ACCOUNTING TODAY.. Critical Tax Points for Funds

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Given affairs in the Capital, we assume that no tax legislation will be enacted the rest of this year and that the prospects for technical corrections for the numerous unartfully drafted provisions of the New Law are poor.

WASH SALES: EVEN WORSE THAN BEFORE. The New Law makes tax efficiency more important than ever. Investors in funds generating substantial management fees and fund expenses are unable to deduct these investment expenses and other miscellaneous itemized expenses under the New Law. High net-worth investors were severely limited under prior law in deductions fund expenses but the New Law means that, if, for example, the total of fees and expenses borne by an investor is 3%, the fund must make at least 3% just for the investor to come out even. Although a 3% hurdle rate may not prove to be a deal killer, combined with other tax inefficiencies, the most important of which is wash sales, the result can be unpleasant to an investor and may be cause for a tax advisor to question the desirability of continuing investment in a tax-inefficient partnership.

Wash sales losses are losses incurred in selling securities at a loss and reacquiring the same or “substantially similar” securities within the 61- calendar day wash sale window (the day of the loss sale, the 30 days prior and the 30 days subsequent). The wash sale testing period can extend into the next calendar year, as shown in this example.

EXAMPLE: Fund LDR, LP sells 10,000 sales of ABC on December 27, 2018 for $30 per share (tax basis $60 per share) and buys 20,000 shares of ABC on January 17, 2019 at $28 per share. ABC's $300,000 loss of December 27, 2018 is disallowed and the deferral increases its tax basis in 10,000 of the ABC shares acquired on January 17, 2019; remaining 10,000 are not affected. The result: LDR, LP reports for financial statement purposes a loss of $300,000 but no corresponding loss is reported on its tax returns, causing an overstatement of investors' tax liability. The wash sale rules match the amount of replacement position shares to the number of shares sold in the wash sale, the wash sale deferral applies only to the first 10,000 of replacement shares.

The wash sale rules are an antique and leave open many technical questions, such as: “What securities are substantially similar to the securities sold at a loss?” This can involve analysis of securities exchanged in mergers and acquisitions, as well as convertible securities. For example, “busted convertibles” (the conversion price becomes so high that the security will never be converted) are not substantially similar to the securities into which they could be converted if market prices were favorable.

STRATEGIES FOR DE-FANGING THE WASH SALE REGIME. The most obvious approach is not to buy the same, or substantially identical, securities within the 61 day window. It is common for the stock to decline in price still further, making a bad problem worse. Another strategy is to employ a type of pairs trading strategy: Sell GM at a loss and buy another automotive stock. The new automotive stock is not GM and is not substantially identical to GM, so that the wash sale deferral rules are inapplicable. The rules are more generous for debt obligations than for stocks, as for debt obligations only the same CUSIP number bond is the same, or substantially identical, to the one sold at a loss. Equities are subject to a more analytical approach as to “substantial similar” which means that trading pricing, securities issued in mergers and acquisitions, and corporate name changes, should be considered.

WHAT TO DO ABOUT MISCELLANEOUS ITEMIZED EXPENSES. We suggest some concepts for your consideration. The New Law does not change the rules distinguishing between funds that are active traders in securities and commodities and funds that are investors. Trader funds are engaged in the conduct of a trade or business and generate trade or business deductions under Section 162 of the tax law. Fund expenses deductible under Section 162 are deductible as any other group of business expenses and are likely to be deductible for the year generated or in a subsequent year.

Some funds employ an investment strategy that is, and always will be, a “buy and hold” strategy. The fees and expenses will always be subject to the non-deductibility rule, but this is the tax price for a fund that if successful, generates substantial capital gains that are realized into the future, a very tax-efficient strategy (but for the non-deductibility of fees and expenses). A tried-and-true strategy for dealing with non-deductibility of expenses is for the manager to pick up the expenses and not charge fees, in exchange for an increased carried interest (such as from 20% going to 25%). This is a substantial change to compensatory arrangements and would require investor consent; however, the investors would benefit and the manager assumes the risk that it will pay the expenses and forego the cash flow from fees even if the fund's results for the year are negative.

While there is no “bright line” for distinguishing trading from investing, informal IRS positions in tax audits indicate that trading must be “regular, substantial and continuous” (based on Supreme Court decisions) throughout the tax year and 100 trades per month is an acceptable level to constitute trading. Regular, substantial and continuous means, among other things, that trading must be conducted throughout the year, that the IRS expects to see trades in the fund's brokerage statements each month, and that taking three months off to go fly-fishing in Patagonia may well be a deal-killer if trader status is desired. The upshot: if a fund's trading is on the cusp of satisfying trader status, consideration may be given to upping the level of trading so as to satisfy the standard for trading. Funds that generate substantial amounts of long-term capital gain may find that they are not likely to satisfy one of the prongs of trader status: that the goal is to generate in –and-out trading gains and not to buy and hold for the long term. It is well-known that when an IRS examination into trader status is being conducted, one of the first questions upon examining the fund's tax return, is how much long-term capital gain is generated versus short-term capital gains and ordinary income such as dividends and interest.

