Opportunity Knocks

Private Wealth Managers and Proactive Tax Services — Lessons Learned from the Hedge Fund Industry

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LIKE HEDGE FUNDS, PRIVATE WEALTH management (PWM) advisory firms and independent Registered Investment Advisors (RIAs) are facing greater complexity and scrutiny regarding tax and reporting requirements. This is being driven by high net worth (HNW) clients (individuals, small business owners, families — pursuing greater returns from more diversified portfolios, exotic asset classes and tax-efficient trading strategies. As a result, tax sensitivities have increased within the PWM space, amplifying the need for more proactive tax analysis of securities transactions. This paper considers several securities tax regulations and will examine how they affect hedge funds and their investors. Moreover, it will explain how private wealth managers — the collective PWM advisory firm and independent RIA community — can learn from these scenarios and how they can benefit from offering differentiating tax services to their HNW clients. This paper will also look at the implementation choices and essential technology that will help private wealth managers advance their tax services from reactive compliance to proactive planning and management.

The new tax compliance and regulatory climate

The past decade has seen the financial services industry become more tightly regulated, a process that has only been intensified by the global financial crisis. A renewed focus on mitigating systemic risk is the common thread that runs through the most recent legislation. Within this broad construct, regulators have chosen to direct their attention to tax compliance and reporting in an effort to police tax shelters and close the so-called tax gap, currently estimated at 1.2 trillion dollars.

The three primary pieces of legislation contributing to the new tax compliance and regulatory regime are the Emergency Economic Stabilization Act of 2008 (H.R. 1424 or EESA), Form PF and FATCA. Large challenges come from EESA, which has introduced a new era of tax reporting requirements that shifts responsibility from individuals to brokers and other intermediaries. These service providers must now submit cost basis and holding period information to support the accuracy of calculated gains and losses to the IRS.

To remain compliant with these tax regulations, since January 2012, firms have needed detailed processes for reporting cost basis information on Form 1099-B provided to clients and the IRS for mutual funds, DRIPs and most ETFs. Before that, EESA "covered securities" were solely equities, effective January 2011. The roll out is due for completion in 2014, at which point fixed income and derivatives will fall under its requirements as well.

The [Hiring Incentives to Restore Employment Act] (HIRE) has also introduced the Foreign Accounting Tax and Compliance Act (FATCA), which is now in the first stages of implementation. FATCA requires financial institutions to identify U.S. tax-payers with off-shore domiciles to reduce losses to the U.S. Treasury from expatriated assets. It has obvious implications for intermediaries working with HNW clients.

"It now appears that the implementation of this legislation will be achieved via various bilateral, intergovernmental agreements rather than a single law applicable to all financial institutions worldwide. Negotiations are in progress with 40 countries, and the first agreement with the United States has recently been signed with the United Kingdom. The first priority for any FATCA compliance project team should be in scoping the size of the data-related endeavor, followed by determining what technology and systems are currently in place to be able to identify and aggregate the U.S. indicia data. Those with a more robust legal entity or client data management framework or anti-money laundering (AML) or know your customer (KYC) assessment scheme in place are likely to be better positioned to tackle the challenge," says Chris Thrappas, senior analyst with Aite Group, and co-author of a recent report on FATCA.

