Massachusetts Tax Authorities Present Draft Directive on Trader vs. Investor Funds

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The Massachusetts Department of Revenue has circulated a draft Directive setting forth the standards the Department proposes to impose for determining whether a professionally-managed fund is a “trader” or “investor” for Massachusetts personal income tax purposes. The Department has invited comments on the draft Directive to be submitted by July 20, 2011.

The classification of a fund as a trader or investor has important implications for a U.S. individual investor’s ability to deduct management fees and certain other expenses of the fund, for both federal and Massachusetts income tax purposes. A U.S. individual investor in a "trader" fund may deduct these expenses as “trade or business” expenses. For federal income tax purposes, however, a U.S. individual investor in an “investor” fund must treat these expenses as investment expenses that are “miscellaneous itemized deductions.” For federal income tax purposes, a U.S. individual investor can deduct miscellaneous itemized deductions from all sources only to the extent they exceed 2 per cent of the investor’s adjusted gross income for the year in question. For Massachusetts personal income tax purposes, no deduction is allowed for investment expenses. In addition, only a trader fund can elect to report income on a mark-to-market basis for federal income tax purposes. Finally, the distinction between trader and investor may also influence the manner in which the general partner’s incentive allocation or incentive fee can be structured.

The draft Directive sets forth six factors, selected from case law, on which the Department proposes to base the determination of whether a fund is a trader or investor. According to these proposed factors, a professionally managed fund may be determined to be a trader if the fund

- 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.

One proposed factor that some funds may have difficulty satisfying is the requirement that the fund “does not impose a redemption restriction on its investors of longer than one year.” The Department’s reasoning for this requirement is not entirely clear, as the existence of a longer “lock-up” does not seem directly relevant to the question whether the fund is a trader or not. All of the other proposed factors relate more directly to the characteristics and operations of the fund. Whether the fund’s activities are those of a trader should not depend on whether its investors are short-term or long-term members of the fund, but should depend, in our view, on whether each investor, through the fund, is investing in short-term investments.

As noted, one of the proposed factors for trader status is an “objective to achieve short-term income or profit.” The draft Directive proposes two alternative safe harbors for this factor:

Short-Term Profit Safe Harbor I. The fund’s holding period for its assets, based on average fair market value during the tax year, is 45 days or less.

Short-Term Profit Safe Harbor II. At least 80 percent of the fund’s assets, based on average fair market value during the tax year, have holding periods of 30 days or less.

“Average fair market value” must be calculated more often than once or twice a year, “for example on a daily or monthly basis.” Cash and cash equivalents are excluded from these calculations.

According to the draft Directive, a fund that meets neither safe harbor may nonetheless treat itself as a trader with respect to some or all of its assets, so long as the fund’s assets with a holding period of one year or less constitute a “sufficiently material portion” of the fund’s assets. The Department may accept any reasonable method of apportionment between trader and investment assets, and proposes one safe-harbor method:

Safe-Harbor Apportionment Method. The amount of trader expenses is equal to the product of (a) total fund expenses times (b) a fraction whose numerator is the fair market value of fund assets with holding periods of 45 days or less at year-end, and whose denominator is the fair market value of total fund assets at year-end.

Finally, the draft Directive explains the Department's view of the trader-versus-investor issue for a fund of funds. That is, expenses of portfolio funds that are trader expenses retain their character as trader, rather than investment, expenses when they are allocated through the fund of funds to its investors. Expenses of the fund of funds, however, are always investment expenses.

Please call Rick Schaul-Yoder, Nicola Lemay, or Jeff Collins if you have questions or comments regarding this Foley Adviser, or if you would like to suggest comments to be made to the Department of Revenue regarding the draft Directive.

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