KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

November 12, 2015

New Tax Audit Rules Impact PE Funds, Sales of Partnership Interests, and Partnership Mergers and Acquisitions

PENpoints

New IRS audit rules will make it easier for the IRS to audit a large partnership and can shift the economic burden of tax audit adjustments among its current and former partners.

On November 2, 2015, President Obama signed the 2015 Bipartisan Budget Act[1] (the "Act"), which, among other things, modifies partnership audit rules in ways that will impact private equity (PE) funds and their portfolio companies (PCs) taxed as flow-through partnerships. These new rules, which are generally effective for tax years beginning on or after January 1, 2018, are intended to allow the Internal Revenue Service (IRS) to more easily audit and assess taxes against large entities taxed as partnerships. Accordingly, we expect the frequency of partnership audits to increase under the new regime.

The most significant effects of the new audit procedures are (1) designation of a "partnership representative" with the sole authority to act on behalf of the partnership in IRS audits and litigation and (2) partnership-level responsibility for federal income taxes resulting from final partnership audit adjustments, which can shift the economic burden of such taxes to different taxpayers in some cases unless an alternative procedure is elected.

The Act leaves many significant details regarding implementation and operation of the new regime to Treasury guidance, which will likely be issued over the next two years.

New Regime Applies to All Partnerships

Under the Act, the new partnership audit procedures apply to all entities (including a flow-through limited liability company) taxed as a partnership,[2] except for a partnership with 100 or fewer partners meeting certain requirements which affirmatively elects to opt out. This "opt-out" election, however, is expected to be of limited utility for many partnerships (including a PE fund or PC partnership) because, in the absence of additional Treasury guidance, it is not available for a partnership that has, as one of its partners, an entity classified as a partnership.

Designated Partnership Representative

The existing concept of a "tax matters partner" will become obsolete for audits covered by the new rules. Instead, a partnership must designate a person to serve as the "partnership representative," who will have *sole* authority to act on behalf of the partnership in an audit or judicial proceeding. The method for designating a partnership representative is left for future Treasury guidance.

There are several significant differences between the new "partnership representative" and the existing "tax matters partner" concept. First, the partnership representative need not be a partner of the partnership. This is a useful liberalization of the existing rules governing the tax matters partner, allowing, for example, a non-partner management company or investment adviser to serve as partnership representative. In addition, the partnership representative is the only person with authority to act on behalf of a partnership in IRS administrative and judicial tax proceedings, with the partnership and each of its partners being bound by the partnership representative's actions vis-à-vis the IRS, including, for example, a settlement with the IRS.

INSIDE KIRKLAND**PEN**

PENbriefs 4
Upcoming Events 5

1 P.L. 114-74 (2015).

2 In this article the term "partnership" includes all entities taxed as a partnership (including, for example, a limited liability company), and the term "partner" includes all partners/members of such an entity.

The Act also strips partners (other than the partnership representative) of their existing statutory rights to notice of, and participation in, audit proceedings. In addition, unlike existing procedures, it appears that *only* the partnership representative, acting on behalf of the partnership, has the right to challenge the results of an audit in court. The Act does not appear to provide partners with the right to revoke the partnership representative's authority to bind them vis-à-vis the IRS (though perhaps future Treasury guidance will allow for the substitution of a new partnership representative in some circumstances). It is not clear under the Act whether a partnership agreement can restrict a partnership representative from taking action without consent of other partners.

Partnership-Level Responsibility for Tax Liabilities

Under the new rules, the IRS will assess and collect from the partnership itself (and not from individual partners) any additional tax, interest and penalties resulting from final audit adjustments, unless an alternative procedure (discussed below) is elected.

The partnership-level tax liability will generally be calculated (under procedures to be specified by Treasury) by taking into account the character of the income (e.g., whether the income is capital gain, qualified dividend income or ordinary income) and the nature of the partners of the partnership (e.g., whether the partners are individuals, corporations, tax-exempt entities or non-U.S. persons), though the burden will be on the partnership to show the portion of the audit adjustments that should be taxed at a rate other than the highest rate in effect for the audit year.[3]

Assessment and collection at the partnership level is a significant departure from the existing audit rules, under which the IRS generally audits the partnership's tax return but assesses and collects any additional tax, interest and penalties from the affected partners.

The default procedure has the effect of shifting, in the first instance, the economic burden (or benefit) of an audit adjustment to the partnership's current partners, which may be different persons from, or have different ownership percentages than, those who were partners in the audit year.

