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Hedge funds lift Romney's income

Tax returns show holdings managed by Bain, others

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Though Mitt Romney made his reputation as a private equity investor, his tax returns show the presidential candidate has a large portion of his wealth in an even more aggressive corner of the investment world: hedge funds.

A Globe examination of Romney's taxes and a prior financial disclosure shows that about one-third of the assets in his Individual Retirement Account are in hedge funds, predominantly those run by his former firm, Bain Capital in Boston. Romney's IRA could be as large as $101 million, according to his financial disclosure form, although he is not required to provide the exact amount. Of the 25 investments in that retirement account, 11 are Bain hedge funds.

Separately, a trust established in the name of Romney's wife, Ann, has about $6 million of its $40 million in assets, or 15 percent, in hedge funds.

Since releasing this and other personal and family trust tax returns this week, Romney has come under scrutiny for earning about $21 million in each of the past two years, and yet paying effective tax rates of 13.9 percent and 15.4 percent. Most of Romney's income is from investments, like Bain's leveraged buyout funds, hedge funds and stocks. They are taxed at a 15 percent long-term capital gains rate, much lower than the top tax rate of 35 percent that would apply to a millionaire's salary or ordinary income.

The funds Romney was best known for at Bain are involved in buyouts - buying companies and overhauling them, with a goal of reselling them at a profit. Hedge funds, by contrast, typically trade in and out of stocks and bonds. Both are elite and often secretive investments generally reserved for the wealthy, or for institutions such as pensions.

"He's making millions and millions of dollars a year from all these investments" said Joshua Dorner, an official with the Center for American Progress Action Fund, a Washington group that has been critical of Romney's low tax rate. He said the rate Romney pays on these gains "is a special loophole enjoyed only by private equity and hedge fund managers."

Some of the largest sources of Romney's current income, according to the tax returns, are hedge funds managed by Bain, Goldman Sachs, and other firms.

Romney's investments, including those in hedge funds, are in blind trusts, meaning he does not control them directly. The investment decisions are made by his trust lawyer at the Boston law firm Ropes & Gray, Brad Malt.

Andrea Saul, a spokeswoman for the Romney campaign, said in an e-mail, "Governor and Mrs. Romney's assets are managed on a blind basis. They do not control the investment of these assets. The assets are under the control and overall management of a trustee."

There is a certain irony to Romney having so much of his money in hedge funds. When he ran Bain Capital from 1984 to 1999, his colleagues wanted to start two hedge operations, but the notoriously cautious Romney was initially reluctant to expand into these businesses. He eventually relented and since his departure, the Bain funds have exploded in size. The two hedge fund businesses are Brookside Capital, which invests in stocks, and Sankaty Advisors, which invests mainly in distressed debt.

Looking at just the Ann D. Romney Blind Trust's 2010 tax return, out of $7.7 million in long-term capital gains, at least $2.2 million came from hedge funds. Most of that was thanks to Bain Capital funds. For instance, one hedge fund at Brookside Capital produced a $1.3 million gain that year. Only one other investment, a Bain private equity fund, produced a larger gain, at $1.7 million.

Chris Edwards, director of tax policy studies at the Cato Institute, a Washington think tank, said most Americans don't know the difference between hedge funds and private equity.

"People just think he's a big money guy, and as a big money guy he seems to get away with low taxation," Edwards said. "The bigger political issue is explaining why capital gains and dividends receive preferential treatment."

Romney has come under attack from Newt Gingrich and other rivals for the Republican nomination for allegedly participating in "vulture capitalism" that burdened companies with debt and cut jobs. Romney presents himself as a job creator who helped grow companies using Bain Capital's buyout and venture funds. But he doesn't talk much about his substantial hedge fund holdings.

Under the federal tax code, partners in private equity funds and hedge funds pay a 15 percent tax rate on their share of long-term profits in the portfolios they invest for clients. That is a big part of what these investment professionals earn, as they are typically paid a 20 percent to 30 percent share of the profits they reap for clients, as an incentive.

Some of the hedge funds also provided large tax deductions in the form of business expenses that helped lower Romney's tax bill. For instance, Brookside Capital Partners Fund II produced a gain of $412,535 to the Ann Romney blind trust in 2010. It also reported business expenses of $158,427, for things like interest and trading costs, which Romney was able to write off, according to an accountant who reviewed the return.

Romney has a separate blind trust in his name that holds as much as $104 million according to his most recent financial disclosure form, but it appears to have no meaningful hedge fund holdings and is invested relatively conservatively. Most of the money is in bonds and investment funds that own stocks and bonds. Another family trust set up for the Romneys' children reported $4.9 million in long-term capital gains - of which about 8 percent, or $413,000, was from hedge funds.