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Effect of the New Medicare Tax on U.S. Investors in Hedge Funds

By Peter J. Elias


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New section 1411 imposes a 3.8 percent tax on net investment income of U.S. individuals, estates, and trusts that have income above specified threshold amounts. There are some interesting features regarding the application of the new tax to U.S. individual investors in offshore and onshore hedge fund structures. This article analyzes those features and the new tax's potential effect on some investments.

The Patient Protection and Affordable Care Act of 2010 and the Health Care and Education Reconciliation Act of 2010 (so-called Obamacare) added section 1411 to the code. This new section generally imposes a 3.8 percent Medicare tax on net investment income (NII) of U.S. individuals, trusts, and estates. The IRS recently issued proposed regulations addressing many open issues concerning section 1411, including its application to private investment funds and onshore and offshore hedge fund structures. Below is a discussion of the impact these new rules may have on U.S. individuals investing in hedge funds.

A. Background

The federal tax law has long imposed Social Security and Medicare taxes on most types of earned income of U.S. individuals, primarily most types of wages, compensation for services, and income from self-employment.[1] These Social Security and Medicare taxes are imposed in addition to regular income taxes but, before 2013, had never applied to unearned income or investment earnings (such as dividends, interest, gains from sales of investments, etc.).

That changes this year. For any tax year beginning on or after January 1, 2013, new section 1411 imposes a 3.8 percent Medicare tax on most types of NII of U.S. individuals, estates, and trusts that have incomes above specified threshold amounts.[2] This new tax does not apply to individuals who are neither residents nor citizens of the United States.[3]

The term ''net investment income'' is defined for this purpose to mean any income falling into one of the following three categories (net of allocable expenses)[4]:

1. income from interest, dividends, annuities, royalties, and rents, except when those items are derived in the ordinary course of a trade or business not described in category 2;

2. other gross income derived in a trade or business involving trading in financial instruments[5] or commodities, or from an active trade or business in which the taxpayer is passive (for example, income from the taxpayer's investment in a business activity in which he does not materially participate); and

3. net gain from the disposition of property, except when that property is held in a trade or business not described in category 2.

Gain from the sale or redemption of an interest in any entity that is treated as a partnership or S corporation for U.S. tax purposes will also be taken into account as NII to the extent of the net gain that

[1] *See* sections 3101-3121 and section 1401.

[2] Section 1411(a)(1). For individuals, the tax applies only if the individual's modified adjusted gross income for the tax year exceeds a threshold amount equal to $200,000 (for single taxpayers) or $250,000 (for married taxpayers filing joint returns). *See* section 1411(b).

[3] Section 1411(e).

[4] Section 1411(c).

[5] The proposed regulations, issued in December 2012, define the term ''financial instruments'' for this purpose to include ''stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of the items described in this paragraph.'' Prop. reg. section 1.1411-5(c).

is attributed to the partnership's or S corporation's assets as of the time of the sale or redemption.[6]

B. Application to U.S. Investors in Hedge Funds

As noted, this new 3.8 percent tax was designed to extend the application of the Medicare taxes, which have historically applied only to earned income, to most types of investment earnings of U.S. individuals, trusts, and estates. Thus, the new 3.8 percent Medicare tax, which is imposed in addition to regular income taxes, would apply to most types of investment earnings of a U.S. individual, including income or gains derived from investments in most types of private investment funds, including hedge funds. However, because of a few quirks in how section 1411 was drafted, there are some interesting features to how the rules apply to a U.S. individual's investment in a typical private hedge fund. These features depend largely on the structure of the investment in the fund (that is, as onshore or offshore).

