Year-End 2022: **TAX CONSIDERATIONS FOR HEDGE FUND MANAGERS**

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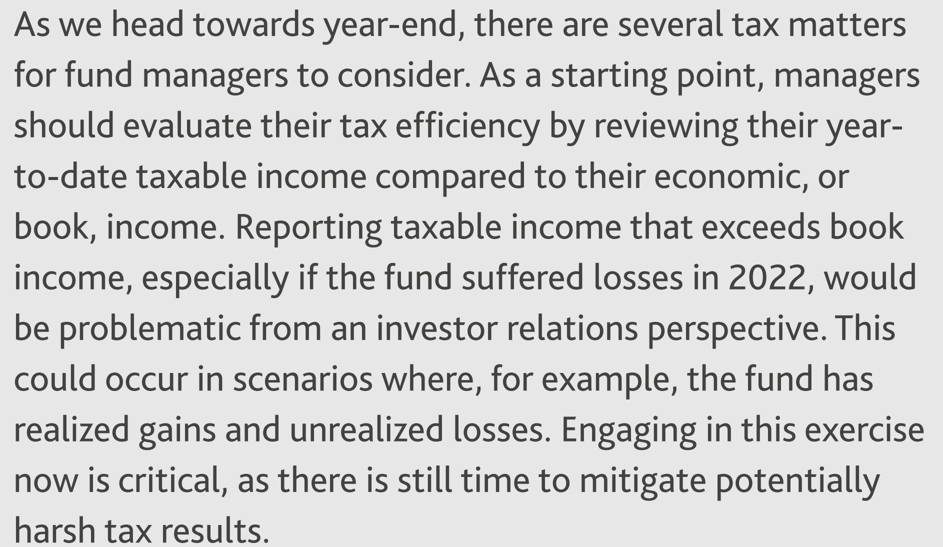

As we head towards year-end, there are several tax matters for fund managers to consider. As a starting point, managers should evaluate their tax efficiency by reviewing their year-to-date taxable income compared to their economic, or book, income. Reporting taxable income that exceeds book income, especially if the fund suffered losses in 2022, would be problematic from an investor relations perspective. This could occur in scenarios where, for example, the fund has realized gains and unrealized losses. Engaging in this exercise now is critical, as there is still time to mitigate potentially harsh tax results.

There are some general guiding principles to keep in mind when evaluating a fund's tax efficiency, particularly with respect to high-net-worth individual investors:

- From a timing perspective, it is preferable to defer income and accelerate losses and deductions.
- From a character (i.e., tax rate) perspective, long-term capital gains are preferable to short-term capital gains or ordinary income. (For the general partner, there is an extended three-year holding period requirement under IRC Section 1061 with respect to gains allocable to their carried interest). On the flip side, ordinary losses are preferable to capital losses, and short-term capital losses are preferable to long-term capital losses.

Note that in a rising tax rate environment, where increases are anticipated in the following year – which is not currently the case — some of these principles may operate in reverse.

With these principles in mind, we will summarize some commonly encountered tax rules and elections that could impact the timing and character of a fund's taxable income or losses.

WASH SALES

The wash sale rules under IRC Section 1091 were enacted to prevent investors from selling depreciated stocks towards the end of the year and then repurchasing the same positions immediately after selling the stocks. Without the wash sale rules, an investor could get the benefit of taxable losses on depreciated positions by selling the position (triggering the loss) while at the same time retaining its economic position in the investment (by immediately repurchasing the same position).

The wash rule rules apply to defer certain realized losses in transactions in which the investor disposes of a position at a loss and reacquires substantially identical property within a 61-day window. Under the wash sale rules, a loss cannot be taken on the sale of a stock if the fund buys the same or a "substantially identical" position 30 days prior, or 30 days after, the realized loss. Stated differently, a fund cannot sell stock and repurchase it within a 61-day window and still recognize the loss currently. The loss associated with the wash sale is deferred until the time at which the fund is out of the replacement position entirely for an uninterrupted 30 days. Note that the wash sale rules apply to short sales as well. However, they are not expected to apply to cryptocurrency transactions under current law since they are unlikely to be considered securities for tax purposes.

