



Tax – 475(f) Elections

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:

1. 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.
2. All income is considered “ordinary” – capital gains and losses are eliminated.

There are both potential positives and negatives to a 475(f) election, which can be best understood if we first review a few tax concepts. Please note that PMI does not give tax advice and the generalizations below would not necessarily apply to all funds or all investors.

- Short-term capital gains are not given the same preferential 15% rate as long-term gains.
- 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.
- Current year capital gains can generally be offset against capital losses, including those carried forward from previous years.
- Wash sales. If a security that is sold for a capital loss is reacquired within 31 days, the loss is disallowed and is transferred to the cost basis of the new position. Wash sales are further complicated with the concept of “substantially identical” property (you can’t necessarily avoid a wash sale by using options instead of reacquiring the common stock) plus the fact that the 31 days is measured both forward and backward in time from the sale date.
- Sales that are capital gains do not “wash” even if immediately reacquired.

Absent the wash sale issue, the conversion of capital gain/loss to ordinary income/loss is usually an advantage only if the fund experiences significant losses – ordinary losses being more deductible for most taxpayers. However, in our experience, that 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% – not a pretty picture. 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 31 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 Service 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, a 475(f) checklist would note the following:

- ✓ The election, if made, needs to be documented within approximately 75 days after the date the fund commences operations (which date would be normally considered the beginning of its tax year).
- ✓ The tax payer is the fund; therefore, the election should be signed by a general partner or director.
- ✓ If desired to prove timeliness, a copy of the election can be sent contemporaneously to the administrator. Alternatively, a manager may choose to place a notarized copy in its files.
- ✓ A copy of the election must be attached to the income tax return.

Based on the language above, the form of a possible election might be as simple as the following:

“_____ Fund hereby makes a 475(f) election for its investment activities in _____ and subsequent tax years.”

Other possibilities

A fund may desire to make a 475(f) election after a fund’s initial tax year or to revoke such an election in some subsequent year. In addition, it may be possible to exclude some aspects of a fund’s investment activities from the 475(f) election. However, these situations are rare in our experience and are beyond the scope of this discussion. You should consult with competent tax advisors.

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