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Hedge Funds and Taxes: Things Just Got Worse in Minnesota and Other High-Tax States

By Bruce Paulson, CPA, JD, CFP®
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The new tax laws make worse an already rocky relationship between hedge funds and taxes. Mutual funds that hold noncorrelated assets and strategies may gain in after-tax favor when compared to hedge funds whose fees are nondeductible, especially if gross returns from hedge funds remain low. Generalizations, of course, are dangerous. Ask your certified personal accountant or advisor to show you how your hedge funds are performing net of fees and tax costs.

Tax Law Changes

The Tax Cuts and Jobs Act (TCJA) is by now old news. Two changes are relevant to our discussion:

- 100 percent repeal of miscellaneous itemized deductions, which for hedge fund investors includes management fees and any other partnership expenses (other than incentive fees). This means investors will pay income tax on gross, rather than net, returns (effective ly paying income tax on fees).

- $10,000 deduction cap on Schedule A for all state and local sales, income, and property taxes. This means effective combined federal and state rates on portfolio-related income will generally be higher.

What these changes mean for high-rate taxpayers in high-tax states will depend upon several taxpayer-specific factors. If you eliminate the federal deduction for state income taxes, the top combined effective tax rates are reflected in Figure One.

Figure One: Top Combined Effective Tax Rates

	Effective Combined Fed-State Tax Rates					
	2017		2018		Increase/Decrease	
State	Ord. Inc. + STCG	LTCG + Div.	Ord. Inc. + STCG	LTCG + Div.	Ord. Inc. + STCG	LTCG + Div.
Minnesota	49.35%	31.68%	50.65%	33.65%	1.30%	1.97%
California	50.83%	33.64%	54.10%	37.10%	3.27%	3.46%
New York City	51.08%	34.80%	53.52%	37.55%	2.44%	2.75%
Arizona	46.12%	27.40%	45.30%	28.30%	-0.82%	0.90%

Effective combined federal and state rates for top ordinary income taxpayers (2017, with federal deduction for city and state taxes; 2018, without city and state income deduction). Net investment income tax (3.8%) is included; Medicare surtax is not. Sources: CAPTRUST Research, CCH State Tax Handbook and IRC Code.

Flow-Through Tax Treatment: Different Than Mutual Funds

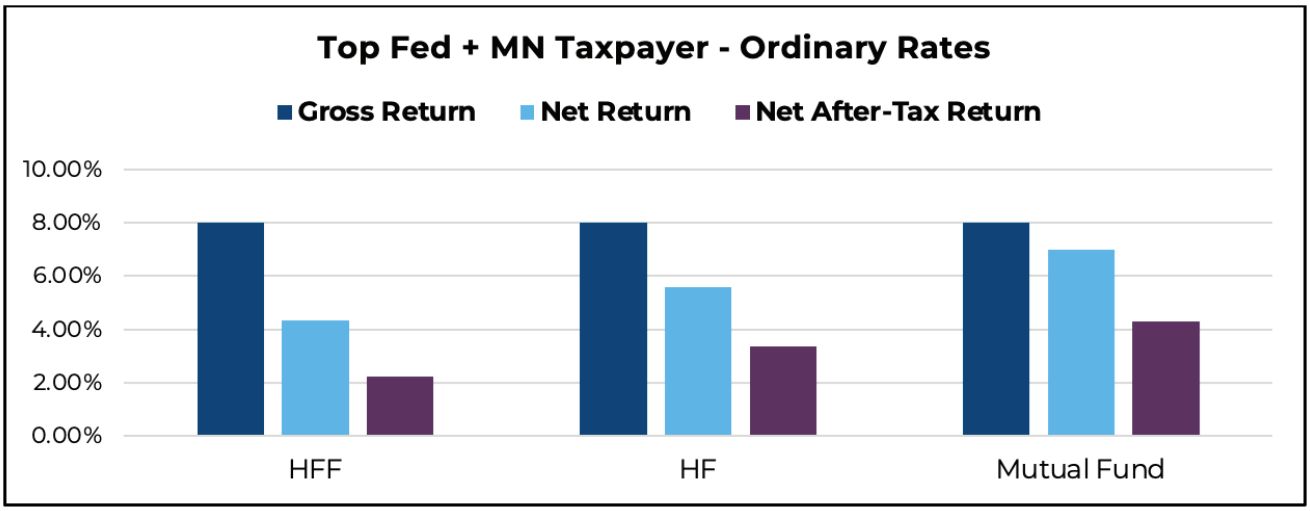
Domestic hedge funds are both like and unlike mutual funds. Both pass through annual income they recognize to their investors. However, one important difference exists. Mutual funds make taxable distributions of net gains; a shareholder pays tax on net realized gains and income, not

