InvestmentNews
The Leading News Source for Financial Advisers

Are your clients traders or investors?

In light of a Massachusetts directive, the after-tax cost of investing hangs on the answer

By Robert N. Gordon

July 24, 2011

Under U.S. tax law, investment expenses are considered miscellaneous itemized deductions. But these so-called Section 212 deductions are limited, and the limits result in most investors' not being able to deduct investment expenses such as management fees. Traders, on the other hand, can deduct investment expenses without limitation as Section 162 deductions.

So who's a trader and who's an investor?

Massachusetts recently issued a directive that creates a definitive, numerical safe-harbor definition of who is and isn't a trader. This issue is particularly important to investors in the state because Massachusetts taxes short-term gains at 12% and offers no deductions for the costs of producing that income, unless those costs are incurred by a “trader.”

A number of court cases on the federal level have touched on the investor/trader issue. Those cases have found that a trader is one who continuously invests exclusively to capture short-term movements in the market. The Internal Revenue Service audit manual instructs agents to challenge a hedge fund's trader status if the offering document reflects investing goals different from those of a short-term investor. In a revenue ruling, the IRS made clear that a fund of funds could not be a trader; the Massachusetts directive echoes that view.

Over the years, I've been troubled by organizations' advertising that their customers can claim trader status, which is not easy to attain. Some have made this claim after a disastrous year for the markets, because once an individual is deemed a trader, he or she is allowed to take investment losses as ordinary deductions under Section 475, rather than as capital losses.

Consider the U.S. Tax Court's July 6 decision in Kay v. Commissioner. Although petitioner Richard Kay Jr. had a full-time job and traded only 18 days in 2001 and 21 days in 2002, he claimed to be a trader. The court denied that status.

To qualify for trader status under the new directive in Massachusetts, 80% of a hedge fund's portfolio must be in securities held 30 days or less (the other 20% could be of any duration). An alternative safe harbor is available if the whole portfolio has a weighted average holding period of 45 days or less. The state suggests that these asset maturity tests be conducted daily or monthly.

If a Massachusetts-based hedge fund cannot satisfy either safe harbor, it may be able to apportion some amount of its investment costs as ordinary deductions. Here it must demonstrate that shorter-term investments constitute a “sufficiently material” portion of the fund's activities. A year-end test will dictate whether this relief is possible. If a hedge fund can qualify for apportionment, the percentage of total holdings that are held 45 days or less will dictate the proportion of expenses allocated to investment and trader deductions.

Finally, to qualify as a trader in Massachusetts, a hedge fund cannot impose a redemption restriction of longer than one year and must claim trader status federally.

Joseph Pacello, a tax partner at the accounting firm Rothstein Kass & Co. PC, finds the state's new safe harbors more restrictive than expected, observing that “under these guidelines, neither venture capital partnerships nor leveraged-buyout hedge funds would qualify as traders,” although both are obviously actively managed funds.

The Massachusetts directive does not apply to mutual funds, following on the federal tax rules that allow a mutual fund to deduct its investment costs before arriving at distributable income. This continues to be an advantage over separately managed accounts and other types of pooled vehicles.

Coincidentally, the same issue of expense deductibility presently confronts single-family offices. The costs of running such an office may be Section 162 expenses if the office is a business or Section 212 expenses if its sole purpose is to manage a family's money. Recent rule changes exempt SFOs from registration as registered investment advisers under certain circumstances. But the exemption is available only if the SFO restricts its services to family members. Single-family offices, therefore, should consider registering as RIAs in order to bolster the argument that they are running a business entitled to deduct the costs of running the office under Section 162.

Whether each $1 in expenses winds up costing an investor $1 or 65 cents hangs in the balance of these apparently technical issues

Robert N. Gordon is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business. He can be reached at bob@twenty-first.com.