The Effect of Obamacare on Hedge Funds, Fund Managers, and Investors:

Discussion of the Proposed Regulations on the New 3.8% Net Investment Income Surtax

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This article focuses on how Obamacare, specifically the proposed regulations related to the surtax on net investment income ("NII"), affects managed funds, fund managers, and investors.

On November 30, 2012, the Treasury Department issued proposed regulations on the new 3.8 percent NII surtax. The NII surtax will significantly affect hedge funds, their managers, and their investors, because Congress directed the NII surtax at investment income which represents most of a hedge fund's income and which, to a large extent, previously escaped employment-type taxes. The proposed regulations provide much detail about how the surtax applies to investors and managers of hedge funds, and some of the rules, such as loss limitations, yield surprising results. Additionally, the rules in the proposed regulations affect investors and managers differently depending on whether the fund is a trader fund or an investor fund. The complexity of the rules and the variance of how the surtax affects different hedge funds highlight the need for hedge fund managers and investors to analyze the possible effects of the surtax and to consider possible planning strategies.

This discussion addresses the following topics:

- General overview of the NII surtax
- What constitutes a trade or business of trading in financial instruments or commodities
- The impact of the NII surtax on fund managers
- Differences between the treatment of trader funds and investor funds
- The use of trading losses to offset trading gains for the NII surtax
- Limitations on the use of investment losses to offset trading gains for the NII surtax
- Ability to carry forward unused losses for the NII surtax
- How expenses of trader funds are accounted for in the NII surtax
- NII surtax treatment of income from certain foreign corporations
- Implications on entity selection and legal structure

As drafted, the proposed regulations include some rules that are disadvantageous to many hedge funds. **For instance, the proposed regulations make no provision for the use of trading losses to offset trading gains in calculating the NII surtax.** Based on our discussions with the drafter of the proposed regulations, final regulations may eliminate this particular harsh result. However, there are a number of other collateral effects and planning opportunities that fund managers and investors should consider, many of which are discussed in further detail below.

The proposed regulations do clarify some of the uncertainties left by the statute, and while the proposed regulations do provide insight into how the Treasury Department and the IRS intend to apply and administer the surtax, taxpayers should keep in mind that there may be changes in the final regulations. Additionally, the Treasury Department has requested comments on a number of matters, as it continues to work through various issues in administering the NII surtax.

General Overview of the NII Surtax

Congress enacted the NII surtax in the Health Care and Education Reconciliation Act of 2010, part of the comprehensive health care legislation often referred to as "Obamacare." Generally, the NII surtax subjects the investment income of individuals, trusts, and estates to a 3.8 percent tax roughly comparable to the Medicare tax on employment income. For individuals, the NII surtax applies to net investment income to the extent the individual's adjusted gross income exceeds a certain threshold ($250,000 for married taxpayers filing jointly or $200,000 for single taxpayers). NII includes, among other items, interest, dividends, rents, royalties, annuities, gains on sales or dispositions, and income from passive activities and trading businesses. Certain active business income is exempt from the surtax. The surtax is applicable for tax years beginning after December 31, 2012, and impacted taxpayers will begin reporting the surtax on 2013 returns. **This means that taxpayers will need to take into consideration the potential impact of the surtax when calculating 2013 estimated tax payments.**

Trade or Business of Trading in Financial Instruments or Commodities

As provided in the Obamacare legislation, the NII surtax applies to the income derived from a trade or business of trading in financial instruments. Not surprisingly, many hedge funds will generate net investment income. The surtax applies to funds differently depending on whether the fund is classified as a trader or an investor. Generally, a trader fund is one that trades with sufficient frequency to be considered engaged in a trade or business of trading in financial instruments or commodities. All gross taxable income derived from a fund that is engaged in a trade or business of trading in financial instruments or commodities constitutes NII subject to the surtax. Alternatively, for an investor fund, only the enumerated items of income – interest, dividends, rents, royalties, annuities, and net gains – contribute to NII.

The proposed regulations provide guidance in determining whether a fund is engaged in a trade or business of trading in financial instruments. The proposed regulations adopt the trade or business concept used for trade or business expenses under section 162. Generally, a fund is engaged in a trade or business if its trading is frequent, regular, and continuous. Additionally, the fund must trade financial instruments and commodities. The definition of financial instruments includes stocks (and other equity interests), evidence of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, and any other interest in any of the listed items (such as short interests or partial interests). Commodities include any commodity which is actively traded and derivatives thereof. Given these definitions, so called trader funds will generally be engaged in a trade or business of trading in commodities. In contrast, a fund whose activity does not reach the level of a trade or business is an investor fund.

