

## Derivative basket options questioned

*Expect a dramatic increase in hedge fund audits, especially since only 1% were examined in 2012*

The Senate Permanent Subcommittee on Investigations has turned its attention to a derivative strategy that, from a tax standpoint, was rendered unusable in an earlier IRS memo.

I attended the July 22<sup>nd</sup> hearing and was not very surprised by the information presented about the “basket option” transactions in question. What did make an impression was the focus on how few “large partnerships” were actually being audited, and the call for more audits from both sides of the aisle.

The transaction that was the subject of IRS Advice Memo 2010-005 was a derivative on a managed portfolio. The tax concept built on the fact that a derivative on the S&P 500 looks only to the price performance of the index and ignores any underlying changes in the composition of the S&P 500.

If that is so, can a derivative on a managed account also avail itself of that privilege? And if a derivative on a managed account ignores portfolio activity, how about if the owner or related entities of the derivative make the decisions on those portfolio changes, as was the case in the IRS memo?

The government did not think the taxpayer could push the non-recognition issue that far. There was also an issue as to whether or not the derivative was really an option. According to testimony at the hearing, these issues are still being debated with at least one taxpayer (Renaissance Technology).

The Government Accountability Office was asked to report on their work on “large partnership” audits, first released in March and updated for the hearing. A “large partnership” is defined as having \$100 million or more in assets and 100 or more direct and indirect partners. James R. White of the GAO reported that less than 1% of large partnerships were audited in 2012, versus 27% of large corporations. There were 14 audits of the 502 partnerships with more than \$1 billion in assets.

Mr. White testified that “in three of the seven years, the total adjustments from the field audits were negative.” That's right, the audits that were done cost the government money — hundreds of millions of dollars in 2013.

Reasons cited for the low audit rate were rules “required by the Tax Equity and Fiscal Responsibility Act of 1982 and the complexity of large partnership structures due to tiering and the large number of partners.” I would expect a reworking of TEFRA to give the IRS more time to do its work. I also expect the audit rate to jump substantially for large partnerships such as hedge funds and private equity funds.

Why should we care? A lot of possible issues could wreak tax havoc on investors. If a large partnership is audited and the IRS makes changes, those will pass through to the partners, who will receive an amended K-1. A road map of possible areas for audit is in Chapter 12 of the IRS partnership audit guide issued in 2002.

Let's explore what could happen when the IRS audits a hedge fund that has filed its returns as if it were a securities trader rather than being “just” an investor. Traders are allowed to deduct expenses above the line; investors are not. Investors' investment expenses are treated as miscellaneous itemized deductions that most of our clients cannot utilize.

The audit manual suggests the auditor get a copy of the private-placement memo and see what it states the strategies are that the partnership will employ. If the activities are not limited to short-term market swings, the auditor is instructed to explore whether that fund really is a trader.

As an example, let's look at the K-1 of a fund that charges a 1% management fee and a 20% performance fee, and has an 11% gross return. Once you remove the fees, the net return is 8%. A trader fund reflects only that 8%. An amended investor fund K-1 would show 11% in taxable income and 3% in fees that most can't deduct. Investors will have to pay a tax on 11% when they made only 8%. The next few years could prove interesting in partnership tax land.