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New Partnership Tax Audit Rules Will Impact Private Investment Fund Vehicles

On November 2, 2015, President Barack Obama signed into law the Bipartisan Budget Act of 2015 (the "BBA"). The BBA includes new rules (the "New Audit Rules") which significantly change many aspects of existing U.S. federal tax law relating to tax audits of entities treated as "partnerships" for U.S. federal tax purposes. These changes are certain to have a significant impact on any such entity, including private equity funds, hedge funds, real estate, and other private investment vehicles.

Summary

Effective for tax years beginning on or after January 1, 2018, the BBA significantly revises the manner in which the IRS will audit tax returns filed by entities classified for tax purposes as "partnerships." Since many private investment fund vehicles are established as entities that are treated as partnerships for tax purposes, these rules will undoubtedly impact these vehicles. Some of the key impacts include the following:

- For the first time ever, the New Audit Rules will allow the IRS to collect any underpayment of U.S. federal income tax (including penalties and interest thereon), owing by the partners as a result of an audit of the partnership, directly from the partnership. As such, those persons who are partners at the time the audit is finalized will bear the economic burden of such underpayment even though the underpayment relates to a prior year. However, the New Audit Rules do provide an elective mechanism by which a partnership (with certain trade-offs) may shift back the responsibility for the payment of the underpaid amounts to those persons that were partners in the year to which the audit relates. This is described in greater detail below.

- Because it will now be much easier and simpler for the IRS to conduct audits of partnerships and collect resulting taxes (i.e., IRS now may only have to collect from one party—the partnership—rather than having to pursue many partners for collection), it should be expected that the rate at which the IRS conducts federal income audits of all partnerships, including private investment vehicles, will increase significantly.

- It can be anticipated that all partnerships and their partners will need to agree contractually as to the manner in which they will share

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such resulting obligations. Thus, many partnership agreements will likely now require detailed indemnity/reimbursement agreements whereby all partners (and former partners) agree to indemnify or reimburse the partnership and other partners for their allocable shares of these obligations. Various types of contracts between the partnership and third parties (such as lenders) will likely also be affected.

- Transferees of interests in existing partnerships may begin to require indemnifications from transferors and/or the partnership for tax liabilities for periods prior to the transfer.

- The New Audit Rules are a continuation of what seems to be a trend in the tax law (which includes the Foreign Account Tax Compliance Act, or FATCA, provisions which were introduced back in 2010) whereby private investment vehicles and other tax partnerships are required to obtain, maintain and update increasingly detailed information—including tax status—not only of its direct partners, but also of the direct and indirect owners of those partners. These types of "know-your-investor" information requirements are likely to continue to pose privacy and data security issues, among others, for private investment funds and similar vehicles.

Key Aspects of the New Audit Rules

The following is a discussion of some of the key aspects of the New Audit Rules:

Partnerships to which the New Audit Rules Apply. The new partnership audit rules are effective for tax years beginning on or after January 1, 2018, although existing partnerships have the option of electing to utilize the New Audit Rules currently. These New Audit Rules generally apply to any entity classified as a partnership for U.S. tax purposes (i.e., including limited liability companies, which are classified as partnerships, etc.) and which is required to file a U.S. partnership return. A partnership to which these rules would otherwise apply can elect out of the New Audit Rules for a tax year only if the following requirements are met with respect to such year:

- The partnership has 100 or fewer partners,

- Each of the partners is an individual, a decedent's estate, a C corporation, an S corporation, or a foreign entity that would be treated as a C corporation if it were domestic, and

- Certain procedural requirements relating to the election are satisfied.

It is important to note that this election to opt-out of the New Audit Rules cannot be made for any tax year if any of the partners during such year is either a trust or a partnership. This is of particular significance to partnerships with tax-exempt entities that may be treated as "trusts" for U.S. federal tax purposes, as well as partnerships that traditionally have "partnerships" as partners, such as "fund-to-fund" vehicles and hedge funds structured through typical "master-feeder" structures.