SECTION 475(f) MARK-TO-MARKET ELECTION. Traders in securities and/or commodities may elect to treat all of their securities held for trading as subject to a regime whereby gains and losses are ordinary and all positions still held at year-end are treated, sold and repurchased at their year-end value (marking-to-market). These rules are based on those applicable to securities dealers, which are mandatory. All trader expenses are, of course, trade or business, so that the itemized miscellaneous deduction problem is inapplicable. Electing traders can still have a separate investment securities account, which is not subject to the mark-to-market regime. A significant benefit of the Section 475(f) election is that it eliminates the wash sale problem; some clients have made the election just to be rid of the troublesome wash sale rules. In a down year, classification of losses as ordinary, rather than capital, is preferable, although clearly not as good as spinning straw into gold.

CARRIED INTEREST HOLDING PERIOD. The New Law made a substantial change to the tax laws governing the carried interest (the incentive reallocation of profit made to the general partner or other fund manager that is a partner of the fund). Prior law placed no restriction on the holding period of the manager or the fund's holding period for assets generating the carried interest allocation. The New Law's provisions, unartfully drafted, do not make clear whether a manager must have a holding period in its interest in the fund for at least three years, or the carried interest is only calculated based on assets held by the fund for at least three years, or both. Whichever rule applies, the carried interest will be short-term capital gain unless some three-year holding period is satisfied. We note that various strategies have been advanced to attempt to take some or all of the sting out of the three-year rule, but what emerges as a concept for your consideration is for managers to make their own capital contribution as a limited partner and not as the manager or a member of the manager, for the purpose of segregating results on the manager's own capital from computation of the carried interest amounts (if any).

Although the consensus view of tax practitioners in the field is that the three-year holding period is measured by the fund's holding period in the asset(s) generating the carried interest, this is by no means certain. The upshot for managers is that managers pursuing an active trading strategy are not likely to qualify under the three-year asset holding period. Venture capital fund managers and other managers whose strategy is long-term holding period are likely to benefit, perhaps, entirely, from the three-year asset holding period requirement. Managers who are not likely to qualify under the three-year rule need to rethink their tax posture compared to prior years, as their effective tax rate is likely to increase. Where assets are on the cusp of the three-year holding period, there is potentially a conflict between the investors' interest, who might want to see gains harvested once the long-term holding period is satisfied, versus the manager's desire to qualify for the carried interest. Such potential conflicts have always present, and arguably, the additional concerns raised by the New Law can be dealt with by disclosure.

There is an exception to the three-year holding period for carried interest allocations for the amount of capital that is contributed in exchange for an interest in the partnership, determined as of the date the capital is contributed. The statute is unclear and amendments appear to be unlikely at the present time. Transfers of capital by the manager (and its affiliates, as appropriate), for a newly issued limited partnership interest (or non-managing member interest in a limited liability company) is the current response to the statutory limitation.

CONFORMING TO PARTNERSHIP AUDIT RULES. 2015 legislation radically changed procedural rules for auditing partnerships. The former rules (the “TEFRA Partnership Audits”) required a partnership to nominate a member as the “Tax Matters Partner,” who was authorized to deal with the IRS in an audit of the partnership. The new rules require a partnership to designate a “Partnership Representative” to deal with the IRS; although the representative need not be a partner (a major departure from the old rules) as a practical matter this is advisable. The new law provides for complicated elections and special rules; it is hard to predict how these rules will affect a particular partnership until an audit by the IRS is underway. We suggest that the simplest way for clients to respond to the new rules, if they have not done so, is to designate a member of the manager as Partnership Representative and to amend the partnership documents to grant to the representative the discretion to make such tax elections, or not, as the representative finds beneficial to the partnership and its partners as a group, and not to benefit any one partner or group of partners.

SECTION 199A QUALIFIED BUSINESS INTERESTS (“QBI”)/CONVERSION TO CORPORATE CLASSIFICATION. The New Law introduced radical changes in the taxation of business entities. The headline news in corporate taxation is the reduction of the corporate income tax. We note that for taxpayers considering moving from fiscally transparent status (partnership or single member limited liability company) to corporate status, state and local taxes can be a major surprise. Liquidation of a corporation, even if a deemed liquidation under the so-called check –the-box system (IRS Form 8832) is a taxable event and result in a major tax liability, where the rules for fiscally transparent entities are more forgiving.

Likewise, the New Law's tax exemption for certain QBI income is attractive, but must be studied in detail whether you can benefit from this exemption, and if so, how it can be accessed without turning your business strategy upside down.

We suggest that given the uncertainties in Washington, a wait and see approach when it comes to big changes in your business is appropriate. We remind you that equally major tax changes were enacted in 1981, and were repealed piecemeal until the Tax Reform Act of 1986 not only wiped out much of the Reagan tax policies, but resulted in tax legislation that is unfavorable to most taxable and which Congress does not appear to be in a hurry to fix.

For more information on these critical tax points, contact Victoria Pellegrino, Partner, Financial Services Practice Leader of Grassi & Co., at vpellegrino@grassicpas.com or Roger Lorence, Senior Tax Advisor, at rlorence@grassicpas.com.

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