Hedge Funds and IRS Partnership Audit Rules
Advanced Tax Strategies in Structuring Private Investment Funds in Light of New IRS Rules

THURSDAY, APRIL 26, 2018
1pm Eastern    |    12pm Central   |   11am Mountain    |    10am Pacific

Today’s faculty features:
Lawrence M. Hill, Partner, Winston & Strawn, New York
Olga A. Loy, Partner, Winston & Strawn, Chicago
Rachel Ingwer, Partner, Winston & Strawn, New York

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Hedge Funds and IRS Partnership Audit Rules

April 26, 2018
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Lawrence M. Hill is a tax partner in the firm's New York office and is chair of the firm's federal tax controversy practice. Prior to joining Winston, he served as a senior partner and global head of tax controversy and litigation at several major international law firms. Earlier in his career, Larry was a trial attorney and National Tax Shelter Project Attorney with the Office of Chief Counsel of the Internal Revenue Service and a Special Assistant United States Attorney with the United States Attorney's Office in Washington, DC. The IRS honored him twice with Special Achievement Awards for his work as a top trial attorney in the country. Larry also previously served as Assistant General Counsel to a “Big Four” accounting firm.
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Rachel Ingwer concentrates her practice on transactional matters. She advises clients on a wide variety of private equity and other transactional issues (both domestic and cross-border), including business formations, taxable and tax-free mergers and acquisitions, divestitures, financings and restructurings and recapitalizations. Rachel also advises clients on debt and equity offerings, tax disclosures issues, and fund formation issues, including structuring and partnership matters.

In addition, she advises high net worth individuals on individual and private foundation tax matters, as well as tax matters relating to their business interests.
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Olga Loy represents funds and fund sponsors in structuring, negotiating, and forming private equity and venture capital funds. She plans and structures other complex business transactions, including corporate mergers and acquisitions, leveraged buyouts, recapitalizations, and venture capital investments. She also regularly represents large and mid-size private equity funds and their management companies and advises real estate funds and investors in tax structuring matters, including REIT counsel and planning and cross-border analysis.

Additionally, Olga is an adjunct professor the University of Illinois College of Law, where she teaches a course on private investment funds and introduces students to business, securities, and tax issues relating to private investment funds with an emphasis on private equity, venture capital, and hedge funds.
New Partnership Audit Rules

• Nov. 2, 2015: New partnership audit rules and procedures were enacted by the Bipartisan Budget Act of 2015 (“Budget Act” or “BBA”)
  • Applicable to partnership taxable years beginning after 12/31/17

• Jan. 18, 2017: Proposed Regulations were issued
  • Such regulations were promptly withdrawn following Pres. Trump’s moratorium.

• June 14, 2017: Slightly modified, the proposed regulations (“Prop. Reg.”) were reissued
New Partnership Audit Rules

• Jan. 2, 2018: Final Regulation § 301.6221(b)-1 regarding the electing out of the centralized partnership audit regime was published

• Feb. 2, 2018: Proposed Regulations covering subjects not contained in the June 2017 Prop. Reg. were issued

• Mar. 23, 2018: Technical Corrections to the audit rules are released as part of the Consolidated Appropriations Act, 2018
Agenda

Background

• What are the tax objectives of the stakeholders associated with private investment funds?
• How are those objectives balanced and structured?
• What were the prior partnership audit rules?

New audit rules and their application to funds

• Why were they changed?
• How do the new rules work?
• How will the new partnership audit rules impact hedge funds?
• What should hedge funds be doing now regarding the new rules?
• What is sample language to address the new rules?
• What should hedge funds anticipate doing in the future regarding the new rules?
Background

• TAX OBJECTIVES OF FUND stakeholders
• How those objectives ARE balanced & structured
Tax Objectives of Fund Stakeholders
## Taxable U.S. Investors

