HEDGE FUND INVESTING AND TAXES

Why 'Liquid Alts' Deserve a Look

By Robert N. Gordon

In "Hedge Funds and the Taxable Investor," published in IMCA's May/June 2012 *Investments & Wealth Monitor*, I observed that mutual funds possess superior tax characteristics compared with other exposures to hedge fund strategies (Gordon 2012). At that time, however, only a handful of such alternative mutual funds, known as "liquid alts," were up and running. But a plethora of mutual funds now employ hedge-fund-like strategies, and it is time to revisit this topic.

Background

The benefits and detractions of the different ways to invest in hedge fund strategies are dealt with more completely in Gordon (2012). As I count them, there are seven ways to get exposure to hedge fund strategies, each with its own pluses and minuses:

- Limited partnership
- Limited liability company
- Passive foreign investment company (with or without a qualified electing fund)
- Private placement life insurance contract
- Captive insurance company
- Derivatives
- Regulated investment company

Limited Partnership or Limited Liability Company

Traditionally, U.S. individual investors have accessed hedge funds through domestically based limited partnerships (LPs) or limited liability companies (LLCs). On the plus side, all taxable items such as long-term gains and qualified dividend income flow through from the portfolio directly to the investor's tax return. On the minus side, these investors can be exposed to hundreds of basis points of phantom taxable income. If your fund of funds makes 11 percent before fees and 9 percent after fees, you may be paying tax on 11 even though you are only making 9. The 200-basis-point difference is income you do not make but still have to pay tax on (i.e., phantom income). This is because investment fees are treated as miscellaneous itemized deductions and thus are not deductible for most high-income taxpayers. This problem can be minimized if your fund is a "trader" and not an investor. Unfortunately, it appears that upon closer inspection, the Internal Revenue Service (IRS) would not consider many of these funds traders. If the government decided that your fund was not a trader but was more accurately described as an investor, the fund would then have to issue corrected K-1 forms. These new K-1s would reflect lots of (phantom) income along with corresponding amounts of useless miscellaneous itemized deductions. During summer 2014, Congress held hearings on the infrequency of hedge fund audits and charged the IRS with increasing the percentage of large partnerships that should be audited. This concern with phantom income is the main reason for taxable investors to explore alternative ways to own alternative investments.

Passive Foreign Investment Company

Gordon (2012) suggests that U.S. taxable investors join the U.S. tax-exempt investors who invest in the offshore versions of funds (all the funds have one). Investing in the offshore fund, known as a passive foreign investment company (PFIC), results in no phantom income tax.

If a PFIC holder does not make a qualifying electing fund (QEF) election, all taxable income will be deferred and converted into ordinary income taxed upon exit with an interest penalty. If your PFIC allows you to make a QEF election, then income will flow through annually and long-term gains will keep their nature as tax-favored income; making this election could be the better route depending on the type of income the fund earns.

In the minus column, in an offshore fund dividend income received by the fund is reduced by withholding burdens. In addition, the investor record-keeping requirements on PFICs have become more complicated in the past two years due to the Foreign Account Tax Compliance Act (FATCA) and the 3.8-percent Medicare tax.

Private Placement Life Insurance Contract

Investing through a private placement life insurance (PPLI) contract also creates no phantom income. All taxable income is deferred and taxed upon exit as ordinary income. Issues include control, which funds are available in an insurance-dedicated vehicle, and of course the requirement to buy some insurance. Used inter-generationally, PPLI could be a home run.

Captive Insurance Company

I've heard a lot lately about getting exposure to hedge fund strategies by owning a captive insurance company (CIC) that would invest its capital in hedge funds. A CIC has potential for conversion of all taxable income into long-term gains because you now own shares in a business. This would eliminate phantom income but entail business risks and complications of being in the insurance business.

Derivatives

Buying a derivative tied to the performance on a hedge fund also would produce no phantom income. The profits would be taxed at exit with an interest penalty, but all long-term gains would stay taxed as long-term gains. On the other hand, this is the only possible method that entails taking on a counterparty risk.

Regulated Investment Company

Another possibility that has risen to the top of the list are regulated investment companies or RICs (mutual funds, closed-end funds, and most exchange-traded funds) that offer hedge-fund-like strategies. These RICs produce no phantom income and income flows through only when it is realized at the portfolio level. Long-term gains and qualifying dividends keep their tax-favored status and investors receive a 1099, not a K-1.

