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Are incentive fees coming to funds?

Prohibitions have been eroding slowly, and the door to hedge-fund-like expenses is now open

By Robert N. Gordon

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Boy, what a difference 25 years makes in the world of fund taxation. When my firm launched the first long/short fund in 1986, we had to contend with several constraints: the “short short” rule, which I will explain in a moment, a limitation on shorting stocks, a severe limitation on the use of futures and a prohibition on incentive-based fees.

Over time and congressional bending, 70 friendly Internal Revenue Service rulings and some financial engineering, these rules no longer seem to matter. And more changes may be coming.

First, a little history.

The Revenue Act of 1936 established that regulated investment companies, more commonly known as mutual funds, must pass certain tests in order to escape being taxed like regular corporations. If the fund flunked one of the tests, a full corporate tax would be levied.

Sen. Carl Levin, D-Mich., in his recent effort to curtail the use of offshore entities, reminded us of that when he said that the act's Section 851(b)(2) “restricts the types of income that mutual funds are allowed to obtain in exchange for favorable tax treatment.”

In the past, a “short short” rule applied to mutual funds, which said that no more than 30% of a fund's income could come from transactions that lasted for less than three months. The Tax Reform Act of 1997 repealed that rule.

The 1936 Act also required mutual funds to garner most of their profits from securities. But that limitation has been tested, as well.

Investing in commodities indexes blossomed in the 1990s, and a few commodities mutual funds were offered. Because futures aren't securities, the funds got their commodities exposure by investing in swaps tied to commodities (or commodities indexes).

The fund's cash was kept idle as collateral for the swaps. All went well until Revenue Ruling 2006-1 stated that the funds had to look through the swaps to the underlying reference asset to see if those assets were securities.

The ruling inferred that notes (debt) tied to commodities wouldn't be looked through and that commodities-linked debt would be counted as an eligible security, throwing off “good income” instead of a swap's “bad income.”

In order to be treated as debt, notes must have a reasonable return of principal feature and not be a derivative. Soon after Rydex Funds received a private-letter ruling from the IRS approving its offerings, others followed suit.

The note structure forced funds to assume an increased counterparty credit risk for each issuer.

Developers of managed-futures mutual funds conceived the idea of using a “blocker” corporation headquartered in a tax haven country. The government permits these so-called blockers when tax-exempt institutions use them to invest in leveraged hedge funds, so why couldn't mutual funds invest in a wholly owned offshore corporation that could invest as it chose in futures, and turn “bad” income into “good” income?

More than 40 IRS private rulings were issued that blessed funds using controlled foreign corporations, and as long as a mutual fund invests in a security — in this case, the common stock of the CFC — it is OK.

Fund creators must have concluded that since CFCs can be used this way, wouldn't it be possible for an offshore CFC to charge a pure incentive fee, too?

Since their inception, domestic funds have been prohibited from charging an incentive fee in the form of an uncapped percentage of profits. But through a CFC, which would invest with commodities-trading advisors that charge a percentage of profits, the incentivized compensation would occur in the CFC, not the fund itself.

That has been happening in several managed-futures funds, and there is some concern in Washington as to how these funds are reporting the “true and total” fees that investors are paying. I suspect that between Mr. Levin's rumblings about tax issues, the regulatory discomfort with fee disclosure and a move by the Commodity Futures Trading Commission toward rethinking fund manager regulation, these funds will have to morph again.

If the situation remains unchanged, the mutual fund world is likely to be deluged by hedge fund managers who don't lift a finger unless they get a cut of the profits, and have never contemplated operating a fund. Their arrival wouldn't necessarily be unwelcome, but we need to know what the rules are.

Robert N. Gordon (bobg@twenty-first.com) is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business.