Many private hedge funds solicit investment capital from a broad range of investors, including U.S. individuals and entities, U.S. tax-exempt investors (such as pension funds and university endowments), and non-U.S. investors. As a result, many hedge funds are structured through multiple entities, often referred to as master feeder or mini-master fund structures. For example, it is not unusual for a hedge fund to establish both a U.S. feeder and an offshore feeder. The U.S. feeder is a U.S. entity (usually taxed as a partnership) through which most U.S. taxable investors will invest their capital. The offshore feeder is a non-U.S. entity (usually treated as a corporation for U.S. tax purposes) through which the U.S. tax-exempt and non-U.S. investors will collectively pool their investment capital. The U.S. feeder and offshore feeder then will make either parallel investments or, perhaps more typically, further pool their collective funds in a master fund (usually treated as a partnership for U.S. tax purposes) through which all the hedge fund's investments are collectively made.

1. Investments in U.S. feeders. For a U.S. individual who invests in a hedge fund through the U.S. feeder, the application of the new 3.8 percent Medicare tax is fairly clear. Because the master fund and the U.S. feeder are each typically treated as a partnership for U.S. tax purposes, U.S. individuals investing in the U.S. feeder will report directly on their U.S. income tax returns, and pay U.S. income taxes on, their allocable shares of the U.S. feeder's and master fund's items of income, gain, profit, loss, or deduction as they are derived by the fund and regardless of the amount of any distributions received.[7] Income that is allocated to an investor in a partnership generally will retain its character for U.S. tax purposes. Thus, most types of income allocated to a U.S. investor in a hedge fund investing through a U.S. feeder (for example, dividends, interest, gains from the sale of stocks and securities, etc.) will be subject to the new 3.8 percent Medicare tax upon being allocated to the U.S. investor (that is, before distribution).[8] Similarly, gain from a U.S. individual's sale or redemption of his interest in the U.S. feeder will also be subject to the new 3.8 percent Medicare tax to the extent of the net gain that is attributed to the U.S. feeder's investment assets.[9]

2. Investments in offshore feeders. If the U.S. individual invests in a hedge fund through the offshore feeder, the offshore feeder would likely be treated as either a controlled foreign corporation or a passive foreign investment company for U.S. tax purposes.[10] The tax rules applicable to CFCs and PFICs are extremely complex, but generally speaking, they would require, for income tax purposes, that the U.S. investor report directly on his U.S. income tax return his allocable share of the offshore feeder's net income each year on a flow-through basis, regardless of the amount of any distributions.[11] Thus, a U.S. individual's investment in an offshore feeder achieves income tax treatment similar (although not identical) to the income tax treatment of his investment in a U.S. feeder.

However, the proposed regulations indicate that a different result would apply for purposes of the new 3.8 percent Medicare tax. The tax law has long

[6]Section 1411(c)(4).

[7]Sections 701 and 702.

[8]Section 1411(c)(1)(A)(i); *see also* prop. reg. section 1.1411-4(b)(3), Example 2 (describing an investment by a U.S. individual in a partnership that is actively involved in trading financial instruments).

[9]Section 1411(c)(4).

[10]*See* sections 951-965 (CFC rules) and sections 1291-1298 (PFIC rules).

[11]*See* sections 951 and 1293. If the offshore feeder is treated as a PFIC rather than a CFC, flow-through taxation of the U.S. investor will require that he file a tax election under section 1293 (known generally as a qualified electing fund (QEF) election). *See* section 1295. If the U.S. investor does not file the QEF election, he will not be taxed on a flow-through basis but instead will be taxed under an alternative set of rules that generally impose income taxes only when distributions are made to that investor from the offshore feeder or when he sells the investment. Those taxes generally will be imposed at ordinary income rates, plus an interest charge to compensate the U.S. government for the deferral. Section 1291. It is usually preferable for a U.S. individual investing in an offshore feeder that is treated as a PFIC to file the QEF election to be taxed on a flow-through basis rather than under the alternative set of rules.