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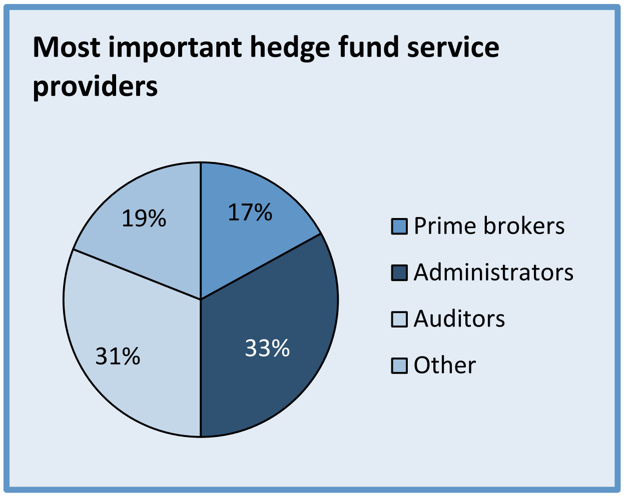
Finally, Form PF has been introduced to address systemic risk in the financial markets. It requires investment firms to complete a 44-page form for every fund and manager either on a quarterly or annual basis, depending on asset size. It too increases the emphasis on accurate and timely reporting of complex data sets drawn from both readily available data and obscure records, if the data is captured at all. Although not tax-specific, Form PF rounds out this trio of regulation-driven compliance initiatives that have increased operational pressures in the financial services marketplace.

The EESA shines a spotlight on tax analysis at a securities transaction level. The spotlight falls primarily on the broker-dealers who generate the 1099-B forms. However, hedge funds also



Corgentum Consulting Survey of HNW individuals, family officers, funds of hedge funds, pensions and endowments

feel the heat, given both the complexity and volume of their securities transactions, and the IRS's signaled intention to further crack down on tax shelters and riskless transactions, trades executed for the sole purpose of tax evasion.

This intention is evident in recent announcements and news events. There have been an increased number of audits performed on HNW individuals; the IRS recently announced that it audited 4% more millionaires in 2011 than 2012. In 2010, eight percent of millionaire earners were audited and the number jumped to 12 percent in 2011. Another indicator of this IRS crackdown can be seen in the fall-out from the Royal Bank of Canada (RBC) wash trade scandal in which the CFTC accused RBC of a massive trading scheme put in place to avoid paying taxes.[1] Furthermore, even where legislation is enacted that is not directly targeting the financial services sector, tax compliance prescriptions are included. A good example is the insertion of the Economic Substance Doctrine (ESD) into the Health Care and Education Reconciliation Act of 2010. The ESD prohibits the execution of transactions made solely for tax avoidance purposes[2].

Hedge funds have rightly interpreted this activity as a clear signal that they can expect more scrutiny of their tax books. For those hedge funds familiar with the tax implications of off-shore status, residency and domicile, the shift in emphasis onto taxation at the securities transaction level is a newer challenge that must be addressed.

Complexity moves into private wealth management space

Hedge funds that have tax-sensitive strategies need to be able to accurately perform tax analysis of large volumes of complex securities transaction data. Although some funds have developed their own proprietary systems to meet this new challenge, many more have turned to specialist technology. In turn, these market pressures are forcing technology providers to deliver better tax analysis tools that have the ability to handle the constantly growing data volumes and run reports more frequently – more often than not on a daily basis.

These technologies have proved to be critical to tax compliance. However, they are largely reactive functions. Where the technology comes into its own is by facilitating a more proactive approach, which transforms tax compliance into a more service-orientated tax planning and management function.

[1] For more information read U.S. regulator accuses RBC of massive trading scheme (Reuters) http://in.reuters.com/article/2012/04/03/rbc-cftc-idINDEE83201320120403.

[2] For more detail on how this legislation is intended to close loopholes in tax shelters, see the G2 FinTech whitepaper, *Using Market Risk Concepts to Re-factor Tax Shelters.*

Pre-trade Tax Analysis

The relevant technology allows early adopters of this proactive approach to assess the tax implications of any securities transaction, prior to final decision making and trade execution. As a result, tax management becomes an ongoing, on-demand activity carried out throughout the year. Meanwhile, the mandatory end-of-year submission of returns to the IRS and related activity remains largely under the remit of the tax accountant. Examples of current practice by these early adopter fund managers include matching or marrying specific security sales with specific purchase transactions to achieve the desired 'high-cost' or 'best-tax' effects. This is also beginning to evolve into daily or even pre-trade alerts to signal that certain trades will trigger a potentially undesired taxable event.