In addition, if a partnership has an S corporation as a partner, the opt-out election is only available if the partnership discloses to the IRS (in a manner to be prescribed by the IRS) the name and taxpayer identification numbers of each of the S corporation's shareholders. (Also, each of the S corporation's shareholders is counted in determining whether the partnership has 100 or fewer partners). Thus, even assuming a partnership otherwise qualifies for this opt-out election, the partnership will need additional covenants from each of its partners to provide the partnership with up-to-date information not only regarding the identify and tax classification of the partners themselves, but also of the owners of such partners. This may be difficult to accomplish.

Partnership Responsible for Partners' Taxes. As is generally the case with current law, the New Audit Rules generally provide that any adjustments to the items of income, gain, loss, deduction, or credit of a partnership will be determined by the IRS at the partnership level. However, in a significant change from long-standing tax law, the New Audit Rules now provide that the IRS will generally assess and collect any additional taxes, penalties, or interest owing by the partners as a result of final partnership audit adjustments directly from the partnership (and not the partners who were partners in the year to which the adjustment relates).

Because the partnership is directly liable for the partners' increased tax liabilities (including penalties and interest, if applicable) resulting from an audit, the persons who are partners during the year in which the audit is finalized will bear the economic burden of the tax, as opposed to the persons who were partners during the year which is the subject of the audit. Thus, any partnership vehicle that has partners whose interests will, or may, change over time (whether through sales, redemptions, defaults, or other events), including hedge funds, as well as private equity/venture capital funds or other investment vehicles, should consider including in their partnership agreements general indemnity obligations whereby each partner and former partner agrees to indemnify the partnership for their appropriate shares of any tax obligations imposed on the partnership as a result of the New Audit Rules.[1]

Clearly, one of the principal purposes of the New Audit Rules was to relieve the IRS of the burden of having to pursue individual partners to assess and collect increased tax liabilities resulting from income tax audits of partnership vehicles. For this reason alone, it should be expected that IRS audits of partnership vehicles will be much easier to accomplish, and thus will likely increase significantly in the coming years.

Calculation of Tax Liabilities. The area of the New Audit Rules which is perhaps subject to the most uncertainty and which is likely to generate the most complexity are the provisions which calculate the amount of the tax liability which is payable by the partnership following an audit adjustment. In general, the New Audit Rules provide that the amount of tax liability payable by a partnership is determined by netting all adjustments of items of income, gain, loss, or deduction pursuant to the audit, and then multiplying any net positive amounts by the highest individual or corporate tax rate in effect for the year which is subject to the audit. The New Audit Rules also direct the IRS to establish procedures under which the amount of the partnership's obligation may be modified "consistent with the requirements" of these rules.

The new statute indicates that these forthcoming procedures from the IRS shall provide for a reduction in the partnership's obligation to the extent the partnership can demonstrate that the audit adjustment is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity (including non-U.S. persons and entities). The IRS is also directed to take into account a lower rate of tax with respect to any portion of the audit adjustment that the partnership demonstrates is allocable to a partner which, in the case of ordinary income, is a C corporation, and in the case of capital gains (or qualified dividends), is an individual. The IRS is also provided with authority to adopt rules modifying the amount of the partnership's obligation on the basis of "such other factors as the [IRS] determines are necessary or appropriate to carry out the purposes of [the New Audit Rules]."

It remains to be seen whether the forthcoming rules from the IRS will take into account other specific tax attributes of particular partners. For example, a partner in a partnership that is a real estate investment trust—or REIT—or partners that have net operating losses, each have tax attributes which, in many cases, could reduce or eliminate an otherwise applicable tax obligation. Yet it is unclear how or if the IRS would permit those types of items to be taken into account under these forthcoming rules. It is also unclear whether in the case of a partner that is itself a "partnership," if these tax attributes will be examined on a look-through basis.

Despite all of the uncertainty, one thing that is reasonably clear is that all partnerships, including private equity funds, hedge funds, and other similar investment vehicles, will need to obtain, maintain, and update very detailed information regarding the identity, and tax status, not only of its direct partners, but also the direct and indirect owners of such partners.