provided that amounts included in taxable income by U.S. persons on a flow-through basis from CFCs or PFICs are not generally treated as dividends for tax purposes.[12] Because of that technicality, the IRS appears to have felt compelled to conclude in the proposed regulations that those income inclusions from offshore feeders are not described in any of the NII categories to which the new 3.8 percent Medicare tax applies, until those amounts are distributed (or until the shares in the offshore feeder are otherwise liquidated).[13] Thus, although income taxes would be imposed on the U.S. individual investing in the offshore feeder on a flow-through basis, the new 3.8 percent Medicare tax would not apply until distribution or liquidation of the shares. Perhaps recognizing the complexities involved in tracking two separate sets of taxes, the proposed regulations permit U.S. individuals investing in offshore feeders to file an election that would cause the 3.8 percent Medicare tax to apply on the same basis as the income tax on those amounts (that is, on a flow-through basis).[14]

C. Incentive to Move Offshore?

Although U.S. individual investors have historically invested in hedge funds through U.S. feeders, the ability to defer the payment of the new 3.8 percent Medicare tax until liquidity might give those investors an incentive to consider making their investments through the offshore feeder rather than the U.S. feeder. As noted above, however, the tax rules applicable to a U.S. individual's investment in an offshore feeder (the CFC and PFIC rules) are extremely complex and impose significant record-keeping and other administrative burdens, and significant potential penalties for noncompliance, not only on the investor, but also on the fund. These additional complexities and administrative costs may outweigh what is, at most, a fairly modest tax deferral benefit, depending, of course, on the length of the deferral.

Nonetheless, with non-trader funds,[15] there are other potential tax benefits for a U.S. investor who makes his investment through the offshore feeder rather than the U.S. feeder. These additional potential tax benefits relate to the deductibility of the management fee paid to the hedge fund manager.

A U.S. investor's allocable share of a management fee allocated through a U.S. feeder of a non-trader fund will likely be characterized under the tax law as a miscellaneous itemized deduction since it is not derived in an active trade or business.[16] A U.S. individual's ability to deduct miscellaneous itemized deductions is subject to significant limitations that can effectively render those amounts almost entirely nondeductible.[17] This nondeductibility of the management fee can significantly increase the overall effective tax rate paid by U.S. individuals investing in non-trader funds through the U.S. feeder because the U.S. investor will, in effect, be taxable on amounts that are being paid to the hedge fund manager.

By contrast, when a U.S. individual invests in a non-trader fund through an offshore feeder, the portion of the management fee paid by the offshore feeder is not considered a miscellaneous itemized

[12]*See, e.g.*, *Rodriguez v. Commissioner*, 137 T.C. 174 (2011), *Doc 2011-25643*, *2011 TNT 236-11*; *see also* REG-130507-11, *Doc 2012-24640*, *2012 TNT 232-15*.

[13]*See* prop. reg. section 1.1411-10(c). An exception would apply if the U.S. individual was himself engaged in an active business of trading securities and the income from the offshore feeder was derived in connection with that trading business. In that case, the proposed regulations take the view that the flow-through income from the offshore feeder would fall under section 1411(c)(1)(A)(ii) (describing income from a business of trading in financial instruments or commodities), and the 3.8 percent Medicare tax would thus apply on a flow-through basis as well. *See* prop. reg. section 1.1411-10(b).

[14]*See* prop. reg. section 1.1411-10(g).

[15]The U.S. tax law has long distinguished between investment funds that are considered to be traders and those that are considered to be investors or non-traders. The principal difference, for tax law purposes, is that a trader fund (because of active trading) is deemed to be engaged in an active trade or business, whereas a non-trader fund is not. In general, an investment fund will be considered a trader for this purpose if the fund's trading activities are frequent and substantial, and if the fund generally seeks profits from short-term market swings rather than long-term appreciation. *See, e.g.*, *Boatner v. Commissioner*, T.C. Memo. 1997-379, *Doc 97-24124*, *97 TNT 162-4*, *aff'd*, 164 F.3d 629 (9th Cir. 1998), *Doc 98-30312*, *98 TNT 200-10* (taxpayer deemed to be a trader when trading activities were ''frequent, regular and continuous''). By contrast, an investor or non-trader is one who purchases and sells securities with the principal purpose of realizing investment income in the form of dividends, interest, and gains from appreciation in value over a relatively longer holding period. *See, e.g.*, *Higgins v. Commissioner*, 312 U.S. 212 (1941); *King v. Commissioner*, 89 T.C. 445 (1987).