Profound Implications

The implications of such a proactive tax planning function are profound, and extend beyond the hedge fund space into other service sectors, most notably PWM. PWM is the term generally used to describe highly customized and sophisticated investment management and financial planning services delivered to HNW investors. Generally, this includes advice on the use of trusts and other estate planning vehicles, business succession or stock option planning, and the use of hedging derivatives for large blocks of stock. By definition, a private wealth manager needs to take a client's after-tax returns into account: it is fundamental to their business, and those that do not consider the tax implications of their advice are not looking at the whole picture.

There is obvious commonality between hedge fund managers and private wealth managers in terms of workflow in its simplest form: the client is offered a specific service – trading or investment advice – and then dispatched to a tax accountant for completion of the relevant annual paperwork.

But this commonality is now also reflected in the trend towards greater complexity that pervades both sectors. There is a natural push by affluent investors, who have a higher risk tolerance, to seek greater returns through a more diversified portfolio. This initially gave a boost to the hedge fund space and has now crossed over to the PWM marketplace.

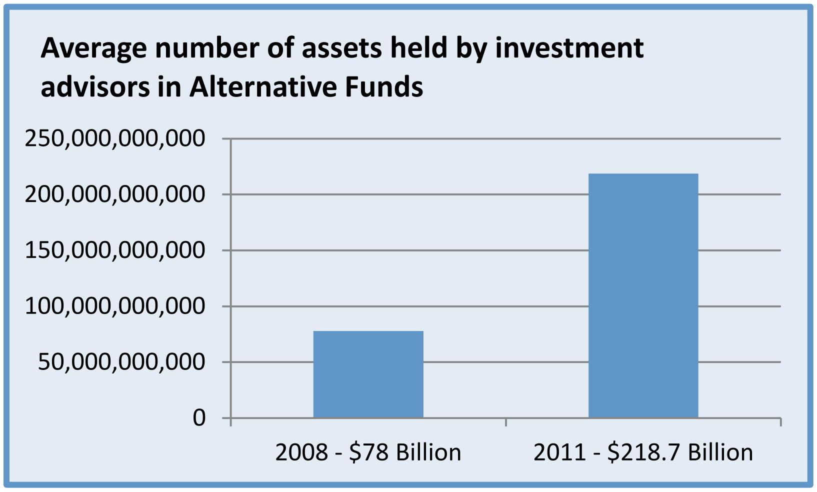
A survey conducted by Jackson National Life Insurance Company indicates that 95% of advisors expect to increase their use of alternative asset classes over the next year,

Top 3 Factors causing an increase in alternatives within retail investments

McKinsey & Co. survey forecasts that retail alternatives, including hedge funds, will likely make up 13 percent of U.S. retail assets and about one quarter of revenues, by 2015 because of:

- **How the products are structured**
- **Financial Advisor interest**
- **Changes in how they are accounted for in portfolios**

Brad Alford of Alpha Capital Management says the McKinsey report, "clearly outlines one of the biggest opportunities in the asset management industry in our lifetime."



Charles Schwab survey of over 1,000 registered investment advisory firms

with 61% citing diversification as the primary reason for using alternatives in client portfolios.

Whether they are small business owners, HNW individuals or affluent families, these investors are turning to their private wealth managers to provide a level of advice and understanding that is commensurate with the complex investment strategies offered by hedge funds.

Equally, private wealth managers are strongly motivated to move into this arena of complex transactions. As with hedge fund managers, their interests are closely aligned with those of their investors, as the amount of assets they manage will increase upon the delivery of higher returns.

There are of course important differences between private wealth and hedge fund management. In general, hedge funds will trade at a higher frequency and with consistently more complex instruments. In contrast, private wealth managers may avoid the intricacies of high frequency trading and have a lower concentration of complex instruments in play, but are likely to have many more intermittently active accounts, with activity spread across various institutions and executing firms.

