



Tax Aware

Limitation on Trader Fund Losses under the CARES Act of 2020

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Hedge funds are characterized by a significant complexity of their tax attributes. In this paper, we explain how hedge fund investors might be affected by a *limitation on excess business losses* codified in a new IRC Section 461(l), introduced as a part of the TCJA of 2017 and later amended by the CARES Act of 2020. In order to allocate business losses a hedge fund must be a trader fund. We thus discuss what makes a hedge fund a trader fund, whether management and performance fees of a trader fund are deductible as trade or business loss, and whether trader fund losses constitute passive activity losses. After explaining the relationship between hedge fund losses and business losses, we illustrate with simple examples how the new provisions of the CARES Act under Section 461(l) may affect hedge fund investors. We find that compared to TCJA some of these new provisions are beneficial while others are detrimental to investors. On the balance, Section 461(l) remains punitive, uneconomic, and unnecessary.

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