[16]Section 67(b).

[17]Those amounts are generally not deductible except to the extent that in the aggregate, they exceed 2 percent of the U.S. individual's AGI for the year. Section 67(a). In any event, miscellaneous itemized deductions are generally nondeductible for alternative minimum tax purposes. Section 56(b)(1)(A)(i). By contrast, for a U.S. individual investing in a trader fund through the U.S. feeder, the U.S. individual's allocable share of a management fee paid by the U.S. feeder would generally be fully deductible by the U.S. individual as a trade or business expense (*i.e.*, since the U.S. feeder itself is engaged in a trading business). *See, e.g.*, Rev. Rul. 2008-39, 2008-2 C.B. 252, *Doc 2008-14741*, *2008 TNT 130-11*.

deduction. Although the U.S. investor is generally required to report his allocable shares of the offshore feeder's net income and profits for tax purposes on a flow-through basis, it is only the net amounts that flow through under the CFC and PFIC rules.[18] In other words, under the CFC and PFIC rules, the offshore feeder first nets all its expenses and costs (even amounts that otherwise might be nondeductible to the U.S. investor if incurred by him directly or through a partnership) against its income, and only the net amounts are reportable to the U.S. investors on a flow-through basis. Thus, costs and expenses such as the management fee, which otherwise might be a nondeductible expense for the U.S. investor in a non-trader fund, become, in effect, fully deductible if incurred through the offshore feeder.[19]

Up until 2009, an investment in an offshore feeder by a U.S. individual likely would not have achieved the benefit of a deductible management fee because hedge fund managers typically deferred the payment of some or all of their annual management fees so they could defer their own U.S. income taxes on those amounts. Thus, before 2009, the U.S. investor in an offshore feeder would not have been permitted to deduct the management fee in this manner (even though it had accrued) because the payment was deferred. But because of changes to the tax law in 2009, U.S. hedge fund managers are generally no longer allowed to defer management fees from offshore feeders. As a result, most hedge fund management fees are now paid on a current basis, and those amounts are therefore deductible by U.S. investors in the offshore feeder.[20]

Certainly each situation is different, and each U.S. individual investing in any particular hedge fund will have his own specific tax and other circumstances to consider. Still, it would seem that the net effect of the 2009 tax law changes on management fee deferrals, combined with the approach taken in the recently proposed section 1411 regulations, should cause U.S. investors in non-trader funds to at least reconsider whether the investment in the offshore feeder, rather than the U.S. feeder, may be more beneficial after all.

D. Summary

Based on the approach outlined by the IRS in the proposed regulations, the exact application of the new 3.8 percent Medicare tax to U.S. individuals investing in hedge funds will largely depend on the structure of that investment (that is, onshore or offshore).

Generally speaking, for investments made through a U.S. feeder, the new 3.8 percent Medicare tax will typically apply to U.S. individuals on a current basis when the items of income and gain from the U.S. feeder are allocated to the U.S. individuals from the U.S. feeder for income tax purposes (that is, on a flow-through basis). By contrast, if the U.S. individual were to invest in a hedge fund through the offshore feeder, the new 3.8 percent Medicare tax typically would *not* apply until distributions were made by the offshore feeder or until the investment were otherwise sold or liquidated at a gain. Alternatively, the proposed regulations also provide U.S. individuals investing in the offshore feeder the ability to file an election that would cause the 3.8 percent Medicare tax to be applied on a flow-through basis (that is, similar to the treatment of an investment in the U.S. feeder) rather than upon distribution or liquidation.