Aggregation is Key

Optimal tax positioning also requires private wealth managers to aggregate the diverse data and information sources across trading institutions to create a complete picture of a client's position and the tax implications of a given transaction. The calculation is fundamentally the same: a wash sale will still have tax implications regardless of who traded it. However, the need for aggregation is the subtle but critical difference with the institutional side of business, since it is the total return that must be considered. Furthermore, the household position of the investor may also come under consideration, requiring private wealth managers to take a complete view of the family position in order to identify the potential effects of spousal activity or that of other dependents and family members.

Aggregation is a time and resource intensive activity when handled manually, simply adding to the argument that private wealth managers benefit from the adoption of the tax planning and management tools used by hedge funds. The demands placed on private wealth managers increasingly reflect those of the hedge fund business. There is an irrefutable case for private wealth managers to use the same tools as hedge fund managers.

Trading strategies now sensitive to tax

Private wealth managers who wish to operate and attract these demanding, but potentially lucrative investors, have to offer a service that is more diverse and more relevant to those demands. This will almost certainly involve greater use of more complex asset classes and trading strategies.

These strategies will inevitably require a more sophisticated tax analysis capability as well. Notably, the most prevalent hedge trading strategy, the long/short strategy, has tax implications. Long/short and other tax-sensitive strategies must consider the impact of taxable securities trading events, as listed within IRS Publication 550 on Investment Income and Expenses, including Capital Gains & Losses. These have particularly demanding requirements when it comes to tax analysis, treatment and compliance.

Taxable Events

The tax shelters policed by the IRS demand that the investors' securities trading activity be carefully analyzed by the investment manager on behalf of their client. These taxable events include wash sales, constructive sales, straddles and qualified dividends.

i. Wash sales

For private wealth managers who offer brokerage services, wash sales can place those private wealth managers directly in the path of the EESA's cost basis reporting requirements. A wash sale is generally described as selling stock at a loss, and buying 'substantially identical' securities within 30 days of the sale. The investor's motivation for undertaking such a transaction has typically been to use the loss incurred to reduce their tax liability while still holding a financially equivalent position in the security concerned. Although a wash sale is a relatively simple transaction, the ramifications of the applicable rule are extraordinarily byzantine. Private wealth managers with a proficient wash sale reporting system are able to make adjustments to a purchase and sales report to calculate the correct tax-adjusted gains and losses. As these adjustments are made, the tax lots that triggered the wash sale will have both their cost basis (which effectively disallows the loss) and their holding periods adjusted.

ii. Constructive Sales

Previously, taxpayers were able to systematically convert any unrealized short-term gains into realized long-term gains with no tax penalty. A constructive sale, also known as short-versus-the-box, occurs when an investor creates an offsetting position via a short sale when an available long lot was available but not retired. In contrast to a wash sale, a constructive sale realizes gains that are independent of any retirement transaction. However, like wash sales, substantially identical securities are considered in the analysis and detection of a constructive sale. In addition, the IRS expects correct tax treatment even when a tax payer creates a constructive sale in error as the by-product of a legitimate trade. To facilitate the analysis, detection, adjustments and reporting for this taxable event, the application system may have to introduce the concept of a pseudo transaction related to the open long lot.

iii. Straddles

As an investment strategy involving the purchase or sale of particular option derivatives, a straddle allows the holder to profit based on how far the price of the underlying security moves, regardless of the direction of price movement. A straddle is constructed by creating two opposing positions in two identical or risk-equivalent securities.