<table>
<thead>
<tr>
<th>Goal</th>
<th>Structure</th>
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<tbody>
<tr>
<td>Fund level tax neutrality</td>
<td>Organize fund as flow-through entity (or entities)</td>
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<tr>
<td>Minimize phantom income</td>
<td>• Avoid CFCs</td>
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<td>• Address other investments case-by-case, e.g. distressed debt</td>
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<tr>
<td>Maximize deductibility of fund expenses</td>
<td>• “Trader” status</td>
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<td>• Particular issues for major expenses</td>
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<tr>
<td>Deferral of income recognition</td>
<td>• Stuffing</td>
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<td>• Timing of income recognition; structured exits</td>
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<tr>
<td>Maximize character benefits</td>
<td>• Trading style</td>
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<td>• 475(f) election (or not)</td>
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<td>• Manage holding period (e.g. harvest ST losses)</td>
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<td>• Address case-by-case (e.g. bullet vs non-bullet equity swaps)</td>
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## Non-U.S. Investors

<table>
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<tr>
<th>Goal</th>
<th>Structure</th>
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<tbody>
<tr>
<td>No investor-level US filing obligations</td>
<td>Fund-level blocker(s) (pervasive)</td>
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<tr>
<td>Minimize fund-level US tax drag</td>
<td>• Qualify for “trading for own account” exception</td>
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<td>• Manage/structure investments to minimize</td>
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<td>• ECI</td>
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<td>• US-source FDAP (other than interest)</td>
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<tr>
<td>Home country tax efficiency</td>
<td>Case by case; generally managed at investor level</td>
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</tbody>
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## Non-taxable U.S. Investors

Includes pension plans, endowments, other tax-exempt investors (such as charities) and governmental entities

<table>
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<th>Structure</th>
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| Minimize unrelated trade or business income, or UBTI (for non-super tax exempts) | • Fund-level blocker(s)  
• Limitations on investment activities  
• Leverage only at portfolio company level  
• Opt out for non-UBTI sensitive  
• Fractions rule |
Sovereign Investors

Includes foreign governments and their controlled entities, e.g. sovereign funds

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<th>Goal</th>
<th>Structure</th>
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<tr>
<td>Avoid “controlled commercial entity” taint</td>
<td>Limitations on sovereign ownership of fund and/or fund’s investment activities</td>
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<tr>
<td>Minimize investor-level US tax drag</td>
<td>Minimize FIRPTA gains</td>
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<td>(managed account or “fund of one”)</td>
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<td>Minimize fund-level US tax drag (foreign feeder)</td>
<td>Manage/structure investments to minimize:</td>
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<td>• ECI</td>
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<td>• US-source FDAP (other than interest)</td>
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## Fund Manager

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<th>Goal</th>
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<tr>
<td>Maximize character benefits</td>
<td>Carried interest</td>
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<tr>
<td>Minimize management company taxes</td>
<td>• Structure as pass-through entities</td>
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<tr>
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<td>• State/local specific</td>
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<tr>
<td>Minimize “Chapter 2” taxes</td>
<td>• Limited partnership</td>
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<td></td>
<td>• Carry vs. incentive fee?</td>
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<tr>
<td>Minimize phantom income (or effects)</td>
<td>Tax distributions</td>
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<tr>
<td>Tax deferral</td>
<td>Limited elective deferrals</td>
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<tr>
<td>Estate planning</td>
<td>Partial ownership of management company outside taxable estate</td>
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<tr>
<td>Compensating key employees on tax-favored basis</td>
<td>“Partners” structures</td>
</tr>
<tr>
<td>Receive incentive awards pre-fund level taxes</td>
<td>“Mini masters” beneath fund-level blockers</td>
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How Are Those Objectives Balanced & Structured?
Example: Hedge Fund Structure*

- **U.S. Taxable Investors**
  - Domestic Feeder Fund (DE LP)
    - Limited partners
    - General Partner (DE LLC)
      - Principals
      - Employees
      - IMA
    - Management fee
    - Limited partner
    - Carried interest
    - Master Fund (Cayman LP)
  - Portfolio Investments
  - Foreign SPV(s)
  - U.S. SPV(s)

