

Hedge Fund Tax Allocations

*Important Note: Tax laws and regulations are very complex and nuanced. The following is a discussion of general tax allocation issues and is intended to provide a high-level view into the way that APM helps if it is asked to assist in the tax allocation process. Other administration and accounting firms may have other interpretations and procedures. **ALPS Price Meadows SM does not provide tax, legal or investment advice.***

Partnership Structure

Most mutual funds are organized as corporations and track ownership by shares. They avoid corporate taxation by "distributing" taxable income items at least annually to shareholders. The unfortunate byproduct of this structure is that the day an investor buys shares, he or she becomes liable for whatever tax distribution is next made and will have to report those distributions as income. This will include all gains and other income that were realized since the most recent prior distribution date including gains realized before the investor's entry date.

In a private fund with pass-through accounting (partnerships and most LLCs), participants are tracked as capital accounts rather than shares or units. Since tax allocations are undertaken account-by-account, tax allocations can more closely track the investor's economic allocations. If a person comes into the fund with cash and has no economic gain by year-end, he or she would likely not be allocated taxable capital gains. The primary exception would be if everyone in the fund ends up being allocated more cumulative taxable income than cumulative economic income. (This would happen if the manager realized gains while retaining losses and went into the next year with net unrealized losses in the portfolio.)

Taxable Versus Economic Income

The economic income of a fund includes all gains and losses, including those that are unrealized and have no current tax effect. Because it is common for funds to have significant unrealized gains and/or losses at the end of a tax year, taxable income will rarely equal economic income. While careful tax management – delaying gains and "harvesting" losses – is attractive to most investors, the eventual "catch-up" in later years

can come as a surprise. However, despite the "catch-up" or "leapfrog" that can occur year-to-year, over the long run, cumulative taxable income will approximate cumulative economic income.

Allocations By "Book-Tax" Disparity

To understand how taxable income from the portfolio is distributed among partners, let's start with a basic allocation concept. Each person in a hedge fund has a "book-tax disparity" – the difference between his or her capital account (called "book") value and his or her accumulated tax basis. In other words, the book-tax disparity is the partner's personal unrealized gain or loss since entry to the fund. Each partner's accumulated tax basis adjusts each year as taxable income or loss is allocated via the year-end K-1, with such amount being added to or subtracted from the previous year's tax basis. A person having a \$1,100,000 value at year-end, having contributed \$1,000,000 earlier that year, would be said to have a \$100,000 positive book-tax disparity. An investor who experienced a loss or who had been allocated more taxable income than his or her economic gain would be said to have a negative disparity.

It is useful to note that the sum of the investors' aggregate book-tax disparities will ordinarily equal the unrealized gain or loss on the fund's balance sheet.

In a fund without capital withdrawals, capital losses are first allocated among the pool of participants who have negative book-tax disparities. Capital gains are first allocated among those who have positive book-tax disparities. This ensures that the taxable gains "go to the investors who made the money." The remainder is then distributed among the partners as a group.

Allocations By “Book-Tax” Disparity continued

The formulae are complex and APM’s process would take up scores of data columns on a spreadsheet, but the process entails just six steps:

1. Allocate ordinary income and expense by time- and dollar-weighted participation.
2. If a withdrawal occurs, allocate sufficient gain or loss to eliminate book-tax disparity on the withdrawal amount.
3. If securities which were contributed are sold, allocate the amount of the unrealized gain or loss at the time of contribution to the contributor.
4. Allocate remaining gains in proportion of positive book-tax disparity; losses in proportion to negative book-tax disparity; both limited to the amount of the book-tax disparity.
5. Remaining gains or losses are allocated by time- and dollar-weighted capital.
6. Each capital item is proportionally reallocated to the general partner in the ratio that the incentive allocation bears to the sum of the gaining partner’s capital accounts.

Withdrawals

As noted in the six-step sequence above, when a capital withdrawal occurs, a special allocation is made to the withdrawing partner to eliminate the book-tax disparity on the withdrawal amount. This allocation is often called a “fill-up,” and to understand its importance, consider the following example:

Assume an investor comes into the fund with \$500K and it grows to \$1 million over 3 years. The tax effect of a withdrawal will depend on the investor’s accumulated tax basis (which would not be \$500K anymore because of intervening tax years and K-1s). Let’s say the investor had \$250K in economic income the first two years, \$200K of which had been realized income – interest, dividends and capital gains. Therefore, at the start of the current year, the capital account (or “book” capital) was \$750K and a tax basis was \$700K.

If the investor now withdraws after a very good year when “book” capital is \$1 million, then, regardless of what others are allocated that year, the tax allocation process will attempt to eliminate the investor’s current “book-tax disparity” by specially allocating \$300K of taxable income (\$1 million minus the \$700K tax basis). If the disparity is not eliminated, what happens?

Let’s say that \$300K in realized gains isn’t available—that there were no realized gains in the current year to allocate. Since investors’ book-tax disparities reflect the overall fund portfolio, that \$300K not allocated reflects an unrealized gain that will be realized at a later time. When it is, it is the remaining partners who will see the gain and pay taxes on it.

What happens to the partner who departs with a disparity? He or she will have to account for the difference in basis outside the partnership on an individual tax return: the investor sold a \$1 million asset with a cost basis of \$700K. What happens to the remaining partners? While they will someday be able to claim an outside basis loss, for now, they will be stuck with their share of the \$300K taxable income when it is realized in the fund.

Clearly, it is important to monitor the tax effects of withdrawals. While ordinary fund tax planning may suggest the harvesting of unrealized losses, it is very important to have sufficient realized gains available to allocate in the event of a withdrawal.

APM recommendation: While some tax preparers choose to delay active elimination of book-tax disparities until an investor completely withdraws, APM recommends eliminating book-tax disparities attributable to each partial withdrawal amount. Because of the potentially negative consequences of not eliminating book-tax disparities on departing capital, it is best to deal with book-tax disparity issues early and incrementally.

Fairness

In general, taxable income can be allocated much more fairly in a hedge fund than a mutual fund. A manager’s decisions about taking tax losses or taking gains off the table are not made for the benefit of any one participant, so making allocations based on each partner’s book-tax disparity leads to a fairer result than simply observing arbitrary time periods.

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