A partnership is, however, permitted to elect into an alternative procedure that results in the additional tax being assessed against and collected from those persons who were partners of the partnership during the year under audit.[4] Under this alternative procedure, the partnership is required to issue a "statement" (e.g., a revised Schedule K-1) to each affected partner reporting its share of adjustments to partnership income, loss, deductions and other relevant tax items for the audit year. Each affected partner must then compute any resulting tax liability for the audit year and any intervening years and report such liability on its current-year return. The affected partner must pay interest on the resulting tax liability (measured from the tax year being audited) at an increased penalty rate (i.e., the federal short-term rate plus five (versus three under current rules) percentage points).

This alternative procedure relieves the partnership of any partnership-level responsibility for tax liabilities resulting from audit adjustments.

The Act leaves many significant details regarding implementation and operation of this new regime to Treasury guidance. For example, the Act is silent on whether current or former partners are permitted to adjust the basis of their partnership interests as a result of any audit adjustments or how capital accounts should be adjusted as a result of partnership-level payments.

Most PE funds and their PC partnerships should be able to elect the alternative procedure, which is likely to be particularly useful where there have been significant transfers of partnership interests between the audit year and the date on which the audit adjustments are finalized.[5] There may, however, be circumstances in which the default procedure may be more desirable (e.g., based on considerations of cost, convenience or partner relations).

Sales of Partnership Interests

Under the new default procedure (but not the elective alternative procedure), when a partner (including an LP in a PE fund or a PE fund buying or selling a PC partnership) sells its partnership interest, the buyer indirectly assumes any pre-acquisition income tax lia-

3 Partner-level tax attributes (e.g., whether the partner has available net operating losses) are ignored in calculating the partnership-level tax.

4 This alternative procedure applies only to audit adjustments resulting in a tax liability. If the adjustments result in a refund, the adjustments must still flow through to the current partners.

5 It is not entirely clear, however, how the alternative procedure will be applied with respect to tiered partnership structures.

bilities arising on audit with respect to that interest. This is a significant departure from the existing audit rules, under which the seller generally remains liable for pre-sale income taxes.

This change will likely complicate the sale of partnership equity, e.g., with the buyer conducting enhanced due diligence on pre-acquisition partnership income tax reporting and the parties negotiating contractual (e.g., indemnification) provisions governing each party's rights and obligations in the event of an audit. In some situations, it may also be appropriate to address whether the partnership is permitted or required to elect the alternative procedure and whether the seller will have rights to participate in the conduct of an audit. Similar issues may arise where a person purchases a new partnership interest from an existing partnership.

Partnership Mergers and Acquisitions

The Act raises important questions about how the new audit rules will apply to a partnership (including a PE fund buying or selling a PC partnership) that is the subject of an M&A transaction. One such question concerns responsibility for an audit adjustment occurring after an acquisition of all or a majority of the partnership equity, resulting in a "technical tax termination" of the partnership or causing it to be treated as a disregarded entity. The Act states that where a partnership "ceases to exist," responsibility for audit adjustments falls to the "former partners." It is not clear whether a partnership "ceases to exist" when the partnership has a "technical tax termination" or becomes a disregarded entity, but continues to exist as a matter of state or other partnership law. It is also not clear whether "former partners" means the partners for the year under audit or the partners immediately prior to the time the partnership ceased to exist.

In addition, because of the increased possibility of partnership-level income tax liabilities under the Act, a buyer and seller of a partnership will need to consider including in the related acquisition agreement provisions governing responsibility for pre-closing income taxes and control of tax return preparation and tax elections, including designation of the "partnership representative" (similar to provisions commonly included in a corporate acquisition agreement). Such provisions will take on added importance for transactions closing in 2016 and later, because of the ability to "elect in" to the new regime for the 2016 and 2017 tax years (as discussed below). Where such an election has not been made on or before the sale, a buyer will likely not want to make such an election and will likely also want a contractual agreement that the seller will not make such an election.

Effective Date

The new rules take effect for tax years beginning on or after January 1, 2018; the existing partnership audit regime remains in effect with respect to an audit of prior tax years. Partnerships may, however, elect to apply the new rules with respect to their 2016 and 2017 tax years. The time and manner of making such an election is subject to future Treasury guidance.[6]

Immediate Impact on Drafting Partnership Agreements

Although it will be several years before the IRS begins to conduct audits under these revised procedures, the new regime will likely begin to impact drafting of partnership agreements and related documents well before then. While some existing partnership agreements may not require changes in response to the Act, existing partnership agreements should be reviewed to determine whether changes may be necessary or appropriate, including, for example, amendments to enable the partnership to recover from partners any tax liabilities paid by the partnership.