gross income. Hedge funds do not distribute cash; instead, they provide each investor with a Form K-1 that states the amount of taxable income the investor must report, and the investor pays taxes on that amount. Unless the hedge fund qualifies for so-called trader status, the investor pays tax on the gross return of the fund; management fees and other expenses incurred by the fund (e.g., accounting fees, legal fees, marketing) are not tax-deductible items at the hedge fund level. This means the hedge fund owner pays tax on fees and costs, giving rise to the term *phantom income*: income taxed but from which no income is received.

High Tax State Example: Minnesota

Using Minnesota (e.g., 50.65 percent ordinary income and short-term capital gains, 33.65 percent long-term capital gains and qualified dividends), let's compare hedge funds of funds (HFF), hedge funds (HF), and mutual funds, using reasonable assumptions and assuming hedge fund fees or costs do not qualify for so-called trader status. We show (by hedge fund standards) in Figure Two a modest level of taxable turnover (trades that create tax) and assume 50 percent of these gains are long term and 50 percent short term. To be fair, we use the same assumptions for the mutual fund, which may or may not be true. To keep it simple, we use 8 percent gross return.

Figure Two: Top Federal Plus Minnesota Ordinary Income Tax Rates with 8 Percent Gross Return



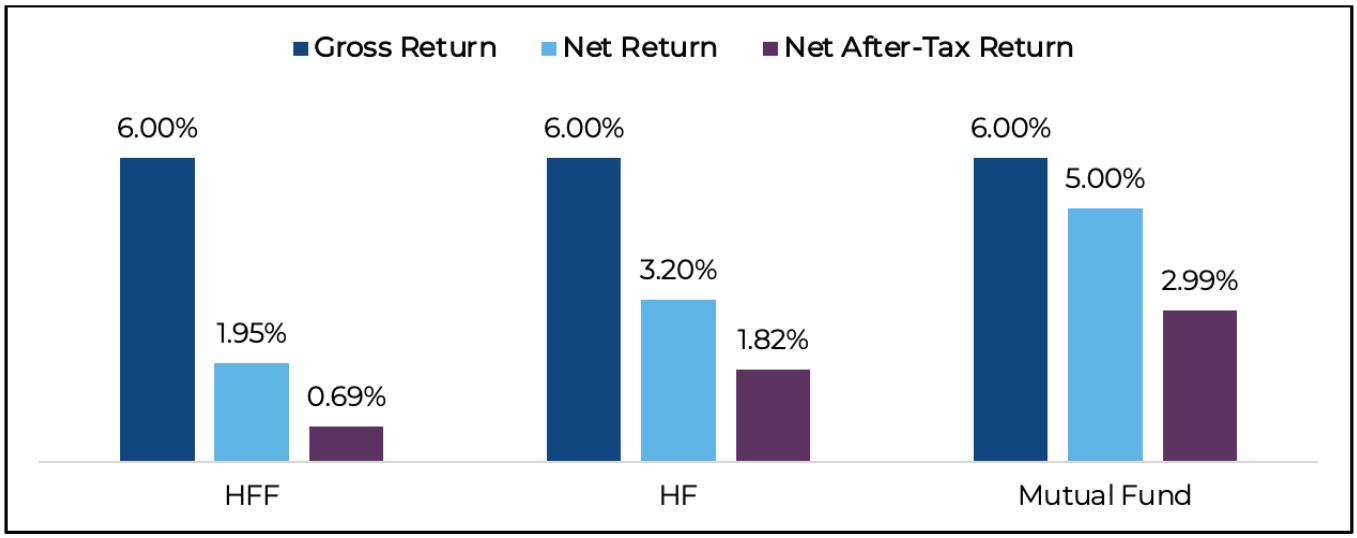
Source: CAPTRUST Research

Phantom income (as a percentage of gross taxable return) is 28 percent for HFF, 19 percent for HF, and 0 percent for mutual funds, a major reason for the mutual fund's higher net after-tax return. The percentages equal total fund expenses that are not tax deductible.

Phantom Income Problem Gets Worse If Gross Returns Fall and Fees Remain the Same

Consider now what happens if gross returns fall to 6 percent, a not unrealistic scenario for hedge funds and mutual funds whose primary role in a portfolio is to provide diversification to equities.

Figure Three: Top Federal Plus Minnesota Ordinary Income Tax Rates with 6 Percent Gross Return



Source: CAPTRUST Research

Now, phantom income rises to 37.5 percent for HFF and 25 percent for HF. It remains 0 percent for mutual funds.

Is Now a Good Time to Make Certain Changes to Improve Your Net After-Tax Returns?

