Tax Aware

Partnership Allocations and Their Effects on Tax-Aware Fund Investors

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Limited partnerships are attractive investment vehicles for investors because, as limited partners, investors cannot lose more than their invested capital despite the leverage of the partnership's portfolio. Consistent with this, the availability of tax losses to a limited partner is also more limited as compared to a separate account investor. Understanding this limitation is particularly important for investors in tax-aware funds which tend to allocate net tax losses. In addition, investors in funds structured as limited partnerships are affected by laws and regulations governing partnership allocations of gains and losses realized by the fund portfolio. This study outlines certain relevant principles of "securities partnership" accounting and shows how these principles apply to investing in tax-aware funds structured as limited partnerships. We argue that the laws and practices of partnership accounting can align tax results with the economic outcomes of the investors and ensure that new investors do not materially suffer from unrealized gains accumulated in a tax-aware fund. Our conclusions are illustrated with a simple stylized model.

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