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Liquid Alts Move Into the Mainstream

May 2014

Stocks and bonds are considered the main asset classes for investors while virtually everything else is labeled an "alternative." Volatile stocks and low yields on bonds in recent years have led many investors to include asset classes outside of the mainstream, such as real estate, precious metals and commodities. Moreover, alternative investment strategies also fall into this broad category, and such strategies frequently are followed by hedge funds.

Historically, only wealthy investors have had access to hedge funds, but this has changed in recent years with the advent of so-called "liquid alts," mutual funds and exchange traded funds (ETFs) that use the techniques of hedge funds. According to Morningstar, investors poured nearly $50 billion into liquid alts in 2013, bringing the total assets held by such funds to about $180 billion.

Going long and short

Originally, hedge funds literally offered investors a chance to hedge their positions in stocks. These funds bought issues the managers preferred (went "long," in stock market parlance) and sold short shares of companies expected to lag. Thus, investors could make money in bull or bear markets, assuming the hedge fund had accurately guessed the relative performance of the stocks it selected.

Over the years, hedge funds have proliferated. Many of them follow strategies other than the classic long-short model. Different hedge funds might try to profit from merger arbitrage, buying distressed securities, dealing in derivatives such as futures contracts and options, focusing on bond market opportunities and so on.

The common denominator is that most hedge funds are not highly correlated to the broad stock or bond markets. This noncorrelation can play a valuable role in your portfolio, reducing volatility. If the stock market sinks, a hedge fund might have a smaller loss, or even a gain, improving overall investment results. Some hedge funds

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Taking IRA Withdrawals

Required minimum withdrawals from traditional IRAs start after age 70½, and almost 44% of all IRA withdrawals are taken by individuals 70 or older.

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have performed very well, delivering superior returns as well as reduced portfolio risk.

That said, hedge funds have their drawbacks. They may have minimum investments of six or seven figures. Many of these funds use leverage that can magnify losses as well as gains. Transparency is low whereas fees are high. Perhaps most daunting, hedge funds aren't liquid; investors might have an initial period with no access to their money, followed by monthly or quarterly redemption opportunities that require advance notice.

Common ground

As the name indicates, liquid alts address these concerns. These vehicles are mutual funds or ETFs with modest minimum investments and daily access to your money. Liquid alts have some transparency, so investors know what they're buying and holding. The mutual fund or ETF fee structure is familiar, if on the high side for many liquid alts.

The bottom line is that you now can get a fund that follows a hedge fund strategy for your portfolio, just as you'd invest in a stock or bond fund. There are long-short liquid alts, merger arbitrage liquid alts, and so on. Liquid alts often are managed by savvy professionals, including some led by people who also run private hedge funds.

Example: Ryan Rogers invests in ABC mutual fund, which has a $2,000 minimum. This fund goes both long and short in the stock market, as described previously. In addition, ABC sells call options on some of the stocks it owns—these options allow other investors to buy shares of the specific stock at a specific price. Revenues from selling the call options may help ABC in down markets, but this tactic also limits the fund's upside.

Whenever he chooses, Ryan can add to his position in ABC or sell shares to raise cash. Ryan can buy ABC and other liquid alts in his taxable brokerage account, in his IRA, and in his 401(k) plan at work, if it's on the list of available choices.

Finding a fit

The recent popularity of liquid alts indicates strong demand from investors. If you're interested, be sure you do your homework carefully because liquid alts vary enormously in their methods and their results. Last year, for example, some liquid alts with bearish strategies lost over 30% while other liquid alts that borrowed money to buy more stocks in last year's bull market returned over 50%.

Generally, though, liquid alts tend to be defensive in their approach to the market. In 2013, when stocks surged and the average domestic equity fund returned over 30%, the average return for liquid alts was around 6%. Tactics such as short selling and covered call writing might be helpful in down years, such as 2000 and 2008, but they also can deprive investors of gains in bull markets.

Some advisers favor holding 5%-10% of a diversified portfolio in alternatives, including liquid alts. Potential advantages include noncorrelation to other asset classes, the possibility of outstanding results in years when stocks or bonds falter, and a long-term reduction in portfolio volatility. ■

Mixing Annuities and IRAs

According to the Investment Company Institute, 68% of households with IRAs have mutual funds in those accounts. That's followed by individual stocks (41%), annuities (35%), and bank deposits (25%). Therefore, annuities are among the most common IRA holdings; they are also among the most controversial because many observers assert that annuities don't belong in an IRA.

Defining the terms

To understand this seeming contradiction, you should know some terminology. Generally, the most heated debate does not involve *immediate* annuities, which also may be known as *income* or *payout* annuities. Here, you give a sum of money to an insurance company in return for a specified flow of cash over a specified time period, perhaps the rest of your life.

Deferred annuities are a different story. With these investments, the money you contribute can grow inside the annuity contract. Different types of deferred annuities offer various ways that the amounts invested can grow over the years. Regardless of the method or the amount of accumulation, earnings inside the annuity aren't taxed until money is withdrawn.

Critics of holding deferred annuities inside an IRA say that they are redundant. Any investment inside an IRA is tax deferred or tax-free (with a Roth IRA), so you don't get any tax benefit by investing IRA money in a deferred annuity. Why pay the costs that come with a deferred annuity when you get the same tax deferral with mutual funds or individual securities or bank accounts held inside your IRA?

Because there might be advantages as well as drawbacks. Deferred annuities offer various guarantees, which might include certain death benefits and certain amounts of cash flow during the investor's life, regardless of investment performance. These guarantees may be a valid reason to include a deferred annuity in an IRA, some annuity issuers and sellers contend.