Thus, an investment in an offshore feeder, as opposed to a U.S. feeder, benefits the U.S. individual investor in the form of a deferral of the obligation to pay the new 3.8 percent Medicare tax. Depending on the length of the deferral, that deferral benefit alone is perhaps relatively minor. After all, it's "only" a 3.8 percent rate. Moreover, there are significant complexities and administrative burdens and costs imposed not just on the investor, but also on the fund, for investments by U.S. individuals in offshore feeders. As a result, this relatively modest deferral benefit, while interesting, may not by itself be sufficient reason to cause a U.S. individual to invest in a hedge fund through an offshore feeder rather than a U.S. feeder.

However, there have been other tax law developments in the past three to four years that, at least for non-trader funds, have created additional potential tax benefits for U.S. individuals investing through the offshore feeder. For example, a U.S. individual investing in a non-trading fund through the U.S. feeder may not be permitted to take a tax deduction for its allocable portion of the fund's management fee paid to the hedge fund manager, whereas an investment in that fund through the offshore feeder may effectively permit such a deduction. Thus, at least for non-trader funds, the combined benefit of achieving full deductibility of the management fee, plus a potential deferral of the payment of the new 3.8 percent Medicare tax, may cause U.S. individuals to reconsider whether an investment in a hedge fund through the offshore feeder (as opposed to the U.S. feeder) may be more beneficial after all.

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[18] *See* section 1293.

[19] *Id.*

[20] *See* section 457A (generally applicable after December 31, 2008, no longer permits deferral of compensation payable from some types of non-U.S. entities, including most types of offshore hedge fund vehicles).

SUMMARY OF APPLICATION OF SE AND MEDICARE TAXES IN THE HEDGE FUND CONTEXT

Peter J. Elias
Jones Day
November 30, 2013

<u>Self Employment Taxes</u>

General Rules

- Generally applies to gross income derived by an individual from any "trade or business" carried on by such individual, less applicable deductions attributable to such trade or business. IRC § 1402(a). Also applies to an individual's distributive share of income (or loss) from any trade or business carried on by a partnership of which the individual is a member. IRC § 1402(a).

- The SE tax rates are actually quite complex.

  -- The "basic" SE tax rates for 2013 are as follows:

    -- 15.3%, applicable to net earnings from self employment in amounts up to $113,700 (this amount increases slightly each year). IRC § 1401(a) & (b)(1).

    -- 2.9% for amounts in excess of $113,700 (again, this amount increases slightly each year). IRC §§ 1401(a) & (b)(1); 1402(b).

    -- Beginning in 2013, an additional 0.9% tax is also imposed on SE earnings in excess of the "threshold amount." IRC § 1401(b)(2). The "threshold amount" means $250,000 for married individuals filing joint returns, $125,000 for married individuals filing separate returns, and $200,000 for single filers. Thus, the total rate on these amounts would be 3.8% (2.9% regular amount, plus 0.9% additional tax).

  -- One half of the SE taxes imposed each year (other than the 0.9% addition tax) is allowed as a deduction both for SE and income tax purposes. IRC § 164(f). Thus, the income tax savings generated by this tax deduction can reduce the "effective" rate of tax imposed on this income. (NOTE: By comparison, no portion of the new 3.8% tax imposed by Section 1411, discussed below, is deductible).

- Consistent with its focus on "earned" income (i.e, income from a trade or business), SE tax does not apply to any of the following:

  -- dividends on stock, interest on notes/debt, rents from real estate. IRC § 1402(a)(1) & (2).

  -- also exempt are gains from the sale of capital assets. IRC § 1402(a)(3)(A).

  -- Section 1402(a)(13) also exempts from SE tax a "limited partner's" distributive share of partnership income.

-- Section 1402(a)(13) was enacted back in the 1970's, prior to the creation of LLCs, LLPs and other "modern" entities and perhaps was more clear what is a "limited partner." No longer the case.

-- The recent case *Renkemeyer v. Commissioner*, 136 T.C. 137 (2011) held that persons who were formally designated as state law "limited partners" in a Kansas law partnership and who were active in the law business of the partnership were subject to SE taxes on their distributive shares of the partnership's income despite being "limited partners."