- **U.S. Tax-Exempt Investors**
  - Investment Manager (DE LP)
    - Employment agreements
    - Shareholders
    - IMA
    - Limited partner
    - Management fee

- **Foreign Investors**
  - Offshore Feeder Fund (Cayman Corp.)
    - Shareholders
    - IMA
    - Limited partner
    - Employment agreements

* Some details omitted
Example: Hedge Fund Structure*

* Some details omitted
Achieving and Balancing Objectives For Hedge Fund

• Flow through domestic and master funds
  • Addresses objectives of US taxable investors and manager

• “Blocker” offshore feeder fund
  • Addresses objectives of USTE and non-US investors

• US tax-related limits on portfolio investments
  • Must satisfy “trading for taxpayer’s own account” exception
  • US and foreign SPVS may be required to preserve this exception, to minimize US tax filings for offshore feeder, and to address foreign or other US tax issues

• Compensation of manager/GP

• Structure of management companies
  • Pictured is typical structure for NYC-based manager
What Are The Prior Rules?

• TEFRA – Tax Equity and Fiscal Responsibility Act of 1982
• General treatment: audit adjustments determined at partnership level, but tax liability of each partner for the affected year must be separately computed by the IRS
• Exceptions to TEFRA treatment
  • Small partnerships
  • Electing large partnerships (adopted 1997)
Prior Law: Tefra Audit Rules

• Apply to partnerships with more than 10 partners and all partnerships where any of the partners is not an individual, C corporation or estate of deceased partner

• Continues to apply to partnership tax years that began before 1/1/18 (unless a partnership elects to have new rules apply earlier)

• IRS issued Temp. Reg. 301.9100-22T to provide the time, form and manner for a partnership to make an election to apply new audit rules to tax years beginning after 11/2/15 and before 1/1/18
Prior Law: Tefra Audit Rules

- TEFRA established unified audit rules
- These rules require the tax treatment of all “partnership items” to be determined at the partnership, rather than the partner level
- Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations
- The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve issues with respect to all partners
Prior Law: Tefra Audit Rules

• The TEFRA rules establish the Tax Matters Partner as the primary representative of a partnership in dealings with the IRS

• The IRS generally is required to give notice at the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS
  • For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest in partnership profits is less than one percent
NEW Audit Rules & Their Application to Funds
Why Were They Changed?

- IRS difficulty administering TEFRA
  - IRS’s responsibility to flow through audit adjustments up chain of ownership and collect from partners
  - Tax Matters Partner has limited authority
- Very low audit rates of large partnerships (as opposed to audit rates of large corporations)
- Increase in number and size of large partnerships
- Increase in tiered partnerships
- Generate $10 billion in new tax revenue
Overview of New Partnership Audit Rules

- The new rules generally will govern IRS income tax audits of partnership tax years beginning 1/1/18
- As a result, the first IRS audits under the BBA rules likely will start no earlier than late 2019 or 2020 for returns filed in 2019
- As noted previously, partnerships that wish to apply the new rules on an expedited basis may elect to apply them to tax years beginning after 11/2/15
How Do The New Rules Work?

• Sacrifice accuracy for administrability: intended to encourage partnership audits by making them easier for the IRS
• Default rule: partnership is liable for tax on audit adjustments
• Partnership/partners may achieve a result closer to current law (flow-through), but burden shifted from IRS to taxpayers
• Not all partners’ interests are aligned: need for planning/documentation
How Do The New Rules Work?

