Evaluation of Trader vs. Investor Status

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Principal – Alternative Investments

Trader vs. Investor

Why we care:

- **Investment Related Expenses (including management fees)**
  - Trader - deductible in arriving at adjusted gross income (as business expenses under IRC § 162).
  - Investor - deductible only as itemized deductions (under IRC § 212) - subject to the 2% floor

- **Investment Interest Limitation (Code Sec. IRC §163(d)**
  - Trader – rules don't apply in the case of interest on debt incurred by a trader where the proceeds are used to buy or carry investments used in the trade or business and the partner materially participates
  - Investor – interest expense may be limited

- **Both investors and traders hold securities as capital assets**
  - Capital gains/losses (whether or not the securities are held in connection with his trade or business)
  - Not to be confused with Dealers who have ordinary trading income
  - Traders may make IRC § 475(f) election to mark to market– taxed as ordinary but avoid wash sales, straddles, etc.
    - May be advantageous to funds with mostly ordinary income from FX or fixed income
    - May otherwise have complex straddle analyses on partial hedges
    - May have eligibility challenged and be subjected to straddle/wash sale/ capital gain/loss matching

Trader vs. Investor

Definition:

- **Trader - buys and sells securities with reasonable frequency in an effort to capture swings in daily market movements and thus profit on a short-term basis**

  - Tax Court two-part test:
    - (1) the taxpayer's trading is substantial (i.e., sporadic trading won't be a trade or business), <u>and</u>
    - (2) the taxpayer seeks to catch the swings in the daily market movements, and to profit from these short-term changes, rather than to profit from long-term holding of investments

- **Investor - purchases securities to be held for capital appreciation and income (dividends and interest), usually without regard to short-term developments that would influence the price of the securities on the daily market**

Trade or business vs ECI

- **A non-U.S. person is subject to net income tax (at applicable graduated tax rates) in the U.S. on income effectively connected ("ECI") with the conduct of a U.S. trade or business ("USTB").**

- **Traders that are engaged in a trade or business will generally <u>NOT</u> generate ECI/UBTI if the trading is limited to <u>stocks and securities.</u>**

- **Types of investment <u>strategies</u> that may generate ECI**
  - Investment in a U.S. pass-through entity that is engaged in an active operating U.S. business
  - MLP's
  - Loan origination activities
  - Certain types of mezzanine lending, distressed debt investments, investments in U.S. real property interests
  - Trading in assets not considered stocks or securities

- **Tax consequences to foreign partners**
  - Effectively connected income (ECI)
  - Withholding taxes

- **Non-US persons may still be subject to US non-resident taxes on "FDAP" income – generally dividends and certain interest**
  - The rule is the same for traders as it is for investors

Trade or business vs UBTI

- **Unrelated business taxable income generally is defined as income from any trade or business the conduct of which is not substantially related to the exercise or performance of such organization of its exempt purpose.**
  - If an exempt organization is a partner in a partnership, it will include its share of partnership gross income from the unrelated trade or business along with related deductions.
- **The following are generally are excluded from UBTI:**
  - Interest;
  - Dividends; and
  - Capital gains.
- **"Exempt" income that is not otherwise substantially related to the organization's exempt purpose may become subject to UBTI under Section 514 if the property generating such income is "debt-financed property."**
- **So while trader funds may not generate UBTI from its trading of securities, the use of debt financing will generally trigger UBTI.**

Trader vs. Investor

Empirical Tests:

- **Turnover Ratio**
  - Gross Proceeds From Realizations/Average NAV
  - Consider shorts?
  - Skew from derivatives (use cost or notional <u>value</u>?)

- **Average Holding Period**
  - Bifurcate by securities type?
    - Include Repos/Money Markets/Cash Equivalents?
  - Do hedges count the same as hedged asset?
  - Weighting by number of shares or <u>value</u> of trade?

- **Long Term vs. Short Term Mix**
  - Doesn't properly consider tax lot identification effect
  - Consider longs and shorts? (shorts are <u>always</u> short term)
  - Realizations may skew result
    - Selling property held for 5 years puts all gain in realization year
    - Based on net gains (gains and losses may offset each other despite significant activity)
    - Perhaps consider absolute <u>value</u> of gains and losses as percentage of total proceeds

Trader vs. Investor

Empirical Tests:

- **Number of trades per year**
  - Lumpiness?
  - Size of Trades?
  - Buys vs. Sells?
  - 100+ per month rule?
    - Consider trade size in comparison to AUM?

- **Percentage of Trades Under 31/61/91 days**
  - Lumpiness?
  - Size of Trades?
    - Use of weighted average by position size?
    - Should bias be toward larger value trades?
  - Effect of Unrealized Holdings?

- **Number of days in the market**
  - Differentiate between buying days and selling days?
  - What if only a buyer? What if only a seller?