-- The *Renkemeyer* case relied on the legislative history and stated as follows:

> "….[T]he intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes."

-- 1997 Proposed Regulations have never been adopted as final, but taxpayers still refer (and rely) on them. These proposed rules generally state that an individual will be a "limited partner" for this purpose unless the individual either (a) has personal liability for partnership debts/claims by reason of being a partner, (b) has authority under the laws where the partnership is formed to contract on behalf of the entity, or (c) participates in the partnership's trade or business for more than 500 hours during the year. Prop. Treas. Reg. § 1.1402(a)-2(h).

Application to Hedge Fund Investors

- U.S. individual investors typically invest in hedge funds through "partnership" vehicles. These individuals would generally be exempt from SE taxes on their distributive shares of the hedge fund's items of income (i.e., dividends, interest, capital gains, and/or as distributive shares to "limited partners"). IRC § 1402(a)(1), (2), (3) & (13).

Application to Hedge Fund Managers

- U.S. individuals who manage hedge funds typically received two types of income from the hedge funds they manage: (1) First, they receive allocations from the funds, both as capital investors in the funds, and also in the form of incentive allocations, and (2) second, they receive fees from the funds, such as management fees and/or incentive fees.

- Amounts received by hedge fund managers as allocations from the hedge fund partnership (such as carried interest allocations and/or amounts received with respect to any amounts invested in the fund by the manager) would typically have the same character to the fund manager as such items have to the fund (e.g., dividends, interest, capital gains, etc.). As such, such amounts are typically exempt from SE taxes. IRC 1402(a)(1), (2) & (3) (exempting interest, dividends and capital gains).

- Amounts paid to the hedge fund manager as fees from the hedge fund (such as management fees, incentive fees, etc.) generally would be considered to be earnings from a trade or business and thus generally are subject to SE taxes. *See, Renkemeyer, supra* (fees for services are "generally included in calculating net earnings from self-employment, unless an exclusion applies."). Hedge fund managers have historically utilized various structures in an attempt to minimize the amount of SE taxes imposed on such fees, including the following:

  -- Formation of hedge fund management entity as a "limited partnership" under state law. The individuals who own the management entity would own their interests as "limited partners" (with a separate entity formed to serve as the GP) and take the position that Section 1402(a)(13) therefore exempts them from SE taxes on their allocable shares of the entity's fee income. This position was probably dubious, at best, even prior to the *Renkemeyer* decision, and is even more so afterwards.

  -- Formation of hedge fund management entity as an "S" corporation. The S corporation receives fees from the hedge fund and then pays salaries to individual/shareholders of the S corporation. Although salaries are wages subject to employment taxes, the "net" fee income remaining in the S corporation after payment of salaries would be distributed to the owners of the S corporation and would not be subject to SE taxes. *See e.g.*, Rev. Rul. 59-221 (amounts passing through to S corporation shareholders not subject to SE taxes). This strategy is sometimes viable, though it is often difficult to justify salaries low enough to achieve meaningful SE tax savings. Also, some states (i.e., California) tax net profits of an S corporation, thereby offsetting any such savings in any event.

  -- Management fee waivers. Some hedge fund managers from time to time will "waive" their rights to receive management or other fees from the hedge fund and, in lieu thereof, will receive an additional profits interest in the fund. Since profits interests are generally structured as allocations of items of profits/gain from the fund which retain their tax character (*i.e.*, as dividends, interest and/or capital gains) to the fund manager, such amounts would convert what otherwise would be a fee subject to SE taxes into an item which is exempt. 1401(a)(1), (2) & (3). This strategy is also viable, though there are technical issues with achieving a valid "waiver" of the fee for tax purposes. (Also, such amounts now subject to 1411 tax, as discussed below).