• In more detail
  • Default rule – imputed underpayment
  • Push-out election
  • Partnership representative
  • Small partnership election
  • Other issues
Default Rule – Imputed Underpayment

• Partnership must pay an entity-level tax in the adjustment year (the “imputed underpayment”) with respect to the reviewed year

• Imputed underpayment = A x B
  • A - amount of net adjustments “of items of income, gain, loss or deduction”
  • B - highest individual federal income tax rate in effect for the year in which the income arose
Calculation of the Imputed Underpayment

• Grouping:
  • Adjustments are first combined into different groupings and then, within each grouping, adjustments may be divided into subgroupings depending on their character, source, etc.
• Three types of adjustment groupings:
  • Reallocation grouping
  • Credit grouping
  • Residual grouping
Calculation of Imputed Underpayment

• Netting:

• Items within the same grouping or subgrouping are netted.
  • E.g., all ordinary adjustments in a subgrouping are netted against each other, but none of the ordinary adjustments are netted against the adjustments in the capital subgrouping

• Any netted amount that is a net non-positive adjustment in the reallocation grouping or the residual grouping is an adjustment that does not result in an imputed underpayment, and is disregarded for the purpose of calculating the imputed underpayment

• Partnership adjustments that do not result in an imputed underpayment generally are taken into account by the partnership in the adjustment year
Modification of Imputed Underpayment

- Partnership representative may request that IRS modify an imputed underpayment to correct potential overstatements of tax under certain circumstances, including:
  - If a reviewed year partner filed amended returns for the reviewed year and for any other years with respect to which any tax attribute is affected and makes all appropriate payments
  - To account for status of reviewed year “tax-exempt partners” (defined by reference to Section 168(n)(2) to include foreign partners)
  - To account for tax rate applicable to the portion of the total netted partnership adjustment allocable to a reviewed year partner that is a C corporation or an individual with respect to capital gains and qualified dividends
- 2018 Technical Corrections Bill clarifies that modification is permitted even if the adjustments do not result in an imputed underpayment
- Modification request must be made within 270 days of mailing of Notice of Proposed Partnership Adjustment (unless extension is granted)
“Pull-In” - Alternative Procedure to Filing Amended Returns

• The 2018 Technical Corrections sets out an alternative procedure to filing amended returns

• Reviewed year partners pay tax that would be due and make changes to tax attributes they would be required if amended returns were filed, but are not required to file actual amended returns (if partners instead provide information substantiating the amount of the tax and evidence of payment to IRS)

• Because the partners file no amended returns, there are generally no residual effects on the partners' personal returns beyond the effects on tax attributes, in other tax years, of the adjustments to partnership-related items

• The pull-in procedure, as well as the amended return modification procedure, generally is available to direct and indirect reviewed-year partners, in the case of tiered partnerships. The pull-in procedure generally does not require the participation of all direct and indirect reviewed-year partners of the partnership

• Potential advantages of pull-in:
  • Presumably does not reopen statute of limitations with respect to individual returns
  • Interest charged for late payments is lower than interest under push-out election
Default Rule

• Further observations/comments:
  • Tax due is likely to be greater or lesser than “correct” tax (possibly substantially so)
  • Economic cost borne by those who are partners at the time of payment (subject to any contractual indemnification obligations of review-year partners)
  • Partnership basis adjustments and other secondary effects
• Example: Fund’s 2018 return audited in 2020. Audit resolved in 2021 with a net adjustment of $100 of additional taxable income. Tax of $39.6 imposed on fund, plus penalties and interest in 2021
Push-Out Election

• If the partnership makes a valid Push-Out election,
  • The partnership is no longer liable for the imputed underpayment, and
  • The reviewed year partners must take into account their share of partnership adjustments determined in the Notice of Final Partnership Administrative Adjustment (“FPAA”) and are liable for the resulting tax, penalties and interest

• In order to make a valid Push-Out election, the partnership must:
  • Make the election within 45 days from the date IRS issues a FPAA
  • Furnish statements to reviewed year partners and file a copy with IRS
Push-Out Election

- The push-out election is irrevocable unless consent is granted by IRS.
- The push-out election can be for one or more of the imputed underpayments. It does not have to be for all imputed underpayments for the year.
  - Underpayment determination for at least each Section 702(a)(1)-(8) category.
- Reviewed year partners must compute tax not only for reviewed year but also intervening years for tax attribute adjustments.
  - Technical corrections permit positive and negative adjustments.
Push-Out Election

• Penalties and other additions to tax are computed at the partnership level and each reviewed year partner is liable for such partner’s distributive share.