Non-Tax Advantages of RICs

On top of all that tax efficiency, these mutual funds offer daily liquidity—quite an advantage over regular hedge funds' standard of quarterly liquidity with 30 to 45 days advance notice. Most of the funds do not charge performance fees. Management fees on these vehicles are high compared to those of other mutual funds, but they are low by hedge fund standards. Expense ratios on these funds may appear higher than they actually are because short dividend expenses are (improperly in our opinion) folded in and reported as part of the expense calculation.

RICs still have some limits on their portfolios that could have saved a few hedge funds from blowing up: Mutual funds must restrict their ownership of illiquid, hard-to-price securities as well as leverage.

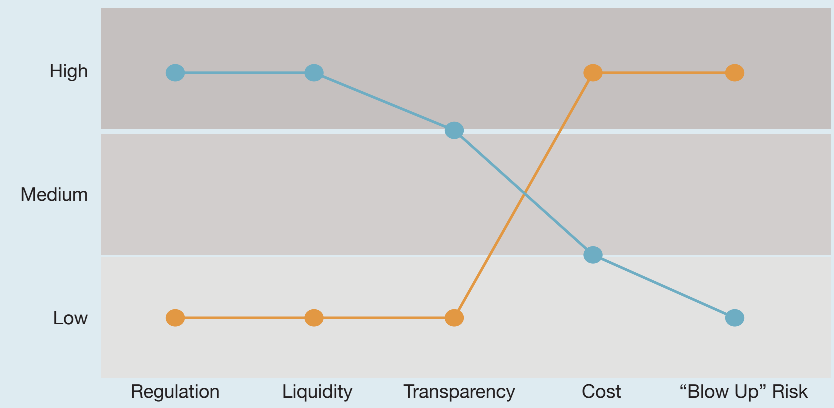
Lake Partners, a firm that manages money in liquid alts, illustrates these other non-tax advantages of being in a RIC versus investing in the domestic LP (see figure 1).

On first inspection, liquid alts appear to possibly offer the most advantageous tax profile, the best liquidity, and the lowest fees. The question is whether you can find the type of hedge fund strategy you desire in the RIC format.

Numbers, Types of Liquid Alts are Growing

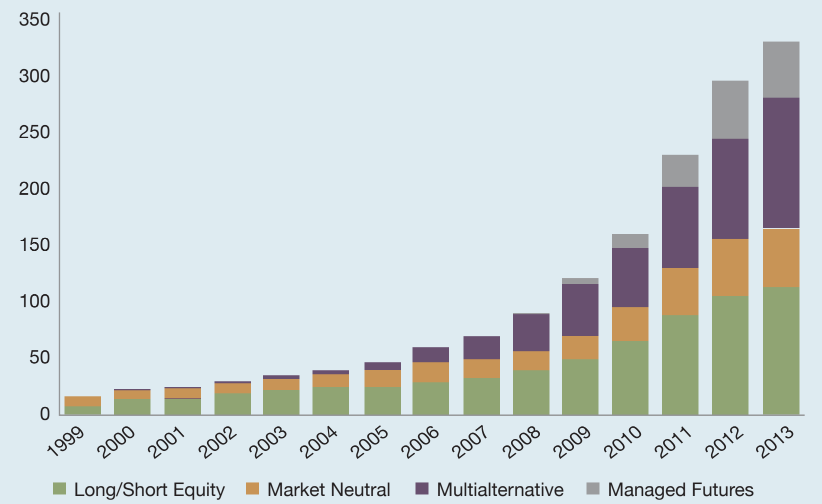
According to Morningstar, 329 alternative strategy funds with $132 billion in assets, not including commodity funds, existed at the end of 2013 (see figure 2). Investors shifted more than $40 billion of assets to liquid alternative mutual funds in 2013, up 43 percent from 2012 (see figure 3). The majority of funds are hedging equities and are either labeled as market neutral or long/short. Merger arbitrage funds, fixed-income long/short, managed futures, and multi-strategy funds also exist. According to *DailyAlts*, an additional 61 new liquid alternative funds were launched in 2014 (Haskin 2014).