One of the positions is long and the other short. As market factors fluctuate, one of the two positions will generate a gain. At the same time the opposing leg will generate a similar loss because it is offsetting the first. Typically an investor would wait until just before the calendar year end to sell off the position with the loss. This would realize a short-term loss, effectively lowering tax liability, while allowing him to retain an open position with a potentially large unrealized gain. A tax-compliant system enables private wealth managers to identify 'unintended' as well as explicitly defined straddles, and make adjustments both to realized losses and the cost basis of surviving positions.

iv. Qualified Dividends

Traditionally, dividends were taxed as ordinary income for investors and this income was therefore taxed at the highest possible rate. The relevant tax law reduced the tax rate for dividends produced by securities that have been held as long-term investments. There is a holding period requirement to be eligible for the lower tax rate. To advise on a position involving these kinds of transactions, a private wealth manager must be able to identify whether the dividend qualifies for preferential tax treatment and consequently whether the risk of loss is diminished by holding the same or risk-equivalent security. If the answer to this question is yes, it is likely to suspend the counting period for dividend qualification while the risk-equivalent security is held.

Key to addressing these taxable events are the concepts of 'substantially identical' and 'risk-equivalent' securities. Under the traditional definition, a given derivative is considered to be substantially identical to its underlying equity in terms of risk element, behavior and potential return. As discussed in G2 FinTech's white paper, *Using Market Risk Concepts to Refactor Tax Shelters*, that definition can be widened so that two securities can be considered substantially identical if they share characteristics that demonstrate that the risk of loss incurred by holding one can be mitigated by holding an appropriate position in the other. The challenge for private wealth managers is to establish and track these relationships among securities, particularly given the high volumes involved and the aggregated position that is the fundamental purview of the PWM role.

It's true that a certain class of taxpayers can flout the wash sale rule. These taxpayers can benefit from making a timely election to mark-to-market accounting under I.R.S. Section 475(f). Section 475(f) essentially changes the character of income from capital to ordinary: losses that otherwise would have been bounded are fully deductable against ordinary income. However, this classification is only available to taxpayers that the IRS considers "traders in securities," characterized by shorter holding periods, higher trading frequency and amounts. Further, the taxpayer's election must be done by the due-date of the previous year's return. Whether this election makes sense warrants careful consideration, especially since once made, it cannot be revoked unless a formal request is made to the IRS.

Tax planning as a differentiator

As the PWM sector continues to mirror successful hedge fund managers by seeking out and delivering incremental, value-added applications to attract and engage investors demanding ever greater returns, the ability to go beyond the standard offerings and create these more sophisticated propositions is increasingly important. Real-time planning and proactive management of the total tax picture is a service that is very distinct from the compliance function handled by tax accountants, and one that has the potential to be a real competitive differentiator for private wealth managers.

To offer such a service, private wealth managers will need a greater level of subject expertise in order to discuss and advise on alternative investments. The Jackson National Life Survey also indicates that this is an area of concern for advisors who are increasing their use of alternatives.

The critical factor is technology. Private wealth managers need solutions that can provide a complete view of the client's aggregated investment book with their positional holdings to give a total picture of wealth at a family or individual level. And, they must closely measure where money is drawn through income and expense of capital gains & losses and other transactional activity.

Specialist tax analysis software can offer a number of powerful benefits. Some of the most important considerations include the following:

- (today's reality) Running tax analyses for tax planning, management and compliance has evolved from a once-a-year event to an on-demand business practice. The ability to rapidly run these analyses and reduce the cycle time of the tax analysis process from days to hours or even seconds has become paramount. Private wealth managers stand to benefit by ensuring an efficient workflow and shorter time between the investment decision and the compliant, tax-efficient investment action since the overall tax implications of a position are made available in near-real time. This minimizes the chances of the market moving against them (and their clients).

- (automation opportunity) Management of 'interweaving' by addressing the complex interaction and inter-reactions of wash sales, constructive sales and straddles and how they affect each other. For example, technology can identify when the effects of a straddle turn a non-wash sale into a wash sale, and the ultimate impact on cost basis, gains or losses. This can be done efficiently and accurately only by running the analysis for multiple taxable events and their interactions on the same analysis engine, it otherwise being a massively challenging process to conduct manually.

