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Wash sales: A lurking issue

Private equity firms executing misleadingly named 'riskless transactions' may be catching the attention of market watchdogs, warns George Michaels of G2 FinTech

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Recently, the US Commodity Futures Trading Commission (CFTC) sued Royal Bank of Canada for committing fraud by executing a series of riskless transactions (or wash trades). From this incident, it's clear that the CFTC is stepping up its pursuit of riskless transactions, searching more aggressively for tax abuse and evasion.

Similarly, the Securities & Exchange Commission (SEC) is pushing, and being pushed, to do the same in its arena. But, what does that have to do with private equity? As recently registered entities with the SEC, private equity and alternative asset firms will be targets of increased scrutiny for corporate fraud and tax evasion issues. Like the recent case with the CFTC, if the SEC sees something that looks like a riskless transaction, then regardless of the logic for the transaction, it needs to be examined for tax abuse or tax evasion.

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So what exactly is a riskless transaction? And how does it relate to wash sales? To start, a wash sale is defined as a set of trades designed to generate artificial capital losses by selling a security and immediately buying it back. A 'wash sale' specifically refers to section 1091 of the US Tax Code. This section governs wash trades done specifically to artificially generate short term capital losses. A riskless transaction is any trade, or set of trades, that generate no net risk for the entity executing the transaction. Basically, riskless transactions shuffle the papers around on the table without really adding or removing anything. Buying the same security back immediately after selling it is a prime example of a riskless transaction. But, the catch is, there really is a risk to these "riskless" transactions. In most cases, there can be negative tax consequences set into motion or in more serious cases IRS laws broken if these gains and losses are not properly reported on.

To understand how this tax issue surfaces in the private equity space, it's important to note the key differences between private equity shares and public equities trading. In the case of private equity, these are firms investing money in entities, so it is different from the classic trades discussed in the alternative investments space in which any investor can buy stock in a company. In the case of private equity, there are different classes of shares, for example, shares that come with voting rights and shares that do not include voting rights. As access to private equity shares becomes available to new investors, the initial set of investors may see the classes of shares available increase from one class to two classes or two classes to three classes, and the next wave of investors may see yet another set of classes emerge - all defined by different attributes.

So how does the existence of different classes of private equity shares put investors at risk of triggering a riskless transaction?

This private equity structure provides the perfect opportunity for an unintentional wash sale to occur. Private equity firms will see this tax consequence come into play when exchanging or trading one class of shares for another. For example, a private equity investor might sell an equity with voting rights, and then buy an option on that equity, with non-voting rights. It is possible that the SEC might view this as a wash sale if an investor buys and sells equity in the same company to move from one class to another. If the SEC were to view this as a riskless transaction, with the added pressure to hunt down any potentially riskless transactions, it might behave in a manner similar to the way the CFTC reacted to the RBC case.

As a result of recent times and cases like RBC, there is an obvious need for increased enforcement by the CFTC and SEC to monitor firms' transactions for tax abuse/evasion purposes and an increased expectation from the IRS that companies will have technology solutions in place to make sure that these types of transactions are being reported appropriately by all firms. As the most newly regulated entities in an increasingly regulated marketplace, private equity firms will need an acute awareness of complex tax issues and how they might be triggered because when the IRS or the SEC reviews its transaction, there really is no such thing as riskless.

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