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Bipartisan Budget Act of 2015 Changes Audit Rules for Private Equity and Hedge Funds

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On November 2, 2015, the United States Congress enacted the Bipartisan Budget Act of 2015 (the Act) to fund the federal government. Among other provisions, the Act significantly modifies how the Internal Revenue Service (IRS) audits large partnerships (including limited liability companies (LLCs) taxed as partnerships) which will likely include hedge funds and private equity funds, along with other types of investment partnerships. Previously, the IRS employed three types of auditing procedures depending on the size of the partnership: (i) individual taxpayer procedures applied to small partnerships (i.e., those with less ten partners); (ii) the so-called Tax Equity and Fiscal Responsibility Act (TEFRA) rules applied to partnerships with more than ten partners; and (iii) the "electing large partnership" (ELP) procedures applied to certain electing partnerships with more than one hundred partners. The IRS has historically struggled to audit large partnerships due to their complexity; for instance, a 2014 study by the Government Accountability Office found that, in the 2012 fiscal year, the IRS audited just 4% of large partnerships while it audited 27.1% of similarly sized corporations (other than S corporations).

The Act replaces the TEFRA rules and the ELP procedures with new—and purportedly "streamlined"—procedures designed to remedy this auditing disparity and allow the IRS to more easily audit and assess taxes and penalties against large partnerships. The new auditing procedures are conducted at the partnership level; according to the Act, "any adjustment to items of income, gain, loss, deduction, or credit of a partnership (and any partner's distributive share thereof) shall be determined, any tax attributable thereto shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share shall be determined, at the partnership level." If the IRS discovers an underpayment of taxes, then the partnership must pay an "imputed underpayment" that is calculated by multiplying the net adjustment by the highest individual or corporate rate of tax in effect for the audited year. Partnerships can present certain information to IRS auditors (e.g., the tax returns of individual partners) to demonstrate that the IRS should utilize a lower "imputed underpayment." The new procedures do not require all partners to participate in the audit; instead, the Act provides that each partnership shall select a representative (who need not be a partner) for the partnership who will have the sole authority to act on behalf of the partnership during the audit; all partners and the partnership are bound by actions of the partnership during the audit and any final decisions reached during the audit, subject, of course, to certain appeal procedures. The "partnership representative" replaces the "tax matters partner" system utilized under the TEFRA rules. A partnership can elect to avoid incurring the partnership level adjustments described previously by notifying the IRS and issuing revised information statements (Form K-1) to its partners. The Act also allows partnerships to file voluntarily requests for administrative adjustments in accordance with the "imputed underpayment" rules or the alternative method (that is, the partnership issuing revised Form K-1s to its partners).

In addition, the Act requires that each partner "treat each item of income, gain, loss, deduction, or credit attributable to a partnership in a manner that is consistent with the treatment of such income, gain, loss, deduction, or credit on the partnership return." The Act directs the IRS to treat any underpayment of tax by a partner by reason of inconsistent reporting as a mathematical error on the partner's return, unless the partner notifies the IRS of the inconsistency.

According to the Congressional Budget Office, the aforementioned partnership auditing procedures are expected to increase Treasury revenues by approximately $11.2 billion over the next ten years. The new auditing procedures contained in the Act take effect for partnership taxable years beginning after December 31, 2017, although a partnership can elect to have these procedures apply to any taxable years beginning after the date of enactment and before January 1, 2018. Partnerships with one hundred or fewer qualifying partners may elect out of the auditing rules described above. A qualifying partner is an individual, a regular corporation (i.e., a C corporation), any foreign entity that would be treated as a C corporation were it a domestic entity, an S corporation, or an estate of a deceased partner. Notably, a qualifying partner does not include a trust or a tax partnership (e.g., an LLC taxed as a partnership). As a result, the tiered partnerships employed by many private equity firms and hedge funds may not elect out of the new auditing procedures.

Taxpayers, particularly private equity firms and hedge funds, should carefully review the potential impact of the IRS's revamped partnership auditing procedures. In addition, taxpayers are advised to review their LLC operating agreement or partnership agreement with their tax advisors to determine if any modifications are necessary to account for the audit procedures discussed above.

We will continue to closely monitor these issues and will provide future client updates. For more information on the matters discussed in this Locke Lord QuickStudy, please contact the authors.

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