



Tax

IRS “Managed Funds Audit Team” Steps Up Audits of Hedge Funds and Hedge Fund Managers, and Investigations of Hedge Fund Tax Compliance Issues

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By Jennifer Banzaca, *Hedge Fund Law Report*

The hedge fund industry has found itself in the crosshairs of various regulators and legislators recently, with a spate of bills and proposed regulations relating to governance of the industry. What's less known, yet equally if not more relevant, is that the Internal Revenue Service (IRS) has a managed funds audit team that was created two years ago and is currently stepping up its audits of hedge funds and hedge fund managers and its investigations of hedge fund tax compliance issues. (The unit also focuses on private equity funds and their managers.) The IRS noted in a statement: “The service seeks to identify any areas of possible non-compliance in the income tax reporting of hedge fund and private equity fund investors and managers, as well as possible non-compliance in the reporting of withholding obligations.”

The managed funds audit team focuses on areas such as compliance with filing requirements, income recognition, characterization of income as ordinary or capital gains, the flow of funds between onshore and offshore entities, the allocation and timing of incentive payments and other income and the accounting methods used to reflect and record income. The IRS has focused significantly on training auditors on tax issues related to the hedge fund industry. Within the hedge fund industry, tax audit activity has increased in the last year. In September 2008, hedge funds experienced the team's first real push to conduct audits.

Viva Hammer, a Partner at Crowell & Moring LLP, noted: “They started a pilot program to perform some audits just to work out if they were up to the task of auditing hedge funds. In their initial audits, the IRS had discovered all sorts of issues, including managers who had never filed tax returns. Now with the success of the pilot program, there are many, many audits being done. Clearly the program, in their estimation, was successful enough for them to go forward and do a lot of audits.”

Formation of the Managed Funds Audit Team

The impetus behind the formation of the managed funds audit team was primarily to test compliance with the tax laws by participants in the industry. Given the additional scrutiny of hedge funds by other regulatory bodies in recent years, the IRS may also have been under some pressure to increase their audits of hedge funds as well, noted Michael Andreola, a Tax Partner

at BDO Seidman, LLP. Given its lack of exclusive focus on the industry in the past, the IRS also created the team to better acquaint itself with how hedge funds operate, Andreola said. (The SEC has taken similar autodidactic measures.)

Philippe Simoens, Tax Senior Manager at accounting firm Weaver and Tidwell LLP, added that in light of the various issues that are unique to hedge funds, such as side pocket allocations, investing versus trading income, etc. – the IRS needed to provide customized training to a specific group of auditors. Added Hammer, “the IRS realized they had no involvement in the industry whatsoever. They had not done audits and had no knowledge of the industry. The IRS then set up a team to begin the process of teaching people to audit hedge funds that to this point had been virtually unaudited.”

According to Ted Dougherty, a Partner with Deloitte Tax LLP: “I think there are probably two distinct but related issues which probably led to the IRS putting this team together. One was the use of deferred compensation structures by hedge funds managers to their offshore funds. The second was the significant volume of either reportable transaction or tax shelter disclosures that the IRS received from the hedge fund community starting in 2004. Both of those, I think in the IRS’ mind, signaled that there is something going on that might result in increased revenue if they pursued it.”

What Might Trigger an Audit?

With hedge funds now on the radar of the IRS and its managed funds audit team, hedge fund managers are asking what might trigger a tax audit. Hedge funds could be selected for audit for any number of reasons, such as a referral from another law enforcement agency, spillover from an audit of an investor, a complaint filed by an investor or late filing of a tax return. Or an audit can be random. Importantly, a manager need not be registered with the SEC as an investment adviser to be subject to a tax audit.

Deloitte’s Dougherty added, “the tax shelter reporting put a lot of the larger hedge fund managers on the radar screen and that triggered a bunch of examinations. I think it’s also reasonable to assume that articles in the press could also trigger an IRS audit. Hedge fund managers have been getting a lot of press over the last four or five years. Once a hedge fund manager’s name is in the news regularly as being aggressive in a particular area, I have to believe there is someone at the IRS looking at those things and it puts the hedge fund manager on their radar.”