Fund Managers Shares of Fees Generally Are Not NII

Since management companies do not rely on trader status to deduct expenses, management companies are not engaged in a trade or business of trading in financial instruments. The "trader" category appears to be relegated to the fund level under the proposed regulations. Thus, much of the income generated by the management company, such as management fees, is not NII to owners who are active in the company. However, incentive allocations, (i.e. profit allocations or "carried interest") will be subject to the NII surtax to the extent they consist of NII. **As a result, in**

some cases, it may be advisable to convert incentive allocations to incentive "fees" to reduce the impact of the NII surtax on fund managers.

Certain Differences between Trader and Investor Funds

Investor funds (not trader funds) only generate the enumerated sources of NII listed: interest, dividends, annuities, royalties, rents, and net gain on the sale of property. For investors in a trader fund, all other gross income from the trader fund is NII. Thus, mark-to-market gains from trader funds that make a section 475(f) election will be net investment income. Additionally, income earned or received pursuant to notional principal contracts, including many types of swaps, will be net investment income if earned through a trader fund, whereas such income is not NII for investor funds. However, the gain on the disposition of notional principal contracts will contribute to NII for investors in both types of funds.

> *Example. During the taxable year, an investor fund receives $100 in payments pursuant to an interest rate swap. At the beginning of the following year, the fund disposes of the swap for a $600 gain.*
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> The investors in the fund would not recognize as NII the $100 of payments pursuant to the swap. However, in the following year, the investors in the fund would recognize the $600 of gain on the disposition of the swap as NII.
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> *Example. Same facts as above, except the fund is a trader fund.*
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> In this case, the $100 payment would be NII for the investors in the trader fund. The $600 gain in the following year would also be NII for the investors.

Questions Remain about the Ability to Use Trading Losses against Trading Gains in Calculating NII

Some surprising results would stem from the proposed regulations as they are currently drafted. Specifically, many trading gains would generate net investment income without being offset by trading losses. This apparent glitch in the proposed regulations is a result of the approach in the regulations to segregate different types of NII into different categories which are calculated independently and then aggregated for the total NII amount. The proposed regulations provide that all "other gross income" (other than interest, dividends, rents, royalties, and rents) derived in a trade or business of trading in financial instruments is one category of net investment income. Included in this "trading" category of NII are gains from marking to market under sections 475(f) and 1256. However, the proposed regulations make no provision for trading losses to reduce this trading category of NII. As a result, the proposed regulations segregate trading losses from trading gains; therefore, many investors in trader funds would not be able to use trading losses to offset NII.

> *Example. Dan invests in two funds, both of which are considered trader funds. In 2013, he recognizes a $100,000 trading gain from one fund and a $200,000 trading loss from another fund. He earns directly $300,000 in interest and dividends from other investments. He also sold stock held directly at a loss of $40,000.*
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> Dan recognizes $400,000 of NII in 2013 ($100,000 of trading gains plus $300,000 of interest and dividends). None of the $200,000 trading loss or the $40,000 loss on the stock disposition can be used to offset NII in 2013. The $40,000 loss on the sale of stock may be carried forward and applied to investment gains from other sources in future years but not against trading gains for purposes of the NII surtax.

This apparent impediment on the use of trading losses to offset NII might not be present in the final regulations according to our discussions with the drafter of the proposed regulations at the IRS. The final regulations may enable trading losses to offset trading gains. Because this anticipated change is not guaranteed, we at Arthur Bell will closely monitor this issue.

Investment Losses Do Not Reduce Trading Gains

Another anomaly under the proposed regulations is that an investor in both a trader and an investor fund would not be able to net his or her net losses from the investor fund against his or her share of gains from the trader fund in calculating NII. Because investment fund losses and gains are calculated independently from trading income, net losses from investing activities cannot offset trading gains. Because the classification of income occurs at the entity level, it would appear that funds-of-funds would have to report trading gains separately to investors to comply with the rules in the proposed regulations. Such detailed reporting would complicate the preparation of Schedule K-1.

On the other hand, although not altogether clear, it appears that investors may be able to use their share of trading losses to offset investment gains generated by investor funds. Thus, trading losses may offset NII to the extent there are net investment gains available.

Loss Carryforwards

This apparent limitation on the use of trading losses to offset NII highlights another difference between trader and investor funds. Under the proposed regulations, investors in trader funds that make a section 475(f) election would not be able to carry forward ordinary trading losses because net operating losses ("NOLs") are specifically not taken into account in calculating NII. However, in the absence of a section 475(f) election, it appears that capital losses from trading can carry over to another year and reduce net investment gains in calculating NII. Thus, investors in trader funds that make a section 475(f) election would encounter more restrictions on their ability to use losses to reduce NII than would apply if the fund was an investor fund or a trader fund that did not make the section 475(f) election.

