Is Your Hedge Fund a Trader or an Investor?

ROBERT N. GORDON

It is a well-accepted fact that most hedge funds are often somewhat tax-inefficient. Gordon [2004] discussed what hedge funds could do to make their trading more tax-efficient. Here, we turn to a somewhat different question, highlighting a problem that most hedge fund investors will face even when their hedge funds employ such tax-friendly trading tools. Indeed, the answer to the apparently innocuous question of whether a hedge fund manager is classified as a trader or an investor could well be the burning issue for individuals investing in hedge funds. For most individuals, the “wrong” answer can cause taxes to be paid on “phantom” profits, and the IRS definition of “trader” may surprise you.

Domestic hedge funds are traditionally set up as flow-through entities, partnerships or limited liability companies (LLCs). The purpose of this structure is to insure that profits are only taxed at the level of the investor, rather than potentially twice, as would happen if the funds were structured as corporations. But a flow-through entity paying high fees to its investment manager can inadvertently force its investors to pay tax on more income than they actually earn.

In this brief article, we quickly review the nature of the problem and the reason why it is a topical issue at this time. We then discuss a variety of possible solutions, ranging from the characterization of fees, to wrap-vehicles and derivative contracts. Note that no solution is absolutely bulletproof, but most address one or another of the aspects of the problem.

ACCOUNTING FOR MANAGEMENT FEES

Management fees are taken as miscellaneous itemized deductions under Section 212. This type of deduction is only usable to the extent it exceeds 2% of the investor’s adjusted gross income. Once this hurdle is met, the deductible amount is added to other itemized deductions, which are then reduced by 3% of the taxpayer’s adjusted gross income. In addition, the deduction is totally disallowed for alternative minimum tax purposes. Because of these limitations, most substantial taxable investors have no use for this type of deduction. And yet, the way in which the manager is classified can actually lead to hedge fund management fees becoming effectively nondeductible.

For example, assume a distressed debt fund charges a base 2% management fee and then charges another 20% performance fee on the remaining profits. If this fund had a gross return of 15%, the net return to the investor would be 10.4%. Many hedge funds take the position that they are traders and that these management and performance fees are incurred in their business and deductible under Section 162. Thus the entity’s form K-1 reflects only taxable income of 10.4%.

If the IRS took the position that the fund was an investor and not a “trader,” then the K-1 would reflect an investment income of 15% and 4.6% in miscellaneous itemized deductions.
deductions. If investors were not able to use those deductions, they would pay tax on 15% even though they only earned 10.4%. So what was thought to be a 10.4% pretax return, and thus a 6.76% after-tax return, is actually only a 5.15% after-tax return. These calculations use a 35% federal tax rate, but are before state and local taxes are taken into consideration. For a New York City resident, state and local taxes can lower the return to less than 4%.

WHY BE CONCERNED NOW?

We believe this problem could well surface sooner rather than later because the IRS has “teed up” the issue in instructions to its agents auditing hedge funds. In its “Audit Technique Guide to Partnerships” (www.irs.gov/pub/irs-mssp/partnershipstg12-16.pdf) released in 2003, Chapter 12 deals with hedge fund issues. This chapter specifically instructs IRS agents to challenge trader status.

Attorney Roger Lorence in the cover story of Derivatives Report September 2003 advises: “Everyone associated with hedge funds should pay serious attention to the IRS Hedge Fund Audit Manual. If a hedge fund is wrong on an issue, it is likely to affect every open year. Not only must the hedge fund file amended returns for the affected open years, but (at least in theory) all, or most, of the members will also have to file amended returns for the affected open years. Thus, if investor versus trader is the issue, the treatment of the fund’s expenses as Section 162 expenses is incorrect.”

The IRS Hedge Fund Audit Manual makes several assumptions. It instructs agents that one factor to consider is the “nature of the income from the activity—only short-term gains qualify as trading income . . . significant long-term capital gains, and even dividends and interest, are strong indications of an investor and not a trader.” The Manual also instructs agents to examine a fund’s offering document to determine whether it uses “capital appreciation” or “conservation of capital” as an objective, and contends that “objectives other than taking advantage of short-term market movements negate securities trader status.” This reasoning probably comes from Liang v. Commissioner (1955).

A search of the case law on this issue is particularly disturbing because the government has been particularly stingy in granting trader status. Levin v. Commissioner, a 1979 U.S. Tax Court case, states, “Although the Supreme Court has yet to find a taxpayer properly characterized as a ‘securities trader,’ it is clear that such a ‘businessman’ exists, given the proper facts.” And in Chen v. Commissioner, in 2004, the Tax Court found that the investor traded rapidly enough to qualify as a trader, but it still denied trader status because the activity was not conducted for all 12 calendar months of the year.