Figure 1: Structured Differences between Alternative Mutual Funds and Hedge Funds



Source: Lake Partners, Inc.; Morningstar Principia, through December 31, 2013

Figure 2: Growth in Number of Alternative Mutual Funds



Source: Lake Partners, Inc.; Morningstar Principia, through December 31, 2013

Boy, what a difference 25 years made in the world of fund taxation and what a mutual fund is and isn't allowed to do. When my firm launched the first long/short fund in 1986, we had to contend with several constraints on our portfolio: the "short short" rule, a limitation on the use of futures, and a severe limitation on shorting stocks. After some congressional bending, 70 friendly IRS rulings, and some financial engineering, these rules no longer seem to matter.

The Revenue Act of 1936 established that RICs must pass certain tests in order to escape being taxed like regular corporations. If a fund flunked one of the tests, a full corporate tax would be levied.

Continued on page 52

WHY "LIQUID ALTS" DESERVE A LOOK

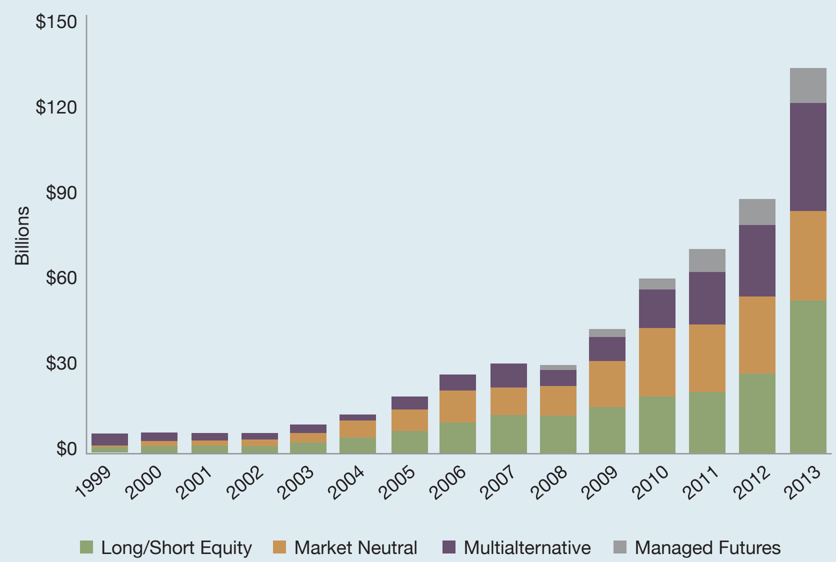
Continued from page 46

Sen. Carl Levin (D-MI) 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."

The Tax Reform Act of 1997 repealed the "short short" rule that was meant to discourage short-term trading in funds (no more than 30 percent of a fund's income could come from transactions that lasted for less than three months). The 1936 Act also required mutual funds to garner most of their profits from securities, not commodities. Developers of managed-futures mutual funds conceived the idea of using a controlled foreign corporation (CFC, an offshore "blocker" corporation) to allow funds to trade more futures. The government permits these so-called blockers when tax-exempt institutions invest in leveraged hedge funds; so, why couldn't mutual funds invest in a wholly owned offshore corporation that in turn could invest as it chose (in this case in futures)? The favorable rulings were given and another roadblock fell. These offshore blockers could even charge a performance fee. If performance fees become the norm in liquid alts, many more quality hedge fund managers may be willing to start mutual funds offering their strategies to the general public.

We see newer liquid alts investing in illiquid assets such as private equity.

Figure 3: Growth in AUM of Alternative Mutual Funds



Source: Lake Partners, Inc.; Morningstar Principia, through December 31, 2013

These vehicles must be closed-end funds because a mutual fund or exchange-traded fund cannot offer liquidity when the underlying investments are not able to be sold to meet redemptions. How are these funds' net asset values (NAVs) calculated on illiquid venture capital or private equity investments?

No doubt the Washington wrangling and fund innovation will continue apace. I predict that more managers of hedge fund strategies will embrace managing RICs, and the RICs will expand to invest into more esoteric strategies and asset classes.

Robert N. Gordon is president of Twenty-First Securities in New York, NY, and an adjunct professor at New York University's Stern School of Business; he has served as a lecturer at and chairman of The Wharton School's Security Industry Institute. Contact him at bob@twenty-first.com.

References

Gordon, Robert N. 2012. Hedge Funds and the Taxable Investor. *Investments & Wealth Monitor* 27, no.3 (May/June): 42–44.

Haskin, Brian. 2014. Top 10 Liquid Alternative Fund Launches in 2014. Daily Alts (December 31). http://dailyalts.com/top-10-liquid-alternative-fund-launches 2014/.