IRS ISSUES DOG U.S. HEDGE FUNDS

Hedge funds face a Catch 22 when complying with tax laws: Scrupulous compliance with laws surrounding wash sales and other transactions requires retaining the services of an outside tax accounting firm, which for smaller funds can be prohibitively expensive. Yet without such outside help, fund managers run the risk of an IRS audit.

"Unlike individual investors who unwittingly engage in wash sales, hedge funds have both the means and the knowledge to deliberately engage in wash sales, and therefore are more likely to be the target of an IRS audit," George Michaels, CEO of G2 Systems, told Markets Media.

G2, a software and consulting firm that provides accounting services for hedge funds, provides a software product, TaxGopher, which ensures that a hedge fund's tax reporting is compliant with IRS regulations.

Wash sales—which involve selling a security to capture a loss for tax purposes, and then immediately the security—have been illegal for decades, but vagueness in the wording of the law has enabled variations of the wash sale to continue to the present day, including the use of derivatives, resulting in a game of cat-and-mouse between taxpayers and the IRS.

While technically not a wash sale, derivatives served the same purpose. "For decades, people would sell off losing stocks and buy a swap or a deep in the money call option," said Michaels.

The IRS didn't close that loophole until 1997, along with other loopholes such as selling a position at one brokerage and purchasing the identical position at another brokerage.

Congress has attempted to curb wash sales abuse by requiring brokers to explicitly identify wash sale transactions on customer statements. But the reports that brokers provide fail to capture the more sophisticated transactions. "The way that broker-dealers calculate wash sales doesn't address the loopholes that the IRS closed in 1997, so their statements aren't IRS-compliant," Michaels said.

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