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ObamaCare tax lacks truth in labeling for hedge fund managers

Professional traders won't find it easy to dodge this levy. By Kevin Brandon and Brian Farmer

Starting this year, Medicare taxes will increase and expand, with a new Unearned Income Medicare Contribution kicking in to tax the lesser of net investment income or adjusted gross income (after additional adjustments) above certain income levels.

Most Americans will not be hit by this new 3.8% tax, and even for those higher income Americans who are, investment income is a fraction of total income and by far the "lesser" amount subject to the tax. As a result, this investment income tax sometimes referred to as the "Obamacare tax" has floated under many people's radar. But for hedge fund managers, net investment income makes up the bulk of their total income, and the following briefly explores how the stealth packaging of this new tax belies a targeted attack on hedge fund managers' bottom lines.

The new tax was passed by Congress as part of the 2010 Health Care Reform Act to help resuscitate the country's increasingly inadequate coffers funding Medicare payments. Many voters and media commentators assume the revenues generated by the tax will go to the pool of money used to pay for Medicare, but amounts collected under this tax are not headed for the Medicare Trust Fund. Like most other taxes, they will fall into the General Fund of the United States Treasury. While tax dollars are fungible, it is clear that this tax is a Medicare Contribution in name only.

Further, the term "unearned income" generally is reserved for capital gains and passive income such as interest, rents, royalties, dividends and the like that accrue to investors and property owners (for the use of investors' cash or


Kevin Brandon


Brian Farmer

owners' property) rather than through the provision of goods and services to the public. The new Obamacare tax is very clear that income earned in a passive trade or business, as well as, income from a trade or business of trading in financial instruments and commodities, will be taxed. Income from a non-passive trade or business is generally excluded from the new tax. Why is the income earned for services provided by hedge fund managers and other financial professionals expressly included among passive/unearned income subject to tax? Because otherwise most hedge fund manager income and gain would escape the tax under the "non-passive business" exclusion available to other industries.

Let's take a step back and mention a Supreme Court case discussed in the Explanation to the Proposed Treasury Regulations on the new tax. The Higgins case established that managing your own investments does not constitute a trade or business regardless of the level of your "sweat equity" or extent of your investments. The Explanation's discussion of Higgins reminds us that any individual taxpayer's investment activities are not a trade or business and so income earned from these investments does not escape the tax under the "non-passive business" exclusion.

By contrast, substantial trading activities in financial instruments and commodities can constitute a non-passive trade or business. Having no Tax Code definition of a trade or business, the new tax borrows from existing case law which generally requires a facts and circumstances analysis looking for (i) a profit-motive, and (ii) "considerable, regular, and continuous" activity in pursuit of profit. Many hedge fund managers would fit within this definition (and even more would try), and so to eliminate their use of the generally available "non-passive" trade or business exclusion, "net investment income" for purposes of this new tax expressly includes income from trading in financial instruments and commodities.

This is the case despite the potential that essentially similar business activities of managers of private equity funds and real estate funds may escape the imposition of the tax with the right business structure and sufficient direct participation in their funds' underlying portfolio businesses. Perhaps even more surprisingly, real estate fund managers may sidestep the tax despite the Code treating real estate rental income as per se passive income.

So why the disparate treatment? The passive activity rules under the tax code (the principals of which are largely adopted by the new tax) recognize that at some requisite level of activity, what is otherwise passive income ceases to be passively generated. For example, if your activities are sufficient to make you a "real estate professional," the rental income generated by your "material participation" in the ordinary course of your real estate business is not "net investment income." These rules can keep certain real estate and private equity manager income from the reach of the new tax.

The key distinction in treatment is that the real estate and private equity industries were not expressly called out in the text of the Obamacare tax. When the bill was constructed in 2010, it was not a politically opportune time to target the real estate market as it limped back from the 2008 meltdown, while big hedge fund managers were in Washington's crosshairs. With even less sympathy out there following the Presidential election and throughout the continuing Congressional fiscal wrangling, taxing carried interest at ordinary income rates (plus 3.8%) may not be too far down the road.

Kevin Brandon and S. Brian Farmer are partners at law firm Hirschler Fleischer in Richmond, Virginia