How an Exclusive Hedge Fund Turbocharged Its Retirement Plan

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How to Never Pay Taxes on a Hedge Fund Investment

It's one of the sweetest employee perks in the hedge-fund world: a chance to invest in Medallion, the wildly profitable fund created by market legend James Simons.

Now, with deft legal maneuvers and a blessing from Washington, the firm Simons started is giving its employees an even richer opportunity -- a tax-advantaged, fee-free ticket to one of the world's top-performing hedge funds.

In a series of unusual moves, Renaissance Technologies abolished its 401(k) plan and won the government's permission to put pieces of Medallion inside Roth IRAs. That means no taxes -- ever -- on the future earnings of a fund that averaged a 71.8 percent annual return, before fees, from 1994 through mid-2014.

The switch -- the result of four years of legal work and two waivers from the U.S. Labor

Department -- could yield an extraordinary payoff for workers at Renaissance, a pioneer in quantitative trading. The loser will be the U.S. Treasury, which stands to miss out on many millions of tax dollars.

How this turns out depends on Medallion. From 2001 through 2013, the fund’s worst year was a 21 percent gain, after subtracting fees. Medallion reaped a 98.2 percent gain in 2008, the year the Standard & Poor’s 500 Index lost 38.5 percent.

If Medallion repeats that 13-year performance, a $300,000 taxable investment would turn into $4.7 million. A Roth IRA funded with $300,000 would be worth $26.3 million -- and a no-fee version would be even bigger.

‘Quite Amazing’

“It’s quite amazing,” said Steve Rosenthal, a senior fellow at the Tax Policy Center in Washington. “They’re very tax-savvy.”

Jonathan Gasthalter, a spokesman for Renaissance, declined to comment.

Simons, the firm’s chairman, is no longer the day-to-day manager. The 77-year-old has a net worth of $15.5 billion, according to the Bloomberg Billionaires Index. Medallion is almost entirely owned by Renaissance’s employees, their families and a few former employees.

“There shouldn’t be two sets of rules –- one for sophisticated organizations leveraging a complex tax system to their benefit and another for middle-class Americans trying to save for retirement,” said Senator Ron Wyden of Oregon, the top Democrat on the Finance Committee who has been probing large retirement accounts. “This is an issue of fairness, and taxpayers end up paying the price.”

It took Renaissance several years to push the changes through. Public filings tell the story.

Ending 401(k) Plan

First, in 2010, the East Setauket, New York-based firm terminated its 401(k) plan -- itself a rare step. That shifted employees’ account balances into IRAs.

The timing was no coincidence. That year, the government ended a policy preventing people earning more than $100,000 a year from converting standard IRAs into Roth IRAs by paying taxes. With standard IRAs, people invest pretax dollars and withdrawals are taxed as ordinary income. Roth IRAs, by contrast, are funded with after-tax dollars and investment gains are tax-free.

As Renaissance ended its 401(k), it approached the Labor Department for an exemption from rules prohibiting employees from investing retirement money in Medallion.

The firm’s lawyers, led by Gary Howell of Katten Muchin Rosenman LLP, argued that Medallion was outperforming the everyday mutual funds available under its old 401(k), which was administered by Fidelity Investments.

‘Exclusive Reason’

“The sole and exclusive reason why Renaissance has gone through the effort and expense to seek this exemption,” Howell wrote to the Labor Department in 2011, “is to provide a benefit to its employees that other firms do not.”

After questioning that yielded a foot-high stack of public records, the Labor Department granted the exemption in 2012.

As of the end of 2013, Renaissance was running an employer IRA plan that attracted $86.6 million in initial investments and had 259 active participants.

Assets in the plan jumped 49 percent to $153 million during its first full year of existence in 2013, and almost all of that came because of growth in the funds, rather than new contributions or rollovers. The fee-free version of Medallion returned about 47 percent that year, compared with about 25.5 percent for the fee-paying version.

While seeking the IRA exemption, Renaissance also set up a new 401(k). (Such plans permit greater annual contributions than IRAs.)

Seeking Permission

Renaissance then returned to the Labor Department to ask for permission for the new 401(k) to invest in Medallion, too. In November 2014, the Labor Department said yes.

> **“The issue is tax fairness,” said Bill Parish, an investment adviser in Portland, Oregon, who has written on his blog about Renaissance. “To the extent that they’re eliminating taxes by stuffing deals in their retirement accounts, the rest of us end up paying more.”**

Other hedge funds have included their own funds in 401(k) lineups, but Renaissance’s combination of an IRA and 401(k), as well as its government exemptions, are unusual.

“We review each of these applications case by case,” said Michael Trupo, a Labor Department spokesman.

As of the end of 2013, the most recent period for which data is available, Renaissance’s retirement plans held $193 million -- a small fraction of the about $23 billion the firm has under management. That was before the Labor Department opened Medallion to employees’ 401(k) accounts.

Over time, a bigger proportion of Medallion may move into the retirement accounts as those grow without fees and annual taxes.

‘Fairly Complicated’

The Renaissance exemption was one of the first “fairly complicated” hedge fund cases, said Ivan Strasfeld, who ran the Labor Department’s exemptions office until early 2012 and was involved in early discussions about Renaissance’s request.

But he said he didn’t think the exemptions were a tough call for the department, which focuses on retirement security for employees rather than maximizing tax receipts.

“These investors were very familiar with their own hedge fund,” Strasfeld said. “It didn’t present a sophistication issue that was often present in other cases.”

$5 Million Assets

As of 2011, about 100 of 275 Renaissance employees were “qualified purchasers,” meaning they generally had at least $5 million in assets to invest. Another 125 were accredited investors, generally worth at least $1 million.

For Renaissance employees, the results of the firm’s maneuvers are fee-free, tax-advantaged investments and the prospect of ballooning balances in their Roth IRAs.

“The power of the Roth is really incredible,” said Robert Friedman, an attorney at Holland & Knight. “If you’re a hedge fund and you turn your dollar into $500, you’re going to get all that appreciated money tax-free.”