6 Until the new rules take effect, a partnership's tax matters partner continues to be responsible for the partnership's response to an IRS audit, subject to the restrictions and obligations imposed by current rules.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Mike Carew
http://www.kirkland.com/mcarew
+1 312-862-3035

Natalie Hoyer Keller
http://www.kirkland.com/nkeller
+1 312-862-2229

Daniel P. Meehan, P.C.
http://www.kirkland.com/dmeehan
+1 312-862-2149

JoAnne Mulder Nagjee
http://www.kirkland.com/jnagjee
+1 312-862-3115

William R. Welke, P.C.
http://www.kirkland.com/wwelke
+1 312-862-2143

PENbriefs

SEC Adopts Final CEO Pay Ratio Rule

The SEC recently adopted final rules implementing CEO pay ratio disclosure requirements under the Dodd-Frank Act. Although in most cases disclosure of CEO pay ratio will not be required for more than two years, compliance with the rules will likely be complicated and time-consuming, so companies are advised to begin preparations for complying with these rules. To learn more, see our recent *Alert*.

Employee Benefit Plan Dollar Limits for 2016

The IRS recently announced 2016 dollar limits for various types of employee benefit plans, which are set out in our recent *Alert*.

NOL Poison Pill – A Timely Prescription

Public companies with significant net operating loss carryforwards (NOLs) may want to consider adopting a NOL rights plan, or poison pill, to protect against a significant change in ownership of their stock which could, under IRS rules, limit their ability to use NOLs to shield taxable income in future years. To learn more, see our recent *M&A Update*.

AIM Update

Recently in our *KirklandAIM* newsletter, which is directed towards Chief Compliance Officers and other compliance professionals, we discussed three SEC enforcement actions settlements, relating to (1) the failure to disclose a change in a fund's investment strategy, (2) the failure to disclose conflicts of interest and (3) an adviser allocating its own registration, compliance, examination and enforcement costs to its private funds. Click here, here and here to access these editions of *KirklandAIM*.

PENnotes

2015 Registered Adviser Seminar & CCO Summit
Los Angeles, California, December 2, 2015

As the SEC continues its focus on private fund managers registered as investment advisers, firms must be familiar with the evolving regulatory environment. This seminar is designed specifically for private fund manager CCOs, general counsel and other senior executives. Click here for more information.

Building the Case for Private Equity Emerging Markets: A Conversation with HBS Professor Josh Lerner
Chicago, Illinois, December 8, 2015

Kirkland & Ellis and The Abraaj Group present this leadership summit for private equity investors focused on growth markets in Latin America, Eastern Europe, the Middle East and beyond. The event will engage industry thought leaders in discussions about the latest developments in the asset class and emerging economies and offer practical insight into capital investment in today's strategic growth markets. Click here for more information.

Drafting and Negotiating Corporate Agreements 2016
New York, New York, January 8, 2016
Chicago, Illinois, February 4, 2016

This PLI seminar will teach the basics of drafting and negotiating corporate agreements — from how the provisions of an agreement fit together, to the fundamental drafting and negotiating principles common to all corporate agreements. Kirkland partner Kevin Morris is co-chair of the Chicago event and partner Sarkis Jebejian will be a panelist at the New York event. Click here for more information.

43rd Annual Securities Regulation Institute
Coronado, California, January 25-27, 2016

Hosted by Northwestern Pritzker School of Law, the 43rd Annual Securities Regulation Institute will take place in Coronado, California. One of the most visible and highly regarded securities and corporate law conferences in the country, the Securities Regulation Institute reaches prominent attorneys from both firm and in-house practices. Kirkland partner Robert Khuzami will be a panel member for the Enforcement and Government Investigations session. Click here for more information.

15th Annual Beecken Petty O'Keefe & Company Private Equity Conference
Chicago, Illinois, February 19, 2016

Kirkland is a sponsor of the Chicago Booth Private Equity Conference (PEC), an annual event that brings together financiers, students and entrepreneurs to network and share insights into the dynamics of investing in a constantly changing economy. This year's conference is themed "Navigating Industry Cycles: Investing in an Evolving Market." Click here for more information.

Private Equity Practice at Kirkland & Ellis

Beijing
Chicago
Hong Kong
Houston
London
Los Angeles
Munich
New York
Palo Alto
San Francisco
Shanghai
Washington, D.C.

Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012, 2013 and 2014 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland was named "Law Firm of the Year in Mergers and Acquisitions Law" by U.S. News Media Group and Best Lawyers in its 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance*'s 2014 Legal Awards, "North American Law Firm of the Year: Fund Formation" and "North American Law Firm of the Year: Transactions" at *Private Equity International*'s 2014 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012, 2013 and 2014, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012, 2013* and *2014*, and has consistently received top rankings among law firms in Private Equity by The Legal 500 and IFLR, among others.

The Lawyer has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

KIRKLANDPEN

KIRKLAND & ELLIS

EDITORS
Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS
To subscribe to *KirklandPEN*, please email
kirklandpen@kirkland.com
+1 (312) 862-3356

 www.kirkland.com