That's your decision. A role in most investment portfolios exists for asset classes and strategies that reduce total portfolio volatility and whose fortunes are not linked to the broader equity market or factors that underlie equity returns. And there are many hedge funds that qualify as traders, placing them on par with mutual funds in terms of fee deduction. Taxpayers with high hedge fund exposure may wish to pause and consider their net after-tax appeal under the new tax laws. It could be that hedge funds make sense pre-tax, using a pre-tax optimizer or other program, but make little sense in the long term after higher fees, tax costs, and incentives are considered.

These and other questions come to mind:

- Do asset classes or strategies, hedge funds, or mutual funds that generate a high percent age of recurring ordinary income and short-term capital gains make any sense at all for a resident of Minnesota or other high-tax states?

- Would lower-cost liquid alternatives replace (or reduce the need for) high-fee, high-cost products that cause their investors to pay tax on income they never receive?

- Where tax-generating hedge funds serve a useful role within a diversified portfolio, would pairing them with lower-cost, tax-loss-harvesting equity solutions (separate account or partnership) make more sense than holding hedge funds and active equity managers side by side?

- If wealth is held across different family generations and within different asset locations (e.g., grantor trusts, nongrantor trusts, charitable remainder trusts, charitable lead trusts, or other), where (considering income taxes, estate taxes, liquidity needs, and volatility) should high-tax-generating hedge funds be held and why?

- Should hedge fund exposure be accessed through tax-advantaged private placement insurance products?

Hedge Fund of Funds, Hedge Fund, and Mutual Fund Assumptions

Assumptions	HFF	HF	Mutual Fund
Gross Return	8.00%	8.00%	8.00%
Management Fees	-1.00%	-1.00%	-1.00%
Other Costs	-0.50%	-0.50%	0.25%
Incentive (20% net)	-1.40%	-1.40%	0.00%
Fund of Funds (Advisor) Fee	-0.75%	0.00%	0.00%
Income %	0.00%	0.00%	0.00%
Taxable Turnover	50.00%	50.00%	50.00%
STCG %	50.00%	50.00%	50.00%
LTCG %	50.00%	50.00%	50.00%

Source: CAPTRUST Research

Note: Readers may disagree with our assumptions. It is true that the management fee and other costs for mutual funds used as portfolio diversifiers (liquid alternatives) may be higher than 1 percent and other costs higher than 0 percent. In fact, this will likely be the case. If so, the advantage of mutual funds over hedge funds declines, most notably (as discussed above) where the hedge fund qualifies as a trader. With that said, the mutual funds that we have in mind as substitutes for hedge funds come without incentive fees. The income percent and taxable turnover numbers will vary based upon the underlying investment strategy of the mutual fund.