• Interest is computed at the partner level from the due date of the reviewed year original return (without extensions) through the earlier of (i) date of payment or (ii) due date (without extensions) of year the partner receives the statement from the partnership.

  • Higher rate of interest charged on any underpayments of tax – i.e., federal short term rate +5% (rather than +3%).
Push-Out Election for Tiered Partnerships

- Section 6226 under the BBA does not distinguish between partners subject to chapter 1 income taxes and passthrough partners, which are generally not subject to such taxes

- Status of Current Guidance:
  - June 14, 2017: Prop. Regs. reserved comment on how adjustments are taken into account by passthrough partners of tiered partnerships
  - Dec. 15, 2017: Prop. Regs. provide rules for pushing out adjustments through passthrough partners
    - Treasury: “adjustments pushed out to partners pursuant to an election under section 6226 should be permitted to be pushed out through the tiers to the ultimate taxpaying owners”
  - Consolidated Appropriations Act’s amendment to Section 6226 affirms the Prop. Regs. and provides penalties for failing to provide correct and timely information in the required manner
Push-Out Election for Tiered Partnerships

• A passthrough partner may be
  • A partnership (regardless of whether or not it elected out of CPAR); an S corporation; a trust that is not wholly owned by only one person, whether the grantor or another person; or a decedent’s estate

• A passthrough partner is not a disregarded entity or a Section 671/678 trust
  • E.g., In the case of a disregarded entity wholly-owned by a C corporation, the C corporation must take into account the adjustments reflected on a statement furnished to the disregarded entity under formerly proposed § 301.6226-2

• For purposes of the passthrough partner rules,
  • An S corporation is treated as a partnership, and its shareholders are treated as partners
  • A trust and estate are treated as a partnership, and their beneficiaries are treated as partners
Push-Out Election for Tiered Partnerships

• A passthrough partner has option to:
  • Push adjustments out further to its partners, shareholders or beneficiaries, or
  • Pay the amount calculated like an imputed underpayment with respect to the adjustments reflected in the statement

• A tiered partnership impacted by a push-out election must abide by the following general requirements:
  • Any statement furnished is treated as a statement furnished by the source (i.e. audited) partnership to its reviewed year partners
  • The partnership must provide the IRS with a “tracking report” in addition to the statements furnished to partners
Push-Out Election: Update

• The Prop. Regs. issued in June 2017 provided a safe harbor amount and interest safe harbor amount that partners can pay in lieu of computing the tax and interest the partner owes as a result of taking the adjustments into account in the year under audit and determining the effect of this computation on tax attributes in subsequent years

• However, this safe harbor is not available in the Prop. Regs. issued in December 2017
  • Treasury: In a tiered partnership context, the safe harbor calculations actually further complicated things, and so were abandoned
Push-Out Election: Summary

• Whether the partnership should pay the tax or elect to push out the adjustment has important implications.

• Unless the partnership agreement provides otherwise, under general partnership tax rules, paying tax at the partnership level places economic burden on partners during the adjustment year. This could impose the economic burden on partners who were not partners in the partnership in the reviewed year.
Partnership Representative

• The partnership must appoint a “Partnership Representative.” No longer any “Tax Matters Partner” for federal income tax purposes.
• Partnership Representative is sole person with authority to bind partnership and partners. Not required to keep partners informed regarding audit.
• Must have a substantial presence in the US.
• Does not have to be a partner.
• If no (or improper) designation, IRS “may select any person as the partnership representative.”
• No change as to who signs returns (still GP or LLC member manager).
Partnership Representative

• Designation
  • The partnership representative is designated on the partnership’s tax return for the applicable taxable year
  • A separate designation must be made for each taxable year, i.e., a designation for one taxable year is not effective for any other taxable year

• Termination
  • Designation is effective until terminated by (i) a valid resignation by the partnership representative, (ii) a valid revocation by the partnership, or (iii) a determination by the IRS that the designation is not in effect
Partnership Representative

