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Bipartisan Budget Act Revamps Partnership Audit Rules; Impact On Tax Exempt Investors

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On November 2, 2015, Congress enacted the Bipartisan Budget Act of 2015 (the "Act") as a compromise measure to continue funding the federal government. The Act includes revamped partnership audit rules that may have a significant effect on private funds, including private equity and hedge funds. The new rules are effective for tax returns filed for the 2017 tax year (*i.e.*, returns filed in 2018), but this legislation is already driving changes to funds' governing documents. This Investor Alert provides an overview of the new rules and what changes investors should expect in fund agreements.

Law through Tax Year 2016

Prior to passage of the Act (and through tax year 2016) IRS audit procedures for partnerships were generally based on the size of the partnership: small partnerships (*i.e.*, less than 10 partners) were audited at the individual taxpayer level; partnerships with more than 10 partners were subject to the Tax Equity and Fiscal Responsibility Act ("TEFRA") audit rules wherein the audit was conducted at the partnership level but any adjustments had to be collected from the underlying partners; and partnerships with 100 or more partners could elect to be treated as electing large partnerships ("ELP"), and audit adjustments would be reflected on partners' current year tax returns rather than on an amended prior-year return.

The IRS has historically struggled to audit large partnerships and the new rules are designed to streamline the audit process.

Audit Rules for Tax Years 2017 and Beyond

The Act sweeps aside the TEFRA and ELP audit rules and replaces them with a single audit process for partnerships. Many of the new rules should not affect investors, but may affect the operations of fund sponsors with respect to audits (for example, the "tax matters partner" is replaced by the "partnership representative"). From an investor's perspective, the most significant aspect of

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the new rules is the requirement that the IRS collect any tax liability (an "Imputed Underpayment"), penalties and interest that result from a tax adjustment directly from the partnership rather than the underlying taxpayers.[1] Further, any adjustments will be based on the highest rate of tax for U.S. individuals (currently 39.6%). Notably, however, there is an alternative procedure available wherein the partnership may elect to require underlying taxpayers to take into account any audit adjustments on their underlying tax returns, likely by issuing such partners an amended Schedule K-1.

The new rules may have an adverse effect on investors who are forced to bear the burden of tax adjustments attributable to other partners. The concern is particularly acute for tax exempt or non-U.S. investors since these investors would otherwise not be subject to U.S. taxes. The Act directs the IRS to provide guidance regarding how to adjust an Imputed Underpayment in a partnership where some partners are tax exempt, but it is unlikely that this guidance is imminent.

Next Steps for Investors

Although the new audit regime is not effective until 2018, fund sponsors are already accounting for this legislation in fund documents. Because private funds are typically treated as pass through entities for U.S. tax purposes, it is likely that private funds will be particularly impacted by the new audit rules. In addition to fund agreements that are under negotiation, fund sponsors may also seek to amend the agreements to comply with the new rules.

Investors should be vigilant in reviewing new partnership agreements or any amendments to existing agreements to ensure that provisions intended to address the Act seek to allocate any Imputed Underpayment to taxable investors. To the extent possible, investors should seek to require fund sponsors to elect the alternative procedure wherein tax adjustments are taken into account by the underlying partners. In any case, fund sponsors should covenant that they will use reasonable efforts to ensure that tax exempt investors or taxable investors that are subject to a lower marginal tax rate do not pay more tax than they would otherwise owe.

Investors may also wish to seek comfort that any former partners remain liable for adjustments that may occur after a transfer or withdrawal takes place, as the alternative would be for the partnership (and all its current partners) to assume that liability. Tension exists because withdrawing investors are likely to resist any escrow requirements and holdbacks to cover possible tax liabilities, and collecting on indemnities from former partners may prove difficult. Further, tax exempt investors will prefer that only those distributions that are made to taxable investors be subject to holdbacks or escrow requirements to cover any partnership audit generated obligations.

New guidance from the IRS is expected to clarify the finer points of the new audit process, but it is expected that this guidance will not be available until closer to the effective date of the new rules.[2] In the meantime, investors may wish to be proactive by taking steps to ensure that their managers intend to allocate Imputed Underpayments to the partners who are ultimately responsible for such payments, and that any former partners will remain "on the hook" for any audit adjustments relating to the period during which they were partners. One step investors may wish to consider is to seek side letter comfort that the manager will allocate Imputed Underpayments to the appropriate partners. For example, an investor could seek language along the following lines:

With respect to tax adjustments and assessments made under the Bipartisan Budget Act of 2015, the General Partner will use commercially reasonable efforts to eliminate the allocation to tax exempt entities of any imputed underpayment of tax assessed to the Partnership.

Investors may also wish to carefully review legal terms to make sure that general partners will not be overly aggressive in imposing holdbacks or escrow requirements on those distributions (*e.g.*, to tax exempt investors) that have low risk of needing to be repaid.

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[1] Partnerships that issue 100 or fewer Schedules K-1 may be permitted to opt out of the new regime. However, the opt-out is available only if each of the partners is an individual, corporation or estate. In other words, no partner can be another partnership or limited liability company, which effectively makes this option unavailable to private funds.

[2] *See* IRS Notice 2016-23, requesting public comments on various issues for which the IRS expects to issue guidance.

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