Expenses of Hedge Funds

Under the proposed rules, expenses incurred by a trader fund will reduce items of gross income for surtax purposes to the extent such expenses are not otherwise applied to self-employment income. This rule ensures that all such expenses will offset either NII or self-employment income.

> *Example. Anthony is the general partner of a trader fund that allocates to him $100,000 of trading gains and $40,000 of expenses. The fund also pays him $50,000 of management fees subject to self-employment taxes.*
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> The $40,000 of expenses would first be applied to Anthony's $50,000 of self-employment income, leaving no trader expenses to offset the $100,000 of NII from the trading gains.
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> *Example. Same facts as above, but Anthony only receives $30,000 of management fees subject to self-employment taxes.*
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> In this case, the $40,000 of expenses first offset the $30,000 of self-employment income, and the remaining $10,000 of expenses offset the $100,000 of trading gains resulting in $90,000 of NII subject to the surtax.

Unlike a trader fund, the expenses of an investor fund used in reducing NII are subject to the same limitations on portfolio deductions that apply to income tax deductions. For example, an investor's share of the expenses of an investor fund would be subject to reduction by the 2 percent floor on itemized deductions for surtax purposes. Moreover, if the investor's adjusted gross income exceeds certain thresholds, such portfolio deductions from the investor fund may be subject to further reductions pursuant to the "Pease" limitations. Pease limitations reduce itemized deductions, including portfolio deductions, by 3 percent of the excess of the investor's AGI over $300,000 (for joint filers) up to 80 percent of such portfolio deductions. Thus, not all of the expenses of an investor fund may be used to offset NII.

Example. Susan and Robert file a joint tax return. Their adjusted gross income ("AGI") is $300,000, $10,000 of which consists of their share of NII from an investor fund and the remainder of which is wages. Their share of the investor fund's expenses is $1,000. They also have another $3,000 of miscellaneous itemized deductions.

No portion of the fund expenses can offset their $10,000 of NII because none of their $4,000 of miscellaneous itemized deductions exceeds $6,000 or 2 percent of their AGI. If the fund was a trader fund, then the limitation would not apply, and the $1,000 of fund expenses would have reduced the $10,000 of NII.

Income from Certain Foreign Corporations

There is a potential timing difference for certain income from foreign corporations depending on whether the income is earned in a trader fund or an investor fund. Under income tax rules, certain shareholders of foreign corporations recognize their share of the foreign corporation's income if the corporation is a controlled foreign corporation ("CFC") or a passive foreign investment corporation ("PFIC") for which an election to recognize income currently is in place ("QEF election"). Taxpayers recognize this "deemed" income from the foreign corporation for income tax purposes regardless of whether such income is actually distributed to the investor. For an investor fund, the proposed regulations do not include this "deemed" income in NII unless the investor in the fund affirmatively elects to treat the deemed income as NII. Thus, there may be a difference in the timing of income recognition for income tax and NII surtax purposes from certain foreign corporations. The recognition of the foreign corporation's earnings for purposes of the surtax is deferred until it distributes earnings to the taxpayer. However, this possible deferral benefit comes at the cost of keeping track of two sets of basis and corporate earnings, one for income tax purposes and the other for NII surtax purposes. To simplify compliance, taxpayers may make an election to forego deferral and recognize the deemed income for NII purposes.

For a trader fund that owns an interest in a CFC or a PFIC with a QEF election in place, the deemed income will be NII to the investors of such trader fund. No deferral is allowed. Thus, investors in trader funds that own interests in foreign corporations will not benefit from the option to defer NII recognition from such foreign corporations.

Example. In year 1, an investor fund, organized as a Delaware limited partnership, owns interests in several PFICs for which a QEF election is in place. The investor fund's share of the PFIC's income is $100, but the PFIC makes no distributions in year 1. In year 2, the PFIC earns no income but distributes $75 to the investor fund.

In year 1, the fund recognizes its $100 share of the PFIC's income for income tax purposes and allocates such income to its investors. However, the investors do not include any of this $100 in NII in year 1, unless they personally elect to do so. In year 2, the fund would recognize the $75 dividend distribution as NII (but not as income for income tax purposes). Thus, the investors benefitted from the deferral of the NII surtax on their shares of the foreign corporation's $100 of earnings in year 1 and the continued deferral of $25 of those earnings after year 2 until the corporation distributes them to the fund.

Example. Same facts as above except the fund is a trader fund.