New Section 1411 Taxes

General Rules

- Effective for tax years beginning 1/1/13, Section 1411 generally imposes a new 3.8% tax on the "net investment income" derived by U.S. individuals and certain trusts and estates. IRC § 1411(a). But the tax won't apply in any year unless the taxpayer's modified adjusted gross income for the year exceeds certain threshold amounts (i.e., $250,000 for married persons filing joint returns, $125,000 for married persons filing separate returns, and $200,000 in other cases). IRC § 1411(b).

- The key to Section 1411 is the definition of "net investment income," which is almost indecipherable on first reading as the statute is very confusingly laced with double (and triple) negatives. Thus, careful review of the statute (and regulations) is required in any particular case. Suffice it to say, however, that the general intent of Section 1411 was to impose an equivalent 3.8% tax on most types of "investment" income. Consistent with this intent, the term "net investment income" generally covers the following items (net of allocable deductions):

  -- interest, dividends, annuities, royalties, rents, and gains from the sale of property, except to the extent derived from a trade or business (other than trading in financial instruments and commodities) in which the taxpayer was "active" during the year;

  -- gross income derived from a business consisting of "trading in financial instruments or commodities" (e.g., a hedge fund);

  -- gross income derived from an activity which is a trade or business but with respect to which the taxpayer was "passive" during the year (e.g., an investment by an individual in an LLC which is engaged in an active trade or business but with respect to which the taxpayer is passive). IRC § 1411(c)(1).

- In short, the SE taxes are imposed on most type of "earned" income (i.e., income derived by individual from the active conduct of a trade or business) whereas new Section 1411 is aimed at imposing an equivalent 3.8% tax on most types of "unearned" income (i.e. most types of typical "investment" income and gains). Thus, although no type of income will be subject to both taxes, very few types will be exempt from both. *See* IRC § 1411(c)(6) (stating that "net investment income" does not include any item taken into account in determining self-employment income under Section 1401(b)).

Application to Hedge Fund Investors

- Hedge funds were one of the main targets of Section 1411 as they generally earn the types of income (e.g., interest, dividends, capital gains, etc.) to which the new 3.8% tax applies. *See* IRC § 1411(c)(2)(A).

- U.S. individual investors typically invest in hedge funds through "partnership" vehicles. The character of the items derived by the hedge fund (e.g., interest, dividends, capital gains) would flow through to the U.S. individual investors in the hedge fund partnership. Thus, such U.S. individuals would be subject to the 3.8% tax under Section 1411 based on their allocable shares of these items from the hedge fund (regardless of whether such items are actually distributed). *See e.g.*, Prop. Treas. Reg. § 1.1411-4(b)(3), Ex. 2.

  -- Due to a technical glitch in the drafting of the statute and proposed regulations, there currently is some doubt as to whether a investors in a "trader" fund will be permitted to net the hedge fund's trading losses against trading gains for this purpose. The IRS has indicated that final regulations will take into account proposed fixes to this glitch. *See*, Amy S. Elliott, "Tax 'Glitch' Disallowing Traders' Losses is Proving Hard to Resolve," *Tax Notes*, May 23, 2013.

  -- Income from derivatives is not clearly covered by the language of the statute. The Proposed Regulations state that "substitute" interest and dividends are treated like "regular" interest and dividends for purposes of Section 1411 (i.e., the 3.8% tax applies to such amounts). *See* Preamble at 72618. Income from notional principal contracts (*e.g.* swaps) derived by "trader" funds would be included as net investment income subject to the 3.8% tax pursuant to Section 1411(c)(1)(A)(ii). However, it appears that income from notional principal contracts which are derived by "non-trader" funds would not be included and thus would be exempt from the tax. On the other hand, non-trader funds are not likely to be making substantial investments in notional principal contracts due to limitations on ability of non-traders to deduct certain losses relating to such transactions.

