Tax Matters

The Wrapper Illusion: Do Entity Structures Neutralize Tax Anti-Abuse Rules?

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We noticed that there is some confusion in the investment community about whether placing trades inside a limited partnership or limited liability company could bypass wash sale, straddle, or constructive sale rules. Consider, e.g., the question: Can an investor hold a long position in 100 shares of a company in a personal brokerage account while simultaneously shorting the same 100 shares through a partnership (say a fund-of-one)—and avoid triggering any anti-abuse provisions?

Answering this question requires an understanding of how the U.S. tax regime operates. The tax law has evolved to follow economic substance, *not* legal form. Strategies that rely on entity wrappers to achieve outcomes unsupported by the underlying economics are a source of meaningful tax, compliance, and reputational risk.

Investors evaluating any legal structure or entity wrapper—terms we use interchangeably here—should first ask: does it have a pre-tax investment rationale? If the wrapper serves no purpose other than to alter a tax outcome, the analysis should end there.

The following table summarizes the more detailed discussion below. We stress again that the conclusions presented in the table are irrelevant if the wrapper was created with a specific intent to circumvent these rules.

	Anti-Abuse Frameworks		
Vehicle Type	**Wash Sales (Section 1091)**	**Straddles (Section 1092)**	**Constructive Sales (Section 1259)**
SMAs	Disregarded entity, so wash sale rules apply	Disregarded entity, so straddle rules apply	Disregarded entity, so constructive sale rules apply
Funds-of-One	Invites heightened IRS scrutiny given the single investor's dominant control	Straddle rules look through the fund-of-one, even when partnership status is respected	The fund-of-one is almost certainly a "related person" to the investor, causing full look-through of positions
Commingled Funds	The partner and the partnership are typically treated as separate units, so wash sales may not apply	Straddle rules look through flowthrough entities, including partnerships, regardless of their independence	May or may not apply depending on whether the investor's interest in the partnership is sufficient for the partnership to qualify as a "related person"

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Anti-Abuse Frameworks

There are three primary anti-abuse frameworks, each designed to align the recognition of tax gains and losses with genuine changes in economic exposure.

Wash Sales (Section 1091)

- Disallows a loss when the taxpayer sells stock or securities and acquires, or contracts to acquire, substantially identical stock or securities during the 30 days before or after the sale.
- This rule prevents an investor from harvesting a tax loss while maintaining continuous economic exposure to the same position.
- Entity Treatment: While there's no black-letter law directly on point, the current prevailing interpretation of the statutes and regulations appears to be that a *true* tax partnership is typically not looked through for the purposes of the wash sale rules. However, broader anti-abuse doctrines still apply. For example, a true partnership formed specifically to avoid wash sales may nevertheless be disregarded under those rules.

Straddles (Section 1092)

- Defers a loss to the extent of unrecognized gain in offsetting positions that substantially diminish the taxpayer's risk of loss.
- This rule disallows an investor from recognizing a loss on one leg if offsetting positions hedge one another and the investor has an embedded gain on the other leg.
- Entity Treatment: Of the three regimes, straddle rules have one of the broadest look-through provisions. The taxpayer is expressly treated as holding positions held by related persons and by certain flowthrough entities. Strictly speaking, for straddle identification purposes, positions should be looked through across all accounts and passthrough entities, including partnerships, in which the taxpayer holds an interest.

Constructive Sales (Section 1259)

- If an investor effectively neutralizes substantive risk of loss and opportunity for gain, e.g., through tight collars, shorts-against-the-box, or total return swaps, the U.S. tax system deems it a "constructive sale" and mandates gain recognition.
- Entity Treatment: Positions held by "related persons," including controlled partnerships, are attributed to the taxpayer when the arrangement is structured to avoid those rules. Constructive sale rules would generally apply if the investor forms a partnership and holds a majority interest in such partnership to avoid the application of those rules, even if such avoidance was not the sole objective. On the other hand, the constructive sale rules may not apply if an investor holds a minority interest in a partnership that invests in certain positions and the investor incidentally holds offsetting trades/positions elsewhere in his or her portfolio.

The Entity Spectrum

The degree to which an entity structure can alter the anti-abuse analysis depends on the genuine economic separation between the investor and the vehicle.

Disregarded Entities and SMAs

A single-member LLC is often disregarded as an entity separate from its owner, and a separately managed account ("SMA") is simply direct ownership with delegated discretion. All wash sale, straddle, and constructive sale rules apply as if the investor transacted directly.

Funds-of-One

A fund-of-one may technically qualify as a partnership, but in substance, it often resembles an SMA far more than a commingled fund. This is the structure where the wrapper illusion is most dangerous.

The key question is whether there is genuine economic separation. The more the sole investor can dictate the investment mandate, approve or restrict the asset universe, monitor positions in real time, or coordinate trades with personal accounts, the weaker the argument that the entity wrapper should alter the anti-abuse outcome. Control, even informal control, collapses the distinction between the investor and the fund.

The case weakens further when the general partner's economics are minimal, i.e., little or no capital interest and no meaningful profit participation. While thin GP economics do not automatically disqualify partnership status, they do nothing to strengthen the narrative of genuine separateness that the anti-abuse analysis requires.

For wash sale purposes, a fund-of-one invites heightened IRS scrutiny given the single investor's dominant control. For instance, the IRS has ruled that where a taxpayer sold stock from his taxable account and subsequently rebought the same shares through a retirement account the next day, the wash sale rules applied to disallow any losses from the sale. The straddle rules look through the fund-of-one regardless, even assuming partnership status is respected. And for constructive sale purposes, the fund-of-one is almost certainly a "related person" to the investor, triggering full attribution of positions.

Ultimately, a fund-of-one structure employed or adopted primarily for anti-abuse arbitrage may be adding compliance and audit risk rather than reducing tax exposure.

Commingled Funds

For a genuine multi-member fund to be taxed as a partnership and create a legitimate case for economic separation, it must have (1) pooled capital from multiple limited partners, (2) truly independent third-party management with full trading discretion, and (3) no single investor with an ability to direct individual trades. An investor in a multi-billion dollar hedge fund generally has no meaningful control over the timing or selection of the fund's trades.

Under the wash sale rules, the partner and the partnership are technically treated as separate units, so wash sale rules may not apply because the analysis starts at the entity level. The straddle rules, however, expressly look through flowthrough entities, including partnerships, regardless of their independence. The constructive sale rules look to both the taxpayer's own positions and those of related persons, but an investor in a genuine commingled fund typically does not hold sufficient interest for the fund to qualify as a "related person."

That said, anti-abuse principles can still apply where positions are coordinated across an investor's personal accounts and fund

investments, even in a commingled structure.

Substance over Form

A legal wrapper cannot be used to circumvent anti-abuse rules. It does not change the economic reality of a position, and the tax code is specifically designed to look past the form to substance.

Sophisticated investors should evaluate LPs and LLCs for what they genuinely provide—administrative efficiency, liability protection, and operational flexibility—rather than as mechanisms to circumvent anti-abuse rules that are, by design, resistant to exactly this kind of structuring. If a structure's primary appeal is a tax outcome that the economics do not support—and, even worse, it is promoted as such—it is best to stay away.

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