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Trader vs. Investor

Qualitative Tests:

- **Amount of time devoted to trading (full time/part time) – “continuous and regular”**
  - Is trading activity exclusive means of earning income (vs. side business)
- **Sophistication of investment strategy**
- **Type of Research**
  - Due Diligence, earnings, financial statements, future outlook, management visits
  - Technical Data – moving average, short interest, oscillators, hedges
- **Use of shorts and derivatives**
- **Staff and office space**
- **Holding self out as a business – hedge fund vs. personal trading**
- **Third party management**
- **Earning management fees**
- **Investor Disclosure – holding out as long term “investment” strategy**
- **Investor lock-ups**

Trader vs. Investor

- **Test is annual – status can change year to year**

- **What if business conditions affect trading strategy – should status change?**
  - 2008-type market uncertainty
  - Liquidity
  - Leverage availability
  - Risk Management Through Cash Positions
  - Start up/Wind Down/Flame Out halfway through year
  - Time out to reassess strategy

- **Interest and Dividends Typically Look Like Investor (Federal Circuit)**
  - What if trades are sophisticated dividend capture trades

- **Ability to Segregate Activities into Separate Lines of Business**

- **Funds of Funds – Rev Rul 2008-39**
  - Upper-tier partnership activities consist solely of acquiring, holding and disposing of interests in the lower-tier funds, the upper-tier fund is considered an investment fund.
  - The upper-tier investment fund's management fee is not connected to the lower-tier fund's trade or business and, therefore, is deductible under IRC § 212.
  - Structure in such a way to have management fees only charged at lower-tier partnership

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Massachusetts Draft Directive

- **Factors**
  - is an entity organized and operated to buy and sell securities and is engaged in such trading activity with continuity, regularity and frequency,
  - has unrelated third party investors,
  - has demonstrated that its primary object is the achievement of short-term income or profit,
  - does not pursue a long-term buy-and-hold investment strategy for capital appreciation and income without regard to short-term developments that would influence the price of the securities on the daily market,
  - does not impose a redemption restriction on its investors of longer than one year, and
  - has not indicated (in investor documents, federal tax documents, or otherwise) an intent or expectation of treatment other than as a trader in securities for federal income tax or other purposes
- **Numerical Safe Harbor Tests**
  - (a) the average holding period of its assets, based on average fair market value during the tax year, is 45 days or less for the tax year, **or**
  - (b) at least 80% of its assets, based on average fair market value during the tax year, have holding periods of 30 days or less.
  - The average fair market value must be calculated on a reasonable basis, for example on a daily or monthly basis as opposed to only once or twice during the tax year.
  - The total amount of a fund's cash and cash-equivalents is excluded from the safe harbor calculations.
- **Ability to apportion**
- **Management Fees in a Fund of Funds Structure - IRC § 212 expenses similar to Rev. Rul. 2008-39**

Rev. Rul. 2008-39 vs. Dagres v. Commissioner

Rev. Rul. 2008-39.

- **An individual owns LP interest in an upper-tier partnership ("UTP"). UTP's only activity is its ownership of LP interest in several lower-tier partnerships ("LTPs"). LTPs pay an annual management fee to their respective managers in consideration for management services.**

- **Holding: Management fee incurred by UTP isn't ordinary and necessary expense on behalf of LTP's trading business, but, rather, is an expense under Section 212.**

Dagres v. Commissioner, 136 T.C. 12.

- **A member manager of venture capital firm takes a Section 166 business bad debt deduction in respect to settled loan debt owed him by a business associate.**

- **IRS argued loan was personal and gave rise to only limited non-business bad debt deduction.**

- **Holding: UTP that served as general partner of venture capital LTP was engaged in trade or business and taxpayer allowed deduction, even though UTP transaction generating the costs is classified by reference to the LTP's trade or business.**

K-1 Reporting

- **For investors, presentation is generally standardized (separate)**

- **For traders, varies from Line 1 vs. Line 11F/13W vs. Separate**

  Income from Trading Activities is sometimes reported as:
  - Line 1, Ordinary Business Income (loss) or
  - Line 11F Other Income (loss)
  - Separate lines such as 5, 6, 8, 9 and 13. Related expenses are either included in 11F or Line 13W Other Deductions

- **Line 1 can often denote passive income/ loss, therefore it is important to footnote breakdown between passive/nonpassive amounts.**

- **Line 1 is also often interpreted as unrelated business taxable income, so additional footnotes regarding UBTI are necessary.**

- **Therefore, line 1 may be more appropriate for an operating trade or business compared to a business of trading**

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K-1 Reporting

- **Line 1 or 11F vs. Lines 5, 6a, 6b, 8, and 9a.**
  - Interest income, dividend income and long and short-term capital gains are sometimes included in Line 1 or 11F and detailed in footnotes to Schedule K-1.
  - Alternatively, these amounts can be reported on their respective lines on the Schedule K-1.
    - Line 5 – Interest Income
    - Line 6a – Dividends
    - Line 6b – Qualified Dividends
    - Line 8 – Net Short-term Capital Gain (loss)
    - Line 9a – Net Long-term Capital Gain (loss)
- **Income from Trading Activities is considered Investment Income to limited partners for purposes of the Investment Interest Expense limitation. Depending on presentation may have to input manually.**

Conforming the Different Presentations

Fund of Funds

- ➢ **Pass through to investors exactly the same manner as reported on underlying K-1's *or***
- ➢ **Reclassify items to report underlying K-1 information in a consistent manner**
  - ❑ All Trading activity on Line 1 or all on Line 11F, etc.

K-1 Footnotes
What's Important to Note

- **What do you mean it's Nonpassive?**

  - Regulation 1.469-1T(E)(6)(i)
    - An activity of trading personal property for the account of owners of interests in the activity is not a passive activity.

- **Disclosure affecting taxation at partner level**

  - U.S. Treasury interest
  - DRD and Foreign QDI
  - Line 13H Investment interest breakdown by trader vs. investor
  - Unrelated Business Taxable Income (UBTI)
  - Effectively Connected Income (ECI)
  - Passive activity information
  - State tax information (i.e., source income, non-resident withholding, etc.)
  - Tax-exempt income

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