Investor vs. Trader Status

Tips to Help Fund Managers in Making This Critical Determination

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A Critical, Annual Determination

The purpose of this article is to provide you with information that will assist you in making determination of whether the Fund will take the position, for U.S. Federal and State income tax purposes, that it was engaged in the "trade or business" of trading in securities (a "Securities Trader") or whether the Fund will take the position that it was an investor in securities (an "Investor").

This is a very important determination that will have a significant impact on the ability of the Fund's non-corporate partners to deduct expenses incurred by the Fund for U.S. Federal and State income tax purposes. The determination must be made on an annual basis and the position that the Fund took in prior tax periods is generally not relevant to current year's determination. This is a very important determination that will have a significant impact on the ability of the Fund's non-corporate partners to deduct expenses incurred by the Fund for U.S. Federal and State income tax purposes.

Trader Status

If the Fund is properly characterized as a Securities Trader, the partners of the Fund will generally be able to fully deduct their share of management fees and other expenses (other than interest expense) incurred by the Fund as ordinary business expenses for Federal, alternative minimum tax ("AMT"), and State income tax purposes. It should also be noted that only Funds that are properly classified as Securities Traders are permitted to elect "mark-to-market" tax treatment pursuant to Section 475(e) or (f) of the Internal Revenue Code (the "Code"). This election is not available to Funds that are properly classified as Investors.

Trader Characteristics

A Securities Trader typically buys and sells securities with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis. In order to qualify as a Securities Trader, the Fund's trading activity must be substantial and it must be frequent, regular, and continuous enough to constitute a trade or business. Sporadic trading, regardless of the number and dollar value of shares traded, does not constitute a "trade or business."

Investor Status

If the Fund is properly characterized as an Investor, a non-corporate partner's share of management fees and other expenses (other than interest expense) incurred by the Fund will be treated as "portfolio deductions" and not qualify to claim as a deduction. For a non-corporate partner, miscellaneous itemized deductions are only deductible to the extent they exceed 2% of the partner's adjusted gross income ("AGI"). Such deductible expenses may be even further reduced as a result of a "three percent phase out" of certain itemized deductions for high-income taxpayers. Furthermore, miscellaneous itemized deductions are not deductible by a non-corporate partner for alternative minimum tax ("AMT") purposes. Miscellaneous itemized deductions may also be limited or denied for State income tax purposes.

Investor Characteristics

An Investor typically purchases securities 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. Merely managing one's own money does not constitute a "trade or business." Significant long-term capital gains, and even dividends and interest, are strong indications a fund is an Investor and not a Securities Trader.

No "Bright-Line" Test

To be considered a Securities Trader, the Fund must be considered to be engaged in a "trade or business". There is no definition of the term "trade or business" in the Code or in the Treasury Regulations. Rather, the meaning of this term has been left for the courts to determine on a case by case basis. There are a number of cases in this area but there is no "bright-line" test to make the distinction between a Securities Trader and an Investor. An analysis of all facts and circumstances is required and no single factor is determinative.

Factors to Consider

Based on the cumulative case law addressing the distinction between a Securities Trader and an Investor, the relevant factors that should be considered include, but are not limited to, the following (not listed in any particular order):

- The intended trading strategy as outlined in the Fund's offering documents. For example, an indication in the offering documents that the Fund seeks capital appreciation suggests that the Fund intended to be an Investor.
- The Fund's portfolio turnover during the Tax Period
- The composition of the Fund's income during the Tax Period. In

this regard, the absolute value of gross "short-term" gains/(losses) vs. absolute value of total gross gains/(losses) during the Tax Period should be considered. For this purpose, the test should be performed assuming that (1) "short-term" means a holding period of 1 year or less, and (2) alternatively, that "short-term" means 30 days or less

- The average holding period of the Fund's securities
- Whether or not there were any lapses or significant reductions in trading activity during any month or months within the Tax Period

Consequences of Incorrect Classification

If the Fund takes the position that it is a Securities Trader and the IRS subsequently determines that the Fund was actually an Investor, the Fund and its investors could be required to file amended Federal and State tax returns. Furthermore, the investors in the Fund would likely owe additional taxes, penalties, and interest as a result of the Fund's misclassification as a Securities Trader.

Tax - 475(f) Election

There are both potential positives and negatives to a 475(f) election. Funds with high turnover and the potential for wash sales may wish to consider a 475(f) election. This discussion provides some general background intended to be helpful for fund managers in deciding its relevance to a fund. Note that a 475(f) election, once made, cannot be revoked without IRS permission therefore it is important to carefully weigh the potential benefits and disadvantages with your tax advisors.

General Characteristics

A 475(f) election has the following characteristics:

- All securities positions are marked-to-market for tax purposes at year-end; in effect this converts all year-end unrealized income or loss to realized
- All income is considered "ordinary" – capital gains and losses are eliminated
- Net capital losses (as opposed to ordinary losses) are subject to limitations on deductibility, depending on what other capital gains and losses a taxpayer might have. Additionally, current year capital gains can generally be offset against capital losses, including those carried forward from previous years

A wash sale occurs when a security was disposed of at a loss and that same security or a substantially identical one was acquired in the 30 days preceding the loss or 30 days following the loss. The loss is deferred until the newly acquired position is sold (or covered short).

The conversion of capital gain/loss to ordinary income/loss is usually an advantage to the typical taxpayer only if the fund experiences significant losses. This is because ordinary losses are usually more deductible for most taxpayers. However, in our experience, losing money is not a common expectation at the time a fund is launched.

The primary reason to make a 475(f) election is to eliminate the problem of wash sales. A high turnover fund that keeps trading the same securities (or substantially identical securities) can find itself adding to its taxable capital gains while realizing few losses due to wash sale rules. For example, a fund with a 15% annual return might have accomplished that by realizing gains of 50% and losses of 35%. If one-half of those losses were disallowed because they were wash sales, investors would see taxable income of over 30%. In addition, wash sales are a challenge to track, especially where "substantially identical" judgments are required.

For a fund with wash sale problems, the alternative to a 475(f) election is careful monitoring of capital losses and the installation of procedures to periodically "cure" wash sales. If losses are cleared out late in the year for a 30 day period, prior wash sales associated with those positions are cured for that tax year.

Making the Election

Revenue Procedure 99-17 states that a new fund "makes the election by placing in its books and records no later than 2 months and 15 days after the first day of the election year a statement that describes the election being made, the first taxable year for which the election is effective, and the trade or business for which the election is made." Additionally, it advises: "To notify the IRS that the election was made, the new taxpayer must attach a copy of the statement to its original federal income tax return for the election year."

Accordingly, the election, if made, needs to be documented within approximately 75 days after the date the fund commences operations. The tax payer is the fund and, therefore, the election should be signed by a general partner or director. A copy of the election must be attached to the income tax return.

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