- (newly introduced functionality) Availability of data on prospective wash sales (securities transactions that will result in a wash sale), which can be used for decision support as part of a daily reporting process or ultimately integrated as a pre-trade alert with an order management platform. Prospective wash sales fall under two broad categories: those that occur due to new positions disallowing realized losses, and those that occur due to disposition of open lots with unrealized losses. Identifying prospective wash sales is a highly complex process and requires a thorough understanding of I.R.C. 1091(a), as well as a mechanism for detecting general wash sales so that incidents of double booking are avoided.

- (the vision) Enabling the private investor to push an 'execute trade' button on a hand-held device after having considered the potential tax consequences of executing certain trades. This will require the integration of the tax analysis software with an order management system (OMS) application accessible from a hand-held device. By extension, investors will ultimately be able to do this in the context of rebalancing their portfolio against the model portfolio supplied by the private wealth manager.

Approaches to technology acquisition

Private wealth managers wishing to acquire this kind of functionality need to weigh and balance the different technology approaches: build, outsource or buy. It is likely that a private wealth manager also offering brokerage services already has implemented a solution to be compliant with the EESA of 2008. If it services a private client as part of a larger solution that includes the firm's executing brokerage arm, then the private wealth manager is at least part of the way to acquiring the necessary functionality. Above all, compliance with the EESA requires the ability to perform tax analysis for single-account, single-CUSIP wash sale activity. On the other hand, a PWM firm that has no responsibility for generating 1099-Bs may not yet have access to tax analysis applications.

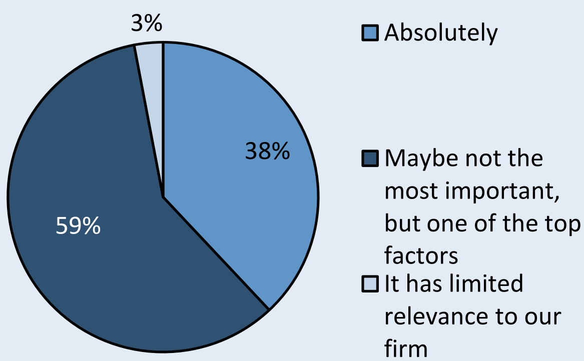
There are serious implications that come with each option:

i. Build

In the EESA-compliant PWM/broker scenario, a system should already be in place to deliver year-end tax compliance for the specific scenarios described above. These systems fundamentally must also address the marrying of buy-and-sell transactions (or 'tax-lot retirement) and report on the client's pre-tax book. To go from this point to producing an after-tax book is still a significant undertaking. It is also not necessarily the core competency of the PWM firm. At the private client level, an individual's tax return is the equivalent to a firm's tax book, which is the concern of the IRS. In cases where the private wealth manager is free of 1099-B responsibility, but sees the benefit of offering tax management services to their clients, building such a technology capability is an even bigger undertaking. It is important to note that in both cases tax-lot level detail is a necessary input to drive the tax analysis engine.

It is also important to remember that providing a differentiating on-demand, tax planning & management service is vastly more challenging than providing a year-end tax analysis and compliance service. The on-demand service will require greater speed, and the ability, if required, to rapidly process large volumes of

Do PWMs believe that utilizing technology will be the most important factor to their firm's success moving forward?



SEI Advisor Network Technology Integration Survey Findings July 2012 data, at times in near real-time.

Spectacular failures of build-it-yourself code litter the investment management landscape. One of the more recent examples is Knight Capital's trading systems glitch, which caused the erroneous purchase of hundreds of stocks and resulted in a $440 million loss.

ii. Outsource

Private wealth managers can outsource a solution where, for a fee, the third-party service bureau will send results to the private wealth manager's client reporting system. This acquisition alternative offers the advantage of low upfront capital investment and the promise of faster time-to-market. However, it is not clear that there is an outsourcing service provider today that has either the full extent of functionality discussed in this paper, or the ability to operate as an on-demand service at an acceptable price.