Key Areas of Focus

In its hedge fund tax audits and examinations, the IRS may look into whether the fund engaged in transactions primarily for tax purposes as opposed to business purposes. The IRS may also look into manager compensation issues, especially in light of new Internal Revenue Code (IRC) Section 409A rules. For more on hedge fund tax rules, see [“Hedge Fund Managers Using ‘Mini-Master Funds’ to Retain Favorable Tax Treatment of Performance-Based Revenue from Offshore Funds,”](#) Hedge Fund Law Report, Vol. 2, No. 22 (Jun. 3, 2008); [“IRS Releases Further Guidance Affecting Offshore Hedge Fund And Other Pooled Investment Vehicle Deferrals,”](#) Hedge Fund Law Report, Vol. 2, No. 6 (Feb. 12, 2009); [“The End of Deferral As We Know It: The New Rules Prohibiting the Deferral of Compensation Paid to U.S. Managers By Off-Shore Hedge Funds,”](#) Hedge Fund Law Report, Vol. 1, No. 23 (Oct. 28, 2008).

BDO Seidman's Andreola explained that the audit team could also look at the individual tax returns of the general partners and management of the hedge fund. "The audit team has a large scope of issues they will be looking at, from the tax implications of offshore funds of U.S.-based managers, to the structure of the partnership agreements. They're looking at the auditor reports, trading activity and how the management fee is computed."

Added Hammer, of Crowell & Moring: "They look at trade tickets and the kind of information that would generate income or deductions. They're going to look at complicated tax laws like the straddle rules and whether a hedge fund complies with these rules. They're looking at foreign currency activity to make sure hedge funds are complying with those rules. They're also looking at whether you're complying with the partnership rules, which is the major source of difficulty in the hedge fund area."

Deloitte's Dougherty also noted, "I think the IRS is likely to focus in two areas, first where they have announced an issue as a "Tier 1" or priority issue, such as information reporting, and second, where an increase in taxes results in permanent revenue to the government. Wash sales and straddles are loss deferral rules but ultimately the taxpayer will get the loss. Constructive sales are a gain acceleration rule and ultimately they would have the gain anyway. So, these don't result in any permanent revenue recognition to the government. They're also very complex in their application and in an actively traded hedge fund it's hard to apply the rules. I think it would be very difficult for the IRS to audit those issues, so they are less likely to audit them."

Wash sales refer to the purchase and sale of a security, either simultaneously or within a short time, often in order to recognize a tax loss without altering an economic position. Wash sale rules apply to long and short positions and are governed by IRC Section 1091. The IRC wash sale rules mandate that losses cannot be recognized if the same or substantially identical security is purchased within a 61-day period, 30 days before or after the wash sale loss transaction. The deferred loss is added to the basis of the replacement securities. The losses will only be realized when the replacement securities are subsequently sold.

Straddles generally occurs when a hedge fund holds two or more offsetting positions in stocks, securities, options contracts, futures or forwards contracts whose positions, when considered together, have the effect of reducing the hedge fund's risk of loss. Under IRC Section 1092, a taxpayer's share of a hedge fund's straddle losses are deferred to the extent the taxpayer has unrealized gains in offsetting straddle positions.

Offshore Concerns

For hedge funds that also manage offshore entities, the two biggest areas of concern for the IRS would be deferred compensation and the use of swaps and other derivatives to avoid withholding tax.

The managed funds audit team could also look at foreign currency activity to make sure hedge funds are complying with applicable rules in that area. If a fund manages a foreign entity, the audit team will also be investigating whether the entity has effectively connected income (ECI) with the United States. ECI tax only applies to foreign persons that carry on trades or businesses in the United States.

The audit team will also be looking at unrelated business taxable income (UBTI) issues, Hammer noted. Tax-exempt investors are subject to additional rules on UBTI. If the fund uses leverage (in a domestic-only fund structure), the tax-exempt investor may be subject to tax on the UBTI to the extent the UBTI is generated by leverage. For more on UBTI issues, see "[Congress](#)

Introduces Legislation That Would Tax Offshore Hedge Funds as U.S. Corporations,” Hedge Fund Law Report, Vol. 2, No. 14 (Apr. 9, 2009)

Weaver and Tidwell’s Simoens said the audit team is looking at offshore structures out of concern that managers are abusing the master-feeder structure. “Not only can foreign investors benefit from that structure but also large tax-exempt entities in the U.S. bypass UBTI via foreign feeders. When a tax-exempt entity is invested into a levered deal via a U.S. entity, it would be subject to UBTI. If the same entity invested in the same deal via a foreign structure, the interest income would be tax-exempt.”

