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New IRS rulings affect investors

Foreign holders of U.S. real estate and hedge funds are targets

By Robert N. Gordon

August 4, 2008

Three new revenue rulings released by the Internal Revenue Service over the past few weeks are likely to have substantial effects on investors.

The first is Revenue Ruling 2008-31, which concerns foreign investors in U.S. real estate. Until 1980, when the Foreign Investment in Real Property Tax Act was passed, non-resident aliens could sell property in the United States without incurring a tax liability on any gains. Since then, property sales by non-resident aliens have been covered by IRS Code Section 897.

In its new revenue ruling, the IRS concluded that payments received by a foreign person under a total return swap over a broad-based real estate index would not be subject to the tax imposed by Firpta. It is important to note that the index must be broad-based. The ruling states, "Because of the broad-based nature of the index, an investor cannot, as a practical matter, directly or indirectly own or lease a material percentage of the real estate, the values of which are reflected by the Index."

We welcome a device that allows non-U.S. investors to avoid Firpta, but caution that the ruling should not be viewed as allowing a swap on a particular building or a "narrow" index.

The second new ruling, 2008-38, fleshes out the implications of an earlier ruling (2008-12) and states that interest expense incurred by a hedge fund should not be netted against other income when reporting to investors, but instead should be broken out as a separate item. This appears to be the IRS's stance even if a hedge fund is classified as a "trader." The impact and challenge to investors will be whether they can currently use the interest expense deductions since interest expense can only be deducted against "investment income."

The third ruling, 20 08-39, will cause pain for investors in a fund of funds who can't utilize itemized deductions. The ruling made clear that a fund of funds is not a trader. Its management fee, therefore, cannot be deducted against the fund's gains, but instead must flow through to the investor as a miscellaneous itemized deduction. Moreover, the fund can't take the position that a proportion of the management fee can be treated as an ordinary expense if some of the underlying funds are "traders."

This is different from what the industry has done in practice, although it exactly reflects the view expressed in my column of April 7. In a July 15 memo, the law firm of Seward and Kissel LLP of New York and Washington suggests that it "seems reasonable to conclude that the IRS would apply the analysis contained in the ruling to other expenses (such as legal and accounting)." An allocation of profits continues to be the preferable method of handling a hedge fund manager's performance fee, because if the performance fee is paid in cash that amount will turn out to be a miscellaneous itemized deduction, too.

The good news in the ruling is that the IRS has confirmed that a fund that qualifies as a "trader" can net management fees against income before completing the K1. Now the only overhanging issue is just what level of trading is necessary to deserve trader status.

In the court cases we've reviewed, the government has been particularly stingy in granting "trader" status. We assume that a certain level of trading activity can make an investor a trader, but what level?

The IRS has never made that clear. If the fund is not a trader, its fees, too, will become miscellaneous itemized deductions.

For its agents examining hedge funds, the IRS provides an audit manual (irs.gov/pub/irs-mssp/partnershipsatg12-16.pdf) that encourages agents to challenge "trader" status. The manual directs agents to consider 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; it claims that "objectives other than taking advantage of short-term market movements negate securities trader status." This reasoning probably comes from Liang v. Commissioner (1955).

The investor-trader battle is not yet over and only time will tell where the line may be drawn. These recent rulings give some clarity to hedge fund investors, but leave much yet to be resolved.

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