Election to Shift Liabilities Back to Partners. The New Audit Rules provide partnerships with a method (referred to as the "6226 Election") by which the obligation to pay these tax liabilities may be shifted away from the partnership (and thus away from the persons who are partners at the time the audit is finalized) and back to those persons who were partners during the year(s) to which the adjustments relate. In order to take advantage of the 6226 Election, the partnership is required to (i) make an election within 45 days of the conclusion of the audit, and (ii) provide (in a time and manner yet to be prescribed by the IRS) to each person or entity who was a partner during the year to which the adjustment relates a statement (i.e., essentially a revised Schedule K-1) showing their respective shares of any adjustments arising from the audit. The individual partners (or former partners) will then be required to compute the impact of the adjustment on their

tax liabilities for the year under audit and to pay any resulting increased taxes in their current year tax returns, along with interest at a rate which is 2 percentage points higher than the normal interest rate applicable to tax underpayments.

The 6226 Election would be particularly useful in vehicles, such as hedge funds, where there are significant changes in the number and identity of partners from year to year. As noted, however, an important "trade-off" of the partnership making the 6226 Election is that the individual partners end up paying the tax liabilities together with a higher than normal interest rate (i.e., plus 2 percent).

A couple of aspects surrounding the 6226 Election remain unclear, however. For example, the timing and manner in which the partnership is required to make the election and provide statements to the persons who were partners during the year which is subject to audit will need to be clarified by the IRS.[2] Moreover, it is unclear how this procedure will work for partners who themselves are partnerships. In addition, it appears as if this procedure only applies with respect to partners whose tax liabilities increase as a result of the audit of the partnership. Thus, any partner whose tax liability for the year of audit would decrease by reason of the adjustment seemingly cannot report this decrease on his/her/its own tax returns. Instead, such decrease is simply treated as a reduction of partnership income for the year in which the audit is finalized (thereby accruing to the benefit of the persons who are partners at that time).[3]

Partnership "Representative." Prior to these New Audit Rules, partnerships were generally required to appoint a "tax matters partner" to represent the partnership in connection with U.S. federal income tax audits. The New Audit Rules eliminate the concept of a "tax matters partner" and now require the partnership to appoint a "partnership representative" who will have sole authority to act on behalf of the partnership in connection with audits or judicial proceedings. However, unlike the "tax matters partner," the partnership representative is no longer required to be a partner of the partnership. This is a useful change in the law, particularly for private investment fund vehicles, as it now permits non-partner persons and entities, such as non-partner management company or investment advisor, to serve in this capacity on behalf of the partnership. If the partnership fails to appoint a representative, the IRS is entitled to appoint one for the partnership. There do not appear to be any limitations on who the IRS may appoint in this capacity.

Another notable change from existing law is that the New Audit Rules eliminate the current law right of partners of the partnership to participate in or even receive notices relating to any U.S. federal income tax audits of the partnership. Thus, individual partners may now need to seek enhanced contractual protections from the partnership on these issues, such as covenants in the partnership agreement to provide information and/or notices relating to tax audits and/or requiring the partnership representative to obtain consents of partners prior to binding the partnership.

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ENDNOTES

1 The New Audit Rules do provide for a reduction in the partnership's obligation to pay such tax liabilities to the extent that the partnership can establish that persons who were partners during the year which is subject to the audit actually filed amended federal income tax returns and paid their shares of the taxes resulting therefrom.

2 For example, it is not clear how the 45 day period works in cases where the partnership contests the assessment in court.

3 For example, many hedge funds utilize so-called "stuffing allocations." In general, stuffing allocations occur when an investor in a hedge fund exercises a withdrawal right, thereby causing the hedge fund to sell one of its investment securities to generate the cash needed to fund the withdrawal. Rather than allocating any tax gains resulting from the sale of securities to all partners in the fund, many hedge funds typically allocate such gains entirely to the withdrawing partner (at least to the extent that the fair market value of the withdrawing partner's interest in the fund exceeds its tax basis in such interest). Whether or not these types of "stuffing allocations" are permissible under current tax law is questionable. If the IRS were to successfully challenge a hedge fund stuffing allocation, the result would be increased allocations of gains to the non-withdrawing partners. The hedge fund could utilize a 6226 Election to cause the persons who were partners during the year of the stuffing allocation to bear the appropriate tax liabilities (plus the higher rate of interest). However, the partner who withdrew from the hedge fund during such year (and who originally received the "stuffing allocation") would have no ability to report the decrease in allocable gain on his/her/its own federal tax return.

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