In some cases, it is possible to harvest unrealized losses and retain some or all of the fund manager's desired exposure without running afoul of the wash sale rules.

For example, the wash sale rules generally will not apply to a transaction in which a fund manager sells a stock and acquires an exchange traded fund (ETF) covering the same industry. Similarly, the wash sale rules ought not apply to a transaction in which a fund manager "doubles up" on a stock position that the manager is bullish about (but which has an unrealized loss), so long as it holds the positions for 31 days before selling the lot with the unrealized loss. However, this approach exposes the fund to twice the exposure to declines in the stock price for the 31-day period. Depending on the fund's desired objectives and risk profile, there are more sophisticated strategies utilizing options or other derivatives that may also be considered.

CONSTRUCTIVE SALES

A classic constructive sale under IRC Section 1259 occurs when an investor owns an appreciated long position and enters a short position on the same stock (short against the box). The constructive sale rule treats this as an actual sale and forces the taxpayer to realize a capital gain. This gain is capitalized into the basis of the long security, so when it is sold the gain will not be taxed again. The constructive sale rule only applies to gains; there is no corresponding rule for constructive sales of loss positions.

There is an important exception to the constructive sale rules. If the short position (in a short against the box transaction) is closed within 30 days after the end of the year and the long position is held open, unhedged, for 60 days after the closing transaction, then the constructive sale rule would not be triggered. This aspect of the constructive sale rule offers a planning opportunity that extends into early 2023. It affords the fund manager some degree of control over the timing of gain recognition, i.e., 2022 versus 2023. Note that, like the wash sale rules, the constructive sale rules do not generally apply to cryptocurrencies under **current law**.

MARK-TO-MARKET ELECTION FOR TRADERS

If a fund qualifies as a "trader," it is eligible to make an election under IRC Section 475(f)(1) to mark its securities to market at the end of the year as if sold. There is also a corresponding election for commodities trading under IRC Section 475(f)(2), which may be applicable to certain cryptocurrencies.

The election has some significant potential benefits. It streamlines the tax reporting process since funds making the election do not have to make adjustments for items such as wash sales and constructive sales, since the portfolio is treated as if sold on the last day of the taxable year. Taxable income typically equals financial statement, or book income, other than some relatively immaterial differences. In addition, the election accelerates unrealized losses, and enables taxable individual investors to treat them as ordinary losses, as opposed to capital losses which are subject to limitations.

The election does carry with it some potential negative consequences, including the fact that unrealized gains are accelerated and treated as ordinary income subject to the highest tax rates. Another consideration is if the fund generated significant unused capital losses prior to the year of the election, those losses could only offset future IRC Section 475 ordinary income on a limited basis ($3,000 per year), assuming an investor does not have other sources of capital gains.

It is too late for existing funds to make the election for 2022 (the due date was March 15), but for funds that launched in late 2022 and have experienced significant losses, there is still time to decide whether to make the election. A new fund makes the election by placing an election statement in its files within two months and 15 days after the first day of its tax year. The fund must also attach the statement to its tax return when later filed.

WORTHLESS POSITIONS

Fund managers should review their portfolios for potentially worthless positions. Securities can be written off for tax purposes under IRC Section 165 in the year they become completely worthless. This is a highly fact-specific determination but generally requires an identifiable event like bankruptcy that eliminates any potential future value. If a security is considered worthless, the cost basis may be written off as a capital loss. As noted, cryptocurrencies are unlikely to be considered securities for tax purposes, so potential deductions for worthlessness are expected to be governed by different rules.

Note that short positions have a different standard, which has the effect of accelerating gain on the position where the borrowed security is substantially worthless, as opposed to completely worthless.

CONCLUSION

Fund managers should consult with their tax advisors to assess their fund's year-to-date tax picture and to implement relevant strategies to improve their overall tax efficiency.

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