In this case, the investors in the trader fund recognize in year 1 all of the $100 for NII surtax purposes as it does for income tax purposes. Thus, the investors in the fund do not benefit from the deferral of the NII in the PFIC. In year 2, there would be no NII from the PFIC allocated to the investors of the fund.

The following table highlights some of the differences in how the NII surtax would apply to investments in trader funds and investor funds under the proposed regulations:

	Investor Funds	Trader Funds
Types of Net Investment Income Produced	• Interest income (including substitute interest) • Dividend income (including substitute dividends) • Annuities • Royalties • Rents • Net gains from investments • Section 1256 mark-to-market gains • Gain on disposition or termination of notional principal contracts (but not payments under the contract)	Same income as investor funds, **plus** any other gross income, including: • Mark-to-market gains under sections 475(f) and 1256 • Income from notional principal contracts
Deemed Income from CFCs or PFICs that make a QEF election included in NII?	**No**, but actual dividend distributions from such foreign corporations would be NII (Taxpayer may elect to include deemed income in NII calculation)	**Yes**
Ability to Use Losses to Offset Net Investment Income	**Yes,** but only to offset other investment gains. Net losses cannot be applied to other types of net investment income, such as interest, dividends, etc.	**Limited Ability*** The proposed regulations make no provision for applying trading losses against trading gains. Although not altogether clear, trading losses may be applied to other, non-trading gains. *This rule may change in the final regulations.
Ability to Carry Forward Losses	• Capital losses may be carried over and applied to gains in future taxable years • NOLs cannot be applied in calculating NII	• Capital loss carryover may apply to other non-trading gains but not to trading gains • Net operating losses do not reduce NII
Limitations on Deducting Expenses Allocable to NII	Expenses are subject to limitations: • Investment interest expense limitations • Limitations on Portfolio deductions (2 percent floor) • Pease limitations that reduce itemized deductions for taxpayers in excess of AGI limits	Expenses are subject to limitations: • Investment interest expense limitations • Deductions limited to those not applied in calculating self-employment tax

Implications for Entity Selection and Fund Structure for Management Companies

For hedge fund managers, management companies organized as S corporations or limited partnerships may provide advantages for active owners in light of the NII surtax. The planning objective should be to minimize both NII and income subject to self-employment taxes, and S corporations and properly structured limited partnership arrangements could enable hedge fund managers to accomplish such objective. An S corporation's ordinary business income, which would include management fees of a management company, is neither NII nor self-employment income in the hands of its active shareholders. Also, active limited partners may derive a similar benefit. In contrast, a general partner's share of the ordinary business income of a partnership would be subject to self-employment taxes.

The benefits of an S corporation or limited partnership interest can be enhanced further by converting an incentive allocation, which would likely be considered NII, into an incentive "fee," which would not be subject to the NII surtax for the active owners.

As a word of caution, for management companies organized as S corporations, the shareholders that participate in the fund management should receive reasonable compensation for their services. Such compensation would be subject to employment taxes. To the extent the shareholder receives income from the management company in the form of compensation, these strategies would not be effective in reducing Medicare taxes.

Example. John, a married taxpayer filing jointly, owns an interest in a fund management company, organized as an S corporation. In 2013, he recognizes a $20,000 share of the company's incentive allocation, all of which is NII, and a $100,000 share of the company's business profits, consisting primarily of management fees. He also earns compensation of $140,000 from the company in the form of salary and bonuses.

The NII surtax applies to $10,000 of John's share of the incentive allocation [$260,000 AGI less $250,000 threshold], resulting in a NII surtax liability of $380 ($10,000 X 3.8%). The threshold amount exempted the remaining $10,000 of the NII from the surtax. John's $100,000 share of the company's business income is not subject to either self-employment taxes or the NII surtax because the management company is an S corporation. However, his $140,000 salary would be subject to employment taxes.

Example. Same facts as above except that instead of an incentive allocation, the management company earns an incentive fee.

In this case, none of John's income would be subject to the NII surtax. An incentive fee would be excluded from NII as active trade or business income, saving John $380 compared to the prior example.

Conclusion

The proposed regulations resolve certain issues and questions about the NII surtax as it relates to hedge funds. For investors in hedge funds, as well as fund managers, the proposed regulations provide much to think about and plenty of room for planning. Of particular importance to investors is the ability to offset losses from hedge fund investments against gains. Also, investors and managers should consider the NII impact of trader status, section 475(f) elections, and other elections available under the proposed regulations.

Bottom Line: There are still questions that remain, and there will likely be some changes in the final regulations. We will continue to monitor and keep you abreast of any significant changes that may impact hedge funds, fund managers, and investors. In the meantime, please contact your Arthur Bell tax advisor if you have any questions at 410.771.0001 or contactus@arthurbellcpas.com.

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