Among different deferred annuities, death benefits and so-called "living benefits" vary widely. Some can be extremely complicated. If you are interested in a deferred annuity, our office can explain the guarantees in the contract, so you can make an informed decision.

Verifying value

Another thing to consider when deciding whether to hold a deferred annuity in your IRA, is that these annuities must be valued for purposes such as Roth IRA conversions and required minimum distributions (RMDs). This also will arise if you already have such an annuity in your IRA. The reported value of the annuity contract may not be the appropriate number.

Example: Sarah Thomson invests $50,000 of her IRA money in a deferred annuity that offers several investment options. After this outlay, Sarah's investments decline, so her annuity account is now reported at $40,000. Sarah decides this reduced value would generate a lower tax cost on a conversion to a Roth IRA.

However, Sarah's deferred annuity also contains a rider guaranteeing to pay her a certain amount per year for the rest of her life. Such a rider has some value, which Sarah must include in valuing the annuity inside the IRA if she does a Roth conversion. The same problem will arise when Sarah must take RMDs. Sarah's best course of action may be to ask the annuity issuer for help with the valuation because insurers typically have actuaries and software designed to perform these intricate calculations.

Holding an annuity in an IRA raises many issues that don't arise with other choices. There may be advantages, but you should proceed cautiously. ■

Trusted Advice

Annuity Payback Time

Variations of immediate annuities include the following:

- **Fixed period annuities**. Here, you receive definite amounts at regular intervals for a specified length of time.
- **Annuities for a single life**. These contracts provide you with definite amounts at regular intervals for life. The payments end at your death.
- **Joint and survivor annuities**. Usually acquired by a married couple, the first annuitant receives a definite amount at regular intervals for life. After he or she dies, a second annuitant receives a definite amount at regular intervals for life. The amount paid to the second annuitant may or may not differ from the amount paid to the first annuitant.

Making Expense Accounts Accountable

Business owners who work for their company typically have expense accounts; the same usually is true for many employees. If your company has what the IRS calls an accountable plan, everyone can benefit from the tax treatment. The company gets a full deduction for its outlays (a 50% deduction for most dining and entertainment expenses), while the employee reports no taxable compensation.

A company expense plan judged to be nonaccountable, on the other hand, won't be as welcome. It's true that the company can deduct 100% of the payments it makes for meals and entertainment, but it also will have to pay the employer's share of payroll taxes (FICA and FUTA) on the expense money paid to employees. The employees, meanwhile, will report those payments as wages, subject to income and payroll taxes.

In that situation, the employee can include employee business expenses (minus 50% of those for meals and entertainment) with other miscellaneous itemized deductions, but only miscellaneous deductions that exceed 2% of adjusted gross income can be subtracted on a tax return. Taxpayers who owe the alternative minimum tax can't get any benefit from their miscellaneous deductions.

Key factors

In order for expense accounts to get favorable tax treatment, they should pass the following tests:

- **Business purpose.** There should be an apparent reason why the company stands to gain from this outlay. An employee might be going out of town to see a customer or a prospect, for example.

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- **Verification.** Employees should submit a record of their expenses, in order to be reimbursed. Lodging expenses require a receipt, as do other items over $75.

In order to reduce the effort of dealing with multiple receipts, employers are allowed to give employees predetermined mileage and per diem travel allowances. Substantiation of other elements besides amounts spent (time, place, business purpose) is still required. If the amounts of those allowances don't exceed the amounts provided to federal employees, the process can be considered an accountable plan. (Excess allowance amounts are taxable wages.) Per diem rates can be found at www.gsa.gov/portal/category/104711.

Example: XYZ Corp. asks a marketing manager, Jill Matthews, to take a two-day business trip to Atlanta to demonstrate new products. The federal rate for Atlanta (lodging, meals and incidentals) on the federal per diem website is $189 per day. As required by the XYZ accountable plan, Jill accounts for the dates, place, and business purpose of the trip. XYZ reimburses Jill $189 a day ($378 total) for living expenses; her expenses in Atlanta are not more than $189 a day. In this situation, XYZ does not include any of the reimbursement on her Form W-2, and Jill does not deduct the expenses on her tax return.

- **Refunds.** Employees must return any amounts that were advanced or reimbursed if they were not spent on substantiated business activities.
- **Timeliness.** Substantiation and any required refunds should be made within a reasonable amount of time after the expense was incurred. Those times vary, but IRS publications indicate that substantiation should be made within 60 days, and any employee refunds should be made within 120 days.

For a plan to be accountable, reimbursements and allowances should be clearly identified. They can be paid to employees in separate checks. Alternatively, expense payments can be combined with wages if the distinction is noted on the check stub. Our office can help you check to see that your company's employee expense plan is accountable, and, thus, qualifies for the resulting tax treatment. ■

Correction Notice

Please note that in the March 2014 issue of the *CPA Client Bulletin*, in the article "Juggling Appreciated Assets and Bequests," the first sentence of the fifth paragraph under the section titled "Reversing course" should have read, "Instead, **Ava** could make the switch mentioned previously, leaving her $100,000 traditional IRA to charity and the $100,000 of appreciated assets to Brad." We regret the error and apologize for any confusion this may have caused.

TAX CALENDAR

MAY 2014

May 12

Employers. For Social Security, Medicare and withheld income tax, file Form 941 for the first quarter of 2014. This due date applies only if you deposited the tax for the quarter in full and on time.

May 15

Employers. For Social Security, Medicare, withheld income tax and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.

JUNE 2014

June 16

Individuals. If you are not paying your 2014 income tax through withholding (or will not pay enough tax during the year that way), pay the second installment of your 2014 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2013. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then, file Form 1040 by October 15.

Corporations. Deposit the second installment of estimated tax for 2014.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in May if the monthly rule applies.

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