• Unlike the TMP under the TEFRA regime, which represents the partnership but cannot bind the other partners, the partnership representative will have the exclusive authority to act on behalf of the partnership and take actions that bind the other partners, including:
  • Agreeing to settlements
  • Agreeing to a notice of final partnership adjustment
  • Making a push-out election
  • Agreeing to an extension of the period for adjustments
• In contrast to TEFRA, the new audit rules do not provide the partners a statutory right to notice of, or to participate in, the partnership-level proceeding
Partnership Representative

• Any action taken by the partnership representative under the new rules is valid and binding on the partnership for purposes of tax law regardless of any other provisions of state law, partnership agreement, or any other document or agreement

• If partnership representative violates the terms of the partnership agreement, the partners may have recourse against the partnership representative for a breach of contract, but they will not be able to opt out of or otherwise renegotiate any agreement with the IRS

• Because of the broad authority of the partnership representative, it is particularly important for partners who are not the partnership representative to negotiate contractual rights and protections in the partnership agreement
Other: Interest Charge

• The general rule for interest with respect to a partnership adjustment is that interest begins on the day after the return due date for the reviewed year and ends on the return due date for the adjustment year, or if earlier, the date a payment is made.

• If the imputed underpayment is not timely paid with the adjustment year return, then additional interest is charged on the failure to timely pay the imputed underpayment.
Other: Inconsistent Reporting

• A partner is (still) allowed to report in a manner inconsistent with the partnership’s return, although the partnership agreement may provide otherwise

• Similar right under TEFRA

• Must give notice to the IRS

• If a Notice of Inconsistent Treatment is filed by a partner then the IRS may not automatically correct the partner’s return to make it consistent with the partnership return

• Consider reliance on estimates from sub-partnerships
Other: Partnership Ceases To Exist

• If a partnership ceases to exist before a partnership adjustment takes effect, such adjustment shall be taken into account by the former partners of such partnership under regulations prescribed by the Secretary.

• The statute is silent with respect to whether this rule applies in a tiered partnership structure where the partnership under examination is in existence but another partnership in its tiered structure no longer exists.

• If the partnership under examination makes a push-out election, it is not clear what happens if one or more of those partners is a partnership which no longer exists.

• Does a partnership making a push-out election have the responsibility of identifying the former partners of the partnership that has gone out of existence or is the adjustment required to be allocated to all remaining reviewed year partners in existence?
Other: Period of Limitations

• New Section 6235 provides for a period of limitations for the IRS to make “adjustments” under the BBA provisions

• General rule: Absent an agreement between the IRS and partnership, the IRS must issue the Notice of Final Partnership Adjustment prior to the expiration of the period of limitations specified in Section 6235, which is generally the later of -
  • the date which is 3 years after the latest of the filing of the partnership return or administrative adjustment request; or
  • in the case of any modification of an underpayment under section 6225(c), the date that is 270 days after the information required to be submitted has been submitted or after a notice of proposed adjustment has been issued

• The period for the IRS to make an “adjustment” may be extended by written agreement

• There are also exceptions for filing a false return, substantial omission of income and failure to file
Other: Penalties

• Existence and amount of penalties are determined at partnership level, as if the partnership is the taxpayer
  • Reasonable cause and good faith defense applies only if partnership has reasonable cause and good faith. Does not matter if partner had reasonable cause and good faith
  • Partner can no longer challenge penalties at a partner level audit
  • It does not matter whether any of the partners underpaid any tax (e.g., they might have NOLs or have losses suspended as passive)
  • Substantial understatement penalty depends on percentage of income that was underreported

• If partnership makes the push-out election, it will issue a penalty statement to “reviewed year” partners:
  • Penalty is nevertheless computed at partnership level
Other: Judicial Review

- The IRS must wait 90 days after issuing the FPAA before assessing the deficiency and, if the partnership timely files a petition in Tax Court, the IRS must wait until the Court’s decision is final before making an assessment.