It would seem that a fund of funds would not be able to make a strong case for receiving trader status since it only allocates monies to other funds and holds the interests for a considerable period of time. In Mayer v. United States (1994), the Tax Court ruled that Mr. Mayer was an investor, not a trader, although he devoted his full time to monitoring the performance of several hired money managers doing over 7,000 trades per year. The reason was that “he personally did not engage in (or direct) the trading of stocks. . . .”

A statistical arbitrage hedge fund that exclusively trades for short holding periods should be a trader. A convertible arbitrage hedge fund that holds its long positions for six months or more might be an investor, not a trader, even though it adjusts its hedge ratio of short sales more often.

POSSIBLE SOLUTIONS

The hedge fund advisors that are aware of this problem advocate a few methods to sidestep it. Certain funds, for instance, take their performance fees as an “allocation of profits,” believing that this would make the fees reduce the capital account and not flow through to the K-1s as a deduction. But the IRS Partnership Audit Manual appears to be implicitly relying on Section 707(a)’s application leads to re-characterization of the partnership arrangement as a disguised fee arrangement, with the $800,000 distributive share as self-employment income to A and Section 212 expense to B, not a Section 162 business expense. The Manual’s chief contention is that A has no risk of loss, and therefore, the arrangement is that of compensation for services. The Manual appears to be implicitly relying on

Copyright 2005 Institutional Investor, Inc.
Treasury’s failure (after nearly 20 years) to issue regulations under the “disguised services” prong of Section 707. See Reg. 1.707-2, “Disguised payments for services.” The regulation is “reserved” (meaning that its contents are blank). The Manual’s attempt to convert any profits interest into a disguised fee—because the same economic result could be achieved through a fee—is an attempt to negate much long-standing law.

REALIZING ONLY NET PROFITS

Recently, it has been reported that a major accounting firm (one of the “final four”) has been suggesting that a domestic fund do nothing more than invest in the offshore entity, usually formed as a corporation in a tax haven. With this approach, any fees are charged to the offshore corporation before the domestic entity level. This solution seems both simple and effective. If the offshore fund makes a Qualified Election Fund (QEF) Section 1295 election, then only net profits earned at the offshore fund will flow through to the domestic fund at the end of each year.

These two ideas are executed at the level of the hedge fund itself. If neither is employed by the fund an investor owns, there are solutions at the investor level as well. One possibility would be to invest in a private placement life contract1 that in turns invests in your chosen hedge funds. This entails its own set of costs, risks and benefits.2 The costs usually necessitate a long holding period and the net profits are realized as ordinary income taxed at the maximum rate (whatever that tax rate may be at the time).

Ironically, the “plebeian” mutual fund is specifically granted relief on this issue. A mutual fund must distribute its realized gains each year or face a corporate tax, but those distributions come exclusively from net profits. There are now a good number of mutual funds employing hedge fund strategies, and, according to the Center for International Securities and Derivatives Markets at the University of Massachusetts, they are doing a good job.3

U.S. investors can invest in an offshore entity usually reserved for foreigners and U.S. tax-exempt organizations concerned with the tax on Unrelated Business Income (UBTI). With this approach, profits are realized net and quite possibly enjoy large tax savings at the state level as well.4

DERIVATIVE USE

Investors can also buy into the payoff pattern of their desired hedge funds by entering into derivative contracts designed to mimic the performance of those funds. For instance, a total return swap or forward contract on a hedge fund would only pay off on the investment’s net profits. Admittedly this method would flunk IRS Section 1260 so that any profits that are taken cannot be long-term gain, but this would not affect the desired goal of only paying tax on net profits.

For investors looking to turn their net profits into long-term gains, two strategies might be considered. The first is a call option on a fund of hedge funds (or fund itself if one can get a derivatives dealer to issue one). A simple call option should pass the tests of Section 1260, but some of the more esoteric structures might not accomplish this goal.5 Also, these options can seem expensive since one pays quite a bit to limit how much one can lose on one’s hedge fund investment.

For those willing or wanting to invest in the hedge fund sector by way of indexes, one also sees the opportunity for long-term gains on only net profits. A “bullet” total return swap or forward would capture the returns on a chosen hedge fund index and seemingly work within Section 1260, with gains not needing re-characterization and therefore staying as long-term gains.6

CONCLUSION

In short, though the investor or trader status of a hedge fund is a serious concern, it is still possible to manage around it. Yet the main issue is that investors must be aware of the problem and able to take the steps required to address it before they wake up a number of years from now, finding it necessary to amend their returns and, most probably, pay additional taxes. These additional taxes indeed might substantially reduce the attractiveness of the investment they had made.

ENDNOTES

1Several authors have substantially commented on these tools and can offer an interesting perspective on a cost/benefit analysis.
2For more information on this, see www.twenty-first.com/newsletter/newsletter_summer2001-2.htm.
3For more on this approach, see www.twenty-first.com/newsletter/newsletter_winter2005.htm.
4For more on this, see Gross [2004].
REFERENCES


To order reprints of this article, please contact Ajani Malik at amalik@ijournals.com or 212-224-3205.