

Criteria for Determining Hedge Fund “Trader or Investor” Tax Status



By Lawrence S. Zeff
Partner, Eisner LLP
212.891.4041
lzeff@eisnerllp.com

One of the fundamental tax concerns facing hedge fund managers is whether or not they can pass on management fees and other fund expenses to their investors in the most tax-efficient manner. The stakes may be high for the managers. There are now approximately 8,800 hedge funds, and their assets under management have reportedly increased in six years from \$324 billion to \$1.2 trillion. This means that investors have many choices. Managers who maximize optimum flow-through of tax deductions may have a marketing edge over those who do not.

Since most US hedge funds are taxed as partnerships, they avoid federal taxation at the fund level, and pass through their profits and losses to their investors. However, federal tax law provides investors with different rules governing deductibility of management fees and other hedge fund expenses, depending upon whether the fund is deemed to be a “trader” or “investor.”

Trader funds consider management and other hedge fund expenses to be incurred in carrying on their trade or business and pass the full deduction against hedge fund income along to their investors in accordance with Internal Revenue Code Section 162. Investor funds separately state the management fee and other hedge fund expenses as “expenses incurred for the production or collection of income,” which may be claimed by investors as Internal Revenue Code Section 212 “miscellaneous itemized deductions,” subject to the limitations placed by Internal Revenue Code Sections 67 and 68. The Section 67 limitation restricts benefit of the deduction solely to the extent it exceeds 2% of the investor’s adjusted gross income. The Section 68 limitation generally adds the remaining deduction to other itemized deductions and then reduces them by the lesser of 3% of the investor’s adjusted gross income or 80% of the amount of itemized deductions otherwise allowable. Furthermore, the investor deduction is completely disallowed for alternative minimum tax purposes. For these reasons, it is important to understand the state of the law concerning trader/investor classification.

Congress has never provided a trader definition, either in the Internal Revenue Code or in regulations. In fact, the US Supreme Court has never found a taxpayer to be properly characterized as a “securities trader,” perhaps because the Internal Revenue Service has

traditionally litigated cases with cherry-picked facts. Fortunately, the courts have given us some guidance. In the case of *Liang v. Commissioner* (23 T.C. 1040), the Tax Court enunciated the standard difference between an investor and a trader by stating, “In the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis.”

On audit, the Internal Revenue Service has presented an exhaustive questionnaire which, aside from eliciting detailed information about the manager’s educational, professional, and investment background, also elicits information which is designed to address three important factors highlighted in the case of *Moeller v. United States*, 721 F.2d 810,813(Fed. Cir. 1983):

1. The frequency, extent, and regularity of the securities transactions;
2. The manager’s investment intent; and
3. The nature of income derived from the activity.

The IRS has been known to determine the frequency, extent and regularity of the securities transactions, as well as the investment intent of the manager, by calculating the “weighted average holding period,” in accordance with a formula set forth in the case of *Mayer v. Commissioner* (T.C. Memo. 1994-209). In conjunction with this formula, the IRS takes into account the total number of trades in the year, the aggregate cost of trades, and the gross proceeds of the trades, and looks at factors such as the percentage of day trades, trades with holding periods of 1-7 days, holding periods of 8 to less than 30 days, and trades with holding periods in excess of 30 days.

On one audit, the IRS did not challenge trader status where the manager maintained a weighted average holding period of approximately 55 days, although the IRS, without judicial guidance, has expressed an unofficial position that over 50 days appears to be an excessive weighted average holding period for a securities trader.

While the absence of investment income is a positive factor signifying trader status, the IRS has not clarified its position as to the amount of investment income that will taint trader status. Apparently it will be left to the courts to ultimately determine a standard. In the meantime, those striving for trader status would be wise to avoid significant amounts of interest and dividend income, as well as long-term capital gains and losses.