Should such a provider exist, investors may be uneasy about their data being shipped offsite, and potentially offshore. Some clients may have legal restrictions in place that prohibit delegation of cost basis reporting. In addition to the data security challenge, outsourcing may cause problems when it comes to reconciliation between the outsourcing vendor's computations with its own tax lot retirement algorithms and those of the private wealth manager's internal systems.

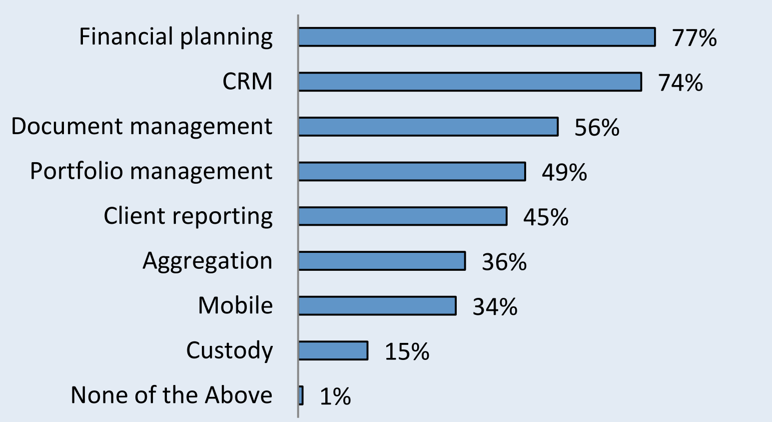
iii. Buy

Software vendor solutions come in two varieties: complete tax lot-driven realized gain & loss computation engines (pre- and post- tax) and tax adjustment post-processors.

As an all-in-one solution, a complete realized gain & loss computation engine processes a PWM firm's trades along with other data to derive purchase and sales information before then performing tax analyses.

For those firms already running software that marries tax-lots with derived purchase and sales information, the alternative is to acquire a tax adjustment post-processor to run tax analyses on securities transactions. The post-processor analyzes the data for all the required taxable events, addresses inter-weaving, and rapidly handles high volumes of data as an on-demand service. This solution makes adjustments for wash sales, constructive sales, straddles and qualified dividends. It generates the data necessary to produce the desired client reports as well as to complete the IRS required tax forms. A post-processor solution

In what areas are PWM's currently using technology or software to improve business practices?



SEI Advisor Network Technology Integration Survey Findings July 2012 can be run on-premise or off-premise as a deployed software solution. A post-processor only solution is streamlined in nature, avoiding the introduction of an additional, undesired reconciliation step.

A recent Celent report discusses the different paths firms have taken in response to cost basis regulations. "Cost Basis Reporting Landscape 2012: An Analysis of Readiness of Firms, Technology Capabilities and Lessons Learned" reports that firms using third-party systems are more satisfied with their solution than those employing in-house systems. In addition, the report cites integration with other internal systems as a high priority.

Conclusion

The increased use of more complex securities and investment strategies within the PWM marketplace has created a more complicated set of tax analysis requirements. Most significantly, this has led to greater focus on tax impact at the securities transaction level. This is fertile ground for a more proactive approach from private wealth managers, who have the opportunity to transform their tax services from reactive compliance to proactive tax management & planning. Like hedge fund managers who have already faced down similar complexities introduced by the current regulatory climate, private wealth managers will need to select the right technology to undertake a level of activity that is too complex for manual processing. Early adopters will give themselves the advantage of significant competitive differentiation by being better able to serve their clients. As HNW individuals and families are subject to greater scrutiny from the IRS, and government initiatives to close down tax loopholes increase, this is a service that will become increasingly attractive to HNW investors. The choice that private wealth managers face is whether to follow the hedge fund experience and benefit immediately, or watch others steal the show while they are forced to play catch up.