Violations and Remedies

If an IRS auditor finds a violation during its examination, the auditor likely will recommend an adjustment of a fund’s or manager’s tax liability.

“Initially an IRS auditor cannot force you to pay more income tax, they can only recommend an adjustment,” Hammer noted. “Then you can either pay it or appeal the adjustment. An audit does not automatically result in you paying more taxes; it results in an adjustment.”

Added Deloitte’s Dougherty, “if the IRS comes in and asserts that the position taken on a tax return is not correct and let’s say the taxpayer decides not to appeal or negotiate a particular settlement, in a domestic fund, generally speaking, the IRS would then send a bill to the investors in the domestic fund. With an offshore fund, the entity itself is the taxable entity and so if they were able to successfully raise effectively connected income issues then the fund itself would be responsible for paying the tax.”

How to Prepare for An IRS Audit

Once a hedge fund or manager receives notice that it has been selected for an IRS audit, there are several steps the manager can take to prepare. The first step is to meet with the manager’s or fund’s tax counsel to review the fund’s transactions or the manager’s tax structures.

“The issue for taxpayers is that in order to properly manage an IRS tax examination, you want to be cooperative and turn over information as quickly as you can, but at the same time you want to look at what you’re giving them before you hand it over so you can anticipate any issues,” Dougherty said.

Added Hammer, “this industry has never done this before and doesn’t know how to deal with IRS auditors. You really need to have representation by somebody who has profound and deep experience with the IRS audit process. As soon as you get into an audit, the most important thing is to get the right person to represent you. Don’t manage it yourself.”

Differences From SEC or Financial Audits

It should be noted that an IRS audit is significantly different from an SEC or accounting firm audit. The purpose of accounting audits generally is to ensure that the books are in compliance with GAAP while the purpose of a tax audit is to ensure that the correct tax amount is paid. The IRS is very narrowly focused on whether taxes were paid and whether the correct amount was paid.

Simoens said the financial audit examines the valuation of the investments while the IRS is focused on the taxation. “The financial audit is going to look at valuation to make sure there are no impairments. The SEC audit is going to look at custody issues and whether you really own the assets you say you do. The SEC will have custody types of questions. The IRS is looking at taxation of these instruments. It’s very different.”

BDO Seidman’s Andreola said the IRS could rely on the audited financial statements in their examination, but the focus of the IRS differs significantly from that of an accountant. “What the IRS is looking at is to see how taxable income is determined. They look at the books and records of the client, the uncertified financial statements. Then they drill down and try to find things. In the audited financial statements, I think they’re looking for anything that sticks out that may allow them to look at an area they weren’t intending to look at, like a FIN 48 issue. If they didn’t look at the audited financial statement, they would never be able to pick up on anything like that.”

As to the differences between SEC and IRS audits, Dougherty explained, “I think an SEC audit and an IRS audit are fundamentally different. Both sides would engage in an examination with a view of the entity being audited having done something wrong, whether it’s a violation of a regulatory issue, which the SEC would look at, or a violation of a tax rule, which the IRS would look at. The key distinction is that the SEC is not in the revenue raising business whereas the IRS is. There is definitely a theme at high levels of government which would be information sharing among the various branches of the government.” For more on preparing for an SEC audit, see [“Key Lessons from the Second Annual Hedge Fund Tax, Accounting & Administration Master Class: IFRS, Fair Value and SEC Examinations,”](#) Hedge Fund Law Report, Vol. 2, No. 21 (May 27, 2009).

Length of Audits and Appeals

The length of the audit varies depending on the facts of the case. The timeline could depend on the firm and the auditor, including how tenacious the auditor is, the resources available to the auditor or audit team leader to perform the audit and what the auditor finds.

An audit could last as little as three weeks, but some can drag on for years. Generally, if the taxpayer refuses to sign an extension of the statute of limitations, the IRS has three years from the filing of the return to propose any additional assessments with respect to the tax year covered by the return. In addition to trying to resolve any issues with the auditors, the manager may seek to have the Appeals Office of the IRS review the case. If the manager cannot resolve the case with the Appeals Office, the manager could initiate litigation in the Tax Court, District Court or the Court of Claims.

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