Important Note: Tax laws and regulations are very complex. The following is a discussion of general tax allocation issues and is intended to provide a high-level view into the way that ALPS views the tax allocation process with regard to alternative investment funds. Other administration and accounting firms may have different interpretations and procedures. ALPS Alternative Investments does not provide tax, legal or investment advice.

Tax in the Partnership Structure compared with the Mutual Fund 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 day an investor buys shares, he or she becomes liable for whatever tax distribution is made and is required to report those distributions as income. This may include income that was 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 (book) allocations. The taxable gains can be allocated to those with book income and losses to those with book losses. An exception would occur if the fund had more taxable income to allocate than it did book income.

Taxable and 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 open positions at the end of a tax year with unrealized gains and/or losses or other tax timing differences, taxable income will rarely equal economic income. While careful tax management by a Fund Manager such as delaying gains and harvesting losses is attractive to most investors, the eventual true up between book and tax can come as a surprise. When an account is liquidated from the Fund, all prior year non-taxable income is realized in that final tax year. Over the long run, cumulative taxable income will approximately equal 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 which is the difference between his or her capital account book value and his or her accumulated tax basis. In other words, the book-tax disparity is the partner’s personal cumulative unrealized gain or loss since entry to the fund. Each partner’s accumulated tax basis is adjusted each year by capital additions and withdrawals plus taxable income or loss allocated via the year-end K-1, with such amount being added to or subtracted from the previous year’s tax basis. The first year, 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. Conversely, 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 all of the investors’ aggregate book-tax disparities in a fund will usually approximately equal the cumulative unrealized gain or loss of open positions except for current wash sales and other timing differences.

The first step in most allocation models is to allocate ordinary income and expense by time- and dollar-weighted participation. Next, most models will allocate taxable income to liquidating Investors such that their cumulative book income across all years equals total cumulative taxable income. This is termed a “fill up” or “fill down” provision and is often employed for partial withdrawals as well to keep each tax basis in line with the account’s book basis.
Then the remaining capital gains/losses are allocated in a manner to minimize book-tax disparity for each account. Capital losses are first allocated among the pool of participants who have negative book-tax disparities up to the point where disparity equals zero. Capital gains are first allocated among those who have positive book-tax disparities up to the point where disparity equals zero. This follows the reasoning that the taxable gains go to the investors who made the money. The remainder is then distributed among the partners as a group based on time- and dollar-weighted capital. Additionally, capital gains and losses are 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 and the Importance of a Fill up or Stuffing Provision
As noted above, when a capital withdrawal occurs, a special allocation is made to the withdrawing partner to eliminate the book-tax disparity on the withdrawn 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? 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 on their K-1.

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. It is typical when a fund closes to have some remaining differences that must be recognized by the last remaining investors. Provided the fill up provision was in place and disparity was filled prior to exiting the fund, this constitutes typically only small timing differences from non-taxable income in prior years.

ALPS Alternative Investments recommendation: While some tax preparers choose to delay active elimination of book-tax disparities until an investor completely withdraws, ALPS Alternative Investments 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.

Year-End Tax Planning
As year end approaches, Fund Managers of taxable funds will focus on a few key issues to optimize the tax consequences for their investors within their trading parameters.

Wash Sales. Losses on securities that were repurchased (or short sold) within 30 days, plus or minus, from the date the loss was realized will be disallowed for tax purposes. To avoid a wash sale consider selling those tax lot positions by year end and not re-entering the position until at least 30 days up through January 30th of the new year.
**Straddle Losses.** When offsetting long and short positions are held and one side of the position is disposed of or expires, to some extent, the loss on the expired position may be deferred unless certain criteria are met.

**Constructive Sale Gains.** Holding offsetting positions, or substantially identical securities, for the purpose of locking in a gain does not always defer the tax recognition of that gain. For tax purposes, if there is an offsetting position, the security will be deemed sold and the gain may be recognized in the current year.

**Settlement of Short Positions.** The treatment of short cover transactions differs slightly from long sales near the end of the tax year. While a long sale loss will be recognized based on a trade date of December 31st, a loss on a short cover must be settled by December 31st in order to be included in the current tax year.

**Harvesting losses.** On a net basis, some positions may show an unrealized gain, while the individual tax lots of that position may include some at a loss. Identification of those positions may result in the desire to harvest those losses for tax purposes. It is critical that the broker and administrator be notified for any specified lot selling in order for it to be recorded properly and reflected in the tax allocations.

**Holding periods.** Long term capital gain status is given when a securities’ holding period is greater than one year. The differential between long term and short term rates may impact timing decisions for the disposition of certain securities.

**Tax – 475(f) Elections**

Please note that ALPS Alternative Investments does not give tax advice and the generalizations below would not necessarily apply to all funds or all investors.

There are both potential positives and negatives to a 475(f) election. Funds with high turnover and the potential for wash sales may wish to consider a 475(f) election. This discussion provides some general background intended to be helpful for fund managers in deciding its relevance to a fund. **Note that a 475(f) election, once made, cannot be revoked without IRS permission – therefore it is important to carefully weigh the potential benefits and disadvantages with your tax advisors.**

**General**

A 475(f) election has the following characteristics:

- All securities positions are marked-to-market for tax purposes at year-end; in effect this converts all year-end unrealized income or loss to realized.
- All income is considered “ordinary” – capital gains and losses are eliminated.

Net capital losses (as opposed to ordinary losses) are subject to limitations on deductibility, depending on what other capital gains and losses a taxpayer might have. Additionally, current year capital gains can generally be offset against capital losses, including those carried forward from previous years.

A wash sale occurs when a security was disposed of at a loss and that same security or a substantially identical one was acquired in the 30 days preceding the loss or 30 days following the loss. The loss is deferred until the newly acquired position is sold (or covered short).
The conversion of capital gain/loss to ordinary income/loss is usually an advantage to the typical taxpayer only if the fund experiences significant losses. This is because ordinary losses are usually more deductible for most taxpayers. However, in our experience, losing money is not a common expectation at the time a fund is launched.

The primary reason to make a 475(f) election is to eliminate the problem of wash sales. A high turnover fund that keeps trading the same securities (or substantially identical securities) can find itself adding to its taxable capital gains while realizing few losses due to wash sale rules. For example, a fund with a 15% annual return might have accomplished that by realizing gains of 50% and losses of 35%. If one-half of those losses were disallowed because they were wash sales, investors would see taxable income of over 30%. In addition, wash sales are a challenge to track, especially where “substantially identical” judgments are required. For a fund with wash sale problems, the alternative to a 475(f) election is careful monitoring of capital losses and the installation of procedures to periodically “cure” wash sales. If losses are cleared out late in the year for a 30 day period, prior wash sales associated with those positions are cured for that tax year.

**Making the election**

Revenue Procedure 99-17 states that a new fund: “makes the election by placing in its books and records no later than 2 months and 15 days after the first day of the election year a statement that describe[s] the election being made, the first taxable year for which the election is effective, and the trade or business for which the election is made.” Additionally, it advises: “To notify the IRS that the election was made, the new taxpayer must attach a copy of the statement to its original federal income tax return for the election year.”

Accordingly, the election, if made, needs to be documented within approximately 75 days after the date the fund commences operations. The taxpayer is the fund and, therefore, the election should be signed by a general partner or director. A copy of the election must be attached to the income tax return.