TAX MATTERS

All Is Not Lost: Trader Fund Losses under the CARES Act

October 6, 2021

The Tax Cuts and Jobs Act (TCJA) of 2017 added a new section to the tax code, Section 461(l), which limits the deductibility of business losses for years 2018 to 2025. Soon after, the CARES Act repealed this section for 2018 to 2020 and amended it for 2021 to 2025. In a recent paper, we explain the impact of these changes on taxable investors, especially those considering an investment in hedge funds.

Hedge funds are commonly perceived as investments that allocate large amounts of taxable capital gains and income to their investors. *But what if a hedge fund realizes a taxable loss?* Under the new rules in the TCJA and the CARES Act, can hedge fund investors still benefit from tax offsets offered by realized losses and deductions—and to what extent?

Hedge fund losses are treated as trade or business losses if a hedge fund determines that it is engaged in a *trader* rather than an *investor* activity. The benefit of a *trader* determination is the deductibility of fees and other fund expenses (which are not deductible for hedge funds treated as *investor* funds under the TCJA and the CARES Act). However, there is also a cost to the trader fund determination: their losses can trigger a new excess business loss limitation for years 2021 to 2025. Translation: their losses might not be deductible. This creates a quite unpleasant asymmetry for a taxpayer who pays taxes on gains and income but cannot use losses as a deduction.

To clarify, the limitation on excess business losses is a limitation on aggregate loss from all trade or business activities not on a loss from an individual trade or business activity.[1]

There is good news and there is bad news, but the bad news may not be all that bad. Let us explain.

The good news is that the CARES Act has explicitly excluded *capital* losses from the calculation of excess business loss limitation, such that the limitation only applies to *ordinary* excess business loss.[2]

> "Excess ordinary business loss can still offset a combined income from employment and investor activity up to a safe harbor amount"

The bad news is that under the CARES Act, income from employment (such as wages) is explicitly excluded from trade or business income, and thus cannot be offset by trade or business losses without limitation.

> "Any remaining excess business loss is carried forward…this loss can be deducted against any ordinary income in future years"

But, as we said, the bad news might not be that bad. Excess ordinary business loss can still offset a combined income from employment and investor activity[3] up to a safe harbor amount of $250,000 ($500,000 for married filing jointly) adjusted for inflation. Any remaining excess business loss is carried forward as a net operating loss. Under the CARES Act, this loss can be deducted against *any* ordinary income in future years, including income from employment and investor activity, this time without the excess business loss limitation.[4]

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[1] For example, if in a given year the taxpayer has a $1,000,000 ordinary income from operating businesses and a $1,500,000 ordinary loss from various hedge fund investments, the hedge fund loss fully offsets the operating business income, and the aggregate excess business loss is only $500,000.

[2] This ordinary excess business loss is computed at the investor level by adding together ordinary income and losses from all the investor's trade or business activities, including trader hedge fund investments.

[3] Some examples of income from investor activity are interest from taxable bonds, various forms of private credit, and ordinary dividends from stocks, mutual funds, and ETFs.

[4] There is currently a proposal to disallow this unlimited offset as a part of the upcoming tax reform. Whether this proposal is eventually enacted in law or not remains to be seen. We recommend our readers to stay abreast of the potential changes to Section 461(l).

Risks of Tax Aware Strategies (Not Exhaustive)

1. **Underperformance of pre-tax returns**: tax aware strategies are investment strategies with the associated risk of pre-tax returns meaningfully underperforming expectations.

2. **Adverse variation in tax benefits**: deductible losses and expenses allocated by the strategy may be less than expected.

3. **Lower marginal tax rates**: the value of losses and expenses depends on an individual investor's marginal tax rate, which may be lower than expected for reasons including low Adjusted Gross Income (AGI) due to unexpected losses and the Alternative Minimum Tax (AMT).

4. **Inefficient use of allocated losses and expenses**: the tax benefit of the strategy may be lower than expected if an investor cannot use the full value of losses and expenses allocated by the strategy to offset gains and income of the same character from other sources. This may occur for a variety of reasons including variation in gains and

income realized by other investments, at-risk rules, limitation on excess business losses and/or net interest expense, or insufficient outside cost basis in a partnership.

5. **Larger tax on redemption or lesser benefit of gifting**: gain deferral and net tax losses may result in large recognized gains on redemption, even in the event of pre-tax losses. Allocation of liabilities should be considered when calculating the tax benefit of gifting.

6. **Adverse changes in tax law or IRS challenge**: the potential tax benefit of the strategy may be lessened or eliminated prospectively by changes in tax law, or retrospectively by an IRS challenge under current law if conceded or upheld by a court. In the case of an IRS challenge, penalties may apply.