possibly generating long-term gains, as opposed to the short-term gains that would have come from trading the portfolio.

By negating the option, the IRS decided that each securities transaction done by the U.K. bank for its account was actually a taxable event to the hedge fund — equivalent to the bank's having done trades in the name of the fund.

The question of control seems to have allowed the IRS to pierce through the derivative. In an index, portfolio changes are rules-based and out of the hands of an index derivative investor. Because of that, when an index portfolio changes, holders of a derivative based on the index do not realize a taxable event.

In this case, the IRS noted that the general partner had control over the portfolio, even having the right to direct the voting of the underlying securities. As a result, the IRS held that the contract was not actually an option, and found the hedge fund to be the owner of the portfolio, not the owner of a derivative.

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Here are three tax-related action items to consider before the end of the year:

Roth IRAs. No matter what happens with 2011 tax rates, investors who contemplate converting to a Roth individual retirement account should do so before Dec. 31. This year's Roth converters can choose to take all the taxable income in 2010, or half in 2011 and half in 2012. Those who convert this year have until Oct. 15, 2011, to make their decision. By then, we should know the 2011 tax rates, which will help shape a more informed decision. Waiting until 2011 to make the Roth conversion limits converters to just one course of action — taking all the income in 2011.

Gifts. For clients in a position to give an outright gift to grandchildren, 2010 is the year to be generous, as there is no generation-skipping tax in effect. The GST effectively would have burdened the grandkids with two levels of estate tax. Although a 35% gift tax is in effect, this year's rate is lower than last year's 45% and next year's possible 55%.

GRATs. Congress has grantor retained annuity trusts in its sights and soon may reintroduce legislation to diminish GRATs' attractiveness by extending their terms. One proposal, in fact, calls for a minimum term of 10 years. Currently, a properly structured GRAT, typically two or three years in term, allows profits above a hurdle rate to transfer to heirs without the imposition of estate or gift taxes. Since there hasn't been talk of applying any new limits retroactively, this closing window of opportunity, coupled with the current low implied hurdle interest rates, makes this an attractive time to execute a GRAT.

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