- Petitions in Tax Court do not require prepayment, but a partnership filing in district court or the Federal Court of Claims must first pay the asserted imputed underpayment.
Judicial Proceedings

• In general, the new rules will allow the IRS to deal exclusively with a single partnership representative in initiating and resolving the audit and any related judicial proceedings

• All direct and indirect partners will be bound by the results of the partnership audit or related judicial proceeding
Other: Partnership Correction Of Prior Return

• A Partnership is allowed to correct a previously-filed partnership tax return by filing an “administrative adjustment request”

• Unlike TEFRA, any adjustment that is made is taken into account for the partnership taxable year in which the administrative adjustment request is made

• The partnership may choose to pay any imputed underpayment at the time the administrative adjustment request is filed

• Alternatively, in an underpayment context, the partnership may follow a process to issue statements to partners “similar to the rules” that apply in the audit context

• For an adjustment that does not result in an underpayment, the partnership is required to follow the rules “similar to the rules” that apply in the audit context and furnish statement to partners
Other: Early Election

- A partnership may elect to apply the new procedures to earlier years
- The IRS issued guidance regarding how to make an early election (Temp. Reg. 301.9100-22T)
- Election must be made within 30 days of the date of audit selection notification
- Election must be in writing, signed by the tax matters partner or by a person authorized to sign the partnership return
- Election must indicate the partnership is electing application of section 1101(g)(4)
- Partnership must not be insolvent and must not have filed, and must not anticipate filing, for ch 11 bankruptcy.
- Election must be signed under penalty of perjury
How Will the New Partnership Audit Rules Impact Hedge Funds?

• More audits should be expected
• Will the push-out election swallow the general rule?
• Could the new rules have an impact on fund structure: master feeder vs. side by side (plus mini-master)?
  • Difference in terms of partnership tiers
• How does state and local tax fit into this regime? Are state and local governments likely to adopt similar rules?
• Any effect on purchase and sale of interests in partnerships, including fund managers? Seeders may (should) have concerns
How Will the New Partnership Audit Rules Impact Hedge Funds?

• Partnerships, both existing and new, should consider steps now to prepare for potential audits under the new rules

• Likely there will be side letter requests:
  • Push-out election
  • Allocation of partnership level savings from permitted modifications to relevant partners, under hybrid method
  • Contractual limits on partnership representative; requirements to disclose audit status
  • To not permit early opt-in
  • No obligation to file amended returns
  • GP-specific items (e.g., related to carried interest) borne by GP

• Funds in tiered structure should be conscious of providing higher-level partnerships time to decide if they want to pay the tax or make the push-out election
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• ASC 740/FIN 48 -
  • To the extent a partnership could be liable for tax, the partnership may need to consider whether this should be addressed in their FIN 48 analysis
  • Will auditors require a push-out election so that they do not need to determine whether a tax reserve is required
    • Tiered partnership issues
  • Could the new rules have an impact on tax return positions taken by funds due to increased audit risk and potential partnership level tax liabilities?
What Should Hedge Funds Be Doing Now ABOUT the New Rules?

- Offering memoranda need to be updated, including to disclose that the partnership, and thus effectively current partners, could be liable for taxes that relate to prior years and for taxes that may not have been imposed at the partner level.

- Consider sources of audit risk.

- Fund operating agreements need to be amended (if they have not been already):
  - Designate a “partnership representative”-- consider who qualifies.
  - Potentially require partners to cooperate with hybrid reporting.
  - Consider how potential fund-level taxes affect preferred returns, carried interest, clawbacks.

- Because the new rules provide that partners generally may not participate in or contest the results of an examination or other partnership proceeding without permission of the IRS, the partnership should consider what safeguards might be appropriate to protect its own and its partners’ interests in the event of an audit.
  - Provide an indemnity in the event tax is paid at the partnership level.

- Funds that make investments in other funds (e.g., funds of funds) or in other partnerships may make requests in side letters for investments.
What Should Hedge Funds Anticipate Doing In the Future ABOUT THE New Rules?

