Tax implications of trading swaps with prime brokers

Interview with Nick Tsafos & Mike Laveman

There are some early signs that the effects of Basel 3 are changing the way that hedge funds do business with their prime brokers. In today's new reality, primes are becoming more prescriptive over how the bank's balance sheet is being utilised to support clients' trades. To mitigate the costs of trading physical securities, some managers are beginning to use more synthetic instruments.

"We are starting to hear from our clients that their prime brokers are steering them towards certain instruments that are more beneficial from a capital perspective," says Nick Tsafos, Audit Partner at EisnerAmper LLP, one of North America's leading accounting and advisory firms.

"If they enter into a derivative-based transaction to mirror what the equity instrument would do from a performance perspective, they need to know what the tax ramifications will be."

A total return swap is inefficient from a tax perspective because the end-user "is generally subject to ordinary income tax treatment not capital gains treatment when marked to market at the end of the year," explains Mike Laveman, Tax Partner & Co-Chair of EisnerAmper's New York Tax Practice. "Moreover, the IRS has come out recently with a couple of notices on basket option contracts."

On 8th July 2015, the IRS issued two notices, (Notice 2015-47, 2015-30 IRB 1, and Notice 2015-48, 2015-30 IRB 1) on the use of basket option contracts as potential tax avoidance transactions.

"If you have an options contract on an underlying basket of 10 securities, the objective of the manager is to hold that contract over say a 12-month period to realise long-term capital gains. Even though they are controlling the trades on a short-term basis in the underlying basket, the IRS views this as tax avoidance, " adds Laveman.

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Laveman adds that one issue that can create problems is determining whether the fund is regarded as a trader or an investor.

A trader fund is anything that puts on frequent numbers of trades whereas an investor fund is one that employs more of a buy and hold strategy.

"The implication here is how fund expenses and some of the pass-through items in the portfolio affect the end investors," says Laveman. "Earlier I mentioned the mark-to-market regime for swaps. You could get whipsawed badly if the instrument appreciates by USD1 million, say, after year one and gets treated as ordinary income, and falls back to zero after year two. That amount is considered to be an expense of the fund."

Laveman says that one tax structuring option for managers who start using derivatives is to put more investors into the offshore fund, which is regarded as a Passive Foreign Investment Company (PFIC).

A PFIC may have onerous US tax consequences including ordinary income treatment upon distributions from the offshore fund or redemption of the offshore fund stock. However, provided the offshore fund agrees to provide an annual PFIC Information Statement, the shareholder may be permitted to make a Qualified Electing Fund (QEF), which preserves capital gain treatment.

"Under the QEF regime the fund would report its share of annual net long-term capital gains and net ordinary income which a US investor would report on its tax return. Net ordinary income would generally include expenses and mark-to-market swap losses, which may not be deductible to the investors in the domestic fund if the fund was treated as an investor," concludes Laveman. ■