Considerations for Asian fund managers under the US New partnership audit regime

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Abstract

Purpose – *This paper aims to explain how the Bipartisan Budget Act of 2015, as modified by the Protecting Americans from Tax Hikes Act of 2015, changes the way the US Internal Revenue Service will conduct audits of collective investment vehicles treated as partnerships for US tax purposes.*

Design/methodology/approach – *This study explains the entities covered by the new partnership audit regime, the effective dates of the new regime and steps to be taken by funds covered by the new audit regime.*

Findings – *The results show that the new regime creates a liability at the partnership level for any unpaid tax, placing the tax burden on current-year partners.*

Practical implications – *A fund manager should determine whether the new audit regime is applicable to any of the funds he or she is managing and, if so, amend the fund documents to accommodate the new audit rules, providing a mechanism to elect and supervise a partnership representative, a mechanism to allocate the economic burden of the tax to the appropriate partners and a procedure for selecting the method to calculate the amount of the fund's tax liability attributable to an audit.*

Originality/value – *This study provides practical guidance from experienced investment, fund and tax lawyers.*

Keywords *Partnerships, Tax, Internal Revenue Service (IRS), Collective investment vehicles, Tax Hikes Act of 2015, US Bipartisan Budget Act of 2015*

Paper type *Technical paper*

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The US Bipartisan Budget Act of 2015, as modified by the Protecting Americans from Tax Hikes Act of 2015, resulted in a fundamental change in the way the US Internal Revenue Service (IRS) will conduct audits of collective investment vehicles treated as partnerships for US tax purposes. In particular, it creates a liability at the level of a partnership for any unpaid tax. Thus, the tax burden falls on the current-year partners even if such tax is with respect to a tax liability arising in a different tax year when investors may not have been partners (much like shareholders in a corporation).

This new audit regime has significant implications to both US and non-US funds and fund managers. It is likely to be a high-priority issue for investors (coming up in comments to fund documents, side-letter negotiations and fund diligence for secondary transfers) and, if not structured correctly, may have significant adverse consequences to managers and non-US investors, otherwise not subject to US tax.

You should continue to read if you are a manager of a fund that

- is a partnership or has a feeder that is a partnership for US tax purposes (including a non-US corporation that has made an election to be treated as a partnership);

- has US investors; and
- files US tax returns (particularly, partnership information returns and K-1s) or is required to file US tax returns.

Key points

- The new partnership audit regime is applicable to any entity treated as a partnership for US tax purposes that is required to file US income tax returns or actually files returns as a partnership for US tax purposes. Certain partnerships (those with 100 or fewer partners where none of the partners is another partnership, a trust or a disregarded entity) can elect out of this new audit regime, and be subject to audit separately at the partner level.
- Under the new regime, audit, assessment and collection of tax are done directly at the partnership level (with some very limited exceptions). As a result, the partnership must pay the tax (and related interest and penalties) resulting from an IRS audit even though a partnership is not otherwise a taxpayer under US tax law and even if it only generates income and gains from non-US securities.
- The new regime is effective for tax years beginning after December 31, 2017. Note that this effective date is for tax years' subject to the new audit regime, meaning that a tax audit for 2018 may not occur until, for example, 2020. For tax audits for tax years before 2018, current law would continue to apply.
- The new partnership audit regime would require amendment to the constitution documents of foreign funds, which are otherwise treated as partnerships for US tax purposes and are required to file a US income tax return (which requirement may still be applicable even if the fund only invests in non-US securities), to ensure that the burden of any tax resulting from an audit falls on the appropriate investors and compliance with the requirements of the new partnership audit regime.
- This is more of an issue for hedge funds (where investors may change over time) as opposed to private equity funds (where the same group of investors stay from inception until liquidation of the fund).

What should you do if this alert is applicable to you?

The first step is to determine whether the new audit regime is applicable to any of the funds you are managing. This analysis is relevant even if the funds are formed outside the USA, invest only in foreign securities and do not currently file US tax returns. The new audit regime is also applicable to funds that are *required* to file US returns (which requirement is determined under a set of complicated rules).

If the audit regime is applicable to one of the funds you are managing, the second step is to amend the fund documents to accommodate the new audit rules. In particular, the amendment needs to deal with the following three issues:

1. *Provide for a mechanism to elect and supervise a partnership representative*. The fund documents need to have the correct procedure for the designation of a "partnership representative," which has the sole authority to act on behalf of the fund in an audit situation with the IRS. In particular, the partnership representative may bind the partnership and the partners regardless of any limitation on that authority under the partnership agreement or applicable state law. Disputes among the partners are resolved through local law mechanisms (arbitration or litigation) even if the partnership representative acted contrary to instructions in the partnership agreement. Thus, choice of an appropriate person to act as the partnership representative is critical:

   - A partnership may designate any person to be the partnership representative, provided that such person has a substantial presence in the USA. The designation is made on the partnership tax return for the tax year. Any designation in the partnership agreement will not be binding on the IRS; it must be reflected on the partnership's tax return. Very restrictive rules apply for revoking a designation or appointing a successor before an audit of the partnership begins.

- Substantial presence in the USA:
  - The partnership representative must be able to meet in person with the IRS in the USA at a reasonable time and place as determined by the IRS.
  - The partnership representative must have a US address and telephone number where the partnership representative can be contacted during normal business hours.
  - The partnership representative must have a US Tax Identification Number.
- The partnership representative may be an entity (e.g. management company), but, in such a case, the partnership must:
  - appoint an individual to act on behalf of such entity and
  - identify such individual on the partnership's federal income tax return.

2. *Provide for a mechanism to allocate the economic burden of the tax to the appropriate partners*. The fund documents need to have a mechanism for maximizing the likelihood that the economic burden of any tax liability attributable to an audit is allocable to the partner with respect to whom the tax liability has arisen. In particular, any such tax liability should reduce the applicable partner's capital account or be indemnified by such applicable partner to the extent of any shortfall (or if the applicable partner is not an investor in the fund at the time the tax is paid by the partnership, a mechanism needs to be put in place to claw back the appropriate share of tax from such former partner). Such mechanism should also provide that the manager compensation should be determined without regard to any such tax liability even if it is a liability of the fund.
3. *Provide for a procedure regarding the method used by the fund to calculate the amount of tax liability of the fund attributable to an audit*. The fund documents need to have a procedure that deals with the different regimes that may be applicable to the fund under the new audit rules and provide for the cooperation of the partners (and former partners) to allow the fund to select the most appropriate regime. For example, the new law allows for an election for the partnership "to push" the liability for the tax to those investors who were partners during the tax year that is audited. In that case, those partners would pay the tax for the year that the tax liability is resolved, and the partnership would not owe any partnership-level tax. Alternatively, the partnership can reduce the amount of its tax payment if one or more of the partners agrees to file certain amended US tax returns and pay the tax or if one or more of the partners is subject to a special tax regime, such as a partner who is not subject to US income tax or has favorable tax attributes.

Please note that the above amendments to your fund documents may or may not require consent of the investors and you should consult with your legal counsel as to the amendment procedure applicable to your specific fund documents.

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