- Fund documents will continue to evolve
- Additional guidance will be issued and proposed regulations will be finalized
- Investors may ask questions regarding how the feeder fund and the master fund will address the new partnership audit rules; likely to show more interest in fund tax planning and positions
- Side letter requests/modifications
- Seed investors will want to address
- The new partnership audit rules will be raised in M&A deals concerning investment managers
- Funds that make investments in other funds (e.g., funds of funds) or in other partnerships may make requests in side letters for investments
- Spending more time thinking about all of this as these rules evolve
New Partnership Audit Rules – Sample Language

• Fund Agreements should provide the Partnership with the flexibility to make any (beneficial) elections:

  • “As an alternative to the foregoing, the Partnership Representative may elect to apply alternative procedures that may allow the Partnership to avoid such entity-level U.S. federal income tax liability in some cases if certain conditions are satisfied. These alternative procedures may require Limited Partners (based on their Interests in the Partnership in the prior tax year under audit) to either file amended returns and pay any tax that would be due for the prior tax year under audit, or adjust the tax liability reported on their income tax returns for the year in which the audit is resolved.”
New Partnership Audit Rules – Sample Language (Alternative)

• Alternatively, the Fund Agreement could require the Partnership to make any election that will reduce taxes under Code Section 6225:

  • “The Partnership Representative and Company shall make all necessary elections to the extent possible to avoid, or to the maximum extent possible reduce, any [material] taxes imposed on the Company under Code Section 6225 (including, at the reasonable discretion of the Partnership Representative, making an election under Code Section 6226). All Members (and former Members) agree to cooperate with, and to take all reasonable actions requested by the Partnership Representative and the Company, to avoid or reduce any [material] tax imposed under Code Section 6225, including cooperating with any election under Code Section 6226, or to otherwise allow the Company and the Partnership Representative to comply with the Revised Partnership Audit Provisions.”
New Partnership Audit Rules – Sample Language

- Indemnity provisions should ensure Partnership’s ability to recover from Limited Partners, even after the Partnership has ended:
  - “If the Partnership is required to pay any Tax imposed under Section 6225 of the Code of the Revised Partnership Audit Provisions (or any similar provision of state or local law), each Limited Partner (and former Limited Partner) shall be required to pay and reimburse the Partnership for such Limited Partner’s share of such tax after written notice from the Partnership Representative requesting such payment or reimbursement. A Limited Partner’s (and former Limited Partner’s) share of such tax shall be determined in good faith by the Partnership Representative.….The obligations of a Limited Partner under this [Section X] shall survive the Limited Partner’s sale or other disposition of its Interests in the Partnership and shall survive the termination, dissolution, liquidation, or winding up of the Partnership.”
New Partnership Audit Rules – Sample Language

• Indemnity provisions should ensure Partnership’s Limited Partners’ cooperation with any audits, even after the Partnership has ended:
  • “[E]ach Limited Partner (and former Limited Partner) shall provide any necessary information to the Partnership Representative (i) to avoid or reduce any tax imposed under Section 6225 of the Code of the Revised Partnership Audit Provisions; (ii) to make any election provided for in the Revised Partnership Audit Provisions, including cooperating with any election under Section 6226 of the Code; or (iii) to otherwise allow the Partnership and the Partnership Representative to comply with the Revised Partnership Audit Provisions. The obligations of a Limited Partner under this Section XX.XX shall survive such Limited Partner’s sale or other disposition of its Interests in the Partnership and the termination, dissolution, liquidation, or winding up of the Partnership.”
Remaining Issues and Future Guidance

• Future Guidance; What Can Be Expected
  • IRS is seeking comments (due 5/3/18) to the Proposed Regulations issued on 2/2/18 regarding a variety of topics, including the application of the successor rules with respect to fungibility of partnership interests and in partnership mergers and divisions
  • It remains to be seen whether the new rules can accomplish their intended goals
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