- In the event that a U.S. individual were to invest in a hedge fund through a non-U.S. corporation (such as through an offshore feeder vehicle), a very different set of rules applies:

  -- If a U.S. individual invests in a hedge fund through a non-U.S. corporation (e.g., such as an offshore feeder fund), the non-U.S. corporation is likely to be treated for U.S. tax purposes as either a controlled foreign corporation ("CFC") or a passive foreign investment company ("PFIC") with respect to such individual (and, if a PFIC, it is usually advisable for the U.S. individual to file an election with the IRS for that PFIC to be treated as a qualified electing fund (or "QEF")). As a result, for ***regular*** U.S. federal income tax purposes, the income and gains from the CFC/QEF would generally be directly taxable to the U.S. individual for U.S. tax purposes on a "flow-through" basis. These amounts are sometimes referred to as CFC or QEF inclusions.

  -- Nonetheless, for purposes of Section 1411, the drafters of the proposed regulations seem to have been concerned that the language of the statute technically does not describe CFC or QEF inclusions in its definition of "net investment income." Therefore, the proposed regulations provided that CFC and

QEF inclusions are not covered by Section 1411. However, when the CFC or QEF makes an actual distribution of those amounts to the U.S. individual (or when the U.S. individual sells, redeems or otherwise disposes of her shares in the corporation at a gain), such amounts would be included in net investment income as of such time. *See* Prop. Reg. § 1.1411-10. In other words, U.S. individuals who invest in hedge funds through non-U.S. corporations may receive the benefit of a deferral of the payment of the 3.8% tax, as compared to an investment through a partnership vehicle.

-- Perhaps in recognition of the resulting complexity of a U.S. investor in a non-U.S. corporation having to maintain and keep track of (at least) two separate sets of books (i.e, one for "regular" tax purposes and a second for Section 1411 purposes), the proposed regulations allow taxpayers to file an election that would cause the 3.8% tax under Section 1411 to apply on the same basis as the income tax on those amounts (that is, on a flow through basis). *See*, Prop. Reg. § 1.1411-10(g).

Application to Hedge Fund Managers

- As noted above, U.S. individuals who manage hedge funds typically received two types of income from the hedge funds they manage: (1) First, they receive allocations from the funds, both as capital investors in the funds, and also in the form of incentive allocations, and (2) second, they receive fees from the funds, such as management fees and/or incentive fees.

- Amounts received by hedge fund managers as allocations from the hedge fund partnership (such as carried interest allocations and/or amounts received with respect to any amounts invested in the fund by the manager) would typically have the same character to the fund manager as such items have to the fund (e.g., dividends, interest, capital gains, etc.). As such, such amounts, to the extent allocable to U.S. individuals owning interests in the fund management entity, would typically be included as "net investment income" subject to the new 3.8% tax under Section 1411 on the same general basis as applied to investors in the hedge fund (see above).

- By contrast, amounts paid to the hedge fund manager as fees from the hedge fund (such as management fees, incentive fees, etc.) generally would be considered to be earnings from a trade or business (i.e., investment management). *See e.g.*, *Dagres v. Commissioner*, 136 T.C. 262 (2011). Thus, these amounts likely would be exempt from the 3.8% taxes imposed by Section 1411.

  -- Although exempt from the Section 1411 tax, such amounts likely will be subject to SE taxes (described above). Still, it may be preferable for hedge fund managers to subject their income to the SE tax rules rather than Section 1411. There are two potential reasons for this:

- -- First, as noted above, there are various structures that can sometimes be utilized to minimize SE taxes (i.e., limited partnership structures and/or S corporation structures, etc.).

- -- Second, although the maximum SE tax rates are the same as the Section 1411 rate (i.e., 3.8% in both cases), the "effective" rate under the SE tax rules may actually be lower due to the ability to deduct for income tax purposes certain portions of the SE taxes imposed each year. *See*, IRC § 164(f). By contrast, no portion of the 3.8% tax paid under Section 1411 is deductible by the taxpayer.

-- In certain cases (e.g., hedge funds which do not earn any significant amounts of qualified dividend income nor long-term capital gains), consideration might be given to converting incentive allocations into incentive fees based on what may be a slightly beneficial effective tax rate applicable to individual managers under the SE tax rules as compared to Section 1411.