

The IRS Targets Private Equity

PENpoints

The IRS signals more PE fund audits.

Last month's restructuring of the Internal Revenue Service's ("IRS") Large Business & International ("LB&I") group, coming on the heels of a recent report by the Government Accountability Office ("GAO") analyzing IRS audits of "large" partnerships, indicates that the IRS intends to follow through on its publicly announced intent to audit more flow-through entities, such as private equity funds and portfolio companies organized as partnerships and LLCs.

In the last few years, IRS officials have publicly expressed their intent to dedicate fewer resources to large corporation audits and focus more on flow-through entities (e.g., partnerships and LLCs), "mid-market" companies (i.e., with assets between \$10 and \$250 million), and "high net worth" individuals and their related entities — groups that historically have had low audit rates.

In September 2014, GAO released a report analyzing the IRS's audit coverage of "large" partnerships (those with 100 or more direct and indirect partners and at least \$100 million in assets). GAO found that in fiscal year 2012 — the last year for which data was available — the IRS closed only 84 large partnership field audits, a 0.8% audit rate, compared to a 27.1% audit rate for similarly sized C corporations.

GAO further found that from 2002 to 2011, the number of large partnerships more than tripled, with a significant majority engaged in financial investment activities (e.g., private equity funds and hedge funds).

Last month, the IRS rolled out a new structure for its LB&I group, with five subject-matter and four geographic practice areas, each containing specialists responsible for identifying risks and developing "campaigns" to address compliance issues. One of these five subject-matter practice areas is "Pass-Through Entities."

While new IRS audit rules enacted by Congress will make it easier for the IRS to audit large partnerships, those rules generally do not apply until 2018 (and later) tax years. (See our [KirklandPEN](#) dated November 12, 2015, for discussion of the new rules.) With its current focus on Pass-Through Entities in the new LB&I structure, the IRS seems to be indicating that it will not wait for those rules to become effective before increasing partnership audits.

With respect to private equity fund audits, it would not be surprising if the IRS scrutinizes certain arrangements that it has previously identified as areas of focus, including management fee waiver arrangements that it believes do not comply with the aggressive principles set forth in the IRS's July 2015 proposed regulations. (See our [KirklandPEN](#) dated July 24, 2015, for discussion of the proposed regulations.) Although the proposed regulations are prospective, the IRS stated when it released the regulations that it believes the principles embodied in the proposed regulations reflect "congressional intent" and current law. Many practitioners, however, believe the legislative history underlying the applicable tax statute is materially more taxpayer favorable than the proposed regulations.

Given this changing procedural and substantive landscape, private equity sponsors and similar firms should be alert to the possibility of increased IRS audit activity and consider retaining experienced tax controversy counsel to assist the firm and its accountants in the event an audit is commenced.

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Courts Increasingly Skeptical of Need to Routinely Disclose Government Investigations under Rule 10b-5

Two recent court decisions demonstrate that companies required to file disclosure documents with the SEC have some leeway to determine whether investigations by governmental regulatory agencies are sufficiently material to require disclosure, rather than reflexively disclosing such investigations in all instances. To learn more, see our recent [Alert](#).

Social Covenants in Mergers — Legal Promises or Moral Commitments?

A public-company acquisition featuring stock consideration, especially a merger-of-equals, often involves significant discussion between the parties of so-called social issues, such as post-closing governance, board composition, management, people and corporate identity (e.g., corporate and brand names, headquarters and facility locations, and charitable and community commitments). Documenting agreement on these issues can raise questions as to whether a buyer is bound from a moral/reputational, as opposed to a legal, standpoint. To learn more, see our recent [M&A Update](#).

U.S. Sanctions on Cuba — Political and Regulatory Steps Toward Normalization Continue

U.S. regulatory authorities recently announced expanded relaxations of restrictions on travel, financial services, commerce and trade between the United States and Cuba. The changes will enable U.S. and Cuban businesses to use the U.S. financial system to engage in certain bilateral trade and investment, U.S. travelers to more easily visit Cuba and baseball fans potentially to see Cuban baseball players signed onto U.S. teams. To learn more, see our recent [Alert](#).

PENnotes

**Energy Outlook: Oil & Gas Dealmaking in 2016
Webcast
March 29, 2016**

This live roundtable discussion will explore the downturn and slow deal flow in the oil and gas industry, when conditions will improve and the kinds of deals that are being forged in the meantime. Kirkland partner Andrew Calder is a panelist. Click [here](#) for more information.

**SEC Update: What Advisers to Private Funds
Should Know
Webex and Dial In
April 5, 2016**

As the SEC continues its focus on advisers to private funds, Kirkland would like to keep you updated on the evolving regulatory environment. The Firm will host a call featuring Kirkland investment funds partners Norm Champ, Scott Moehrke and Aaron Schlaphoff. Norm and Aaron recently joined Kirkland from the Division of Investment Management of the U.S. Securities and Exchange Commission. Click [here](#) for more information.

**Kellogg Private Equity and Venture Capital
Conference
Chicago, Illinois
April 13, 2016**

Kirkland is a sponsor of this year's conference, which will focus on "Breaking Boundaries: Differentiation in Private Equity and Venture Capital Markets." The event will address opportunities and challenges in the healthcare, energy and technology industries and evaluate alternative capital providers. Kirkland partner Martin DiLoreto will moderate a panel on "Investing in the Highly-Regulated and Rapidly Evolving World of Healthcare." Click [here](#) for more information.

**36th Annual Ray Garrett Jr. Corporate and
Securities Law Institute
Chicago, Illinois
April 28-29, 2016**

The Ray Garrett Jr. Corporate and Securities Law Institute is the pre-eminent securities law conference in the Midwest. It is the only Midwest conference that brings together senior officials from the U.S. Securities and Exchange Commission and leading securities practitioners. Kirkland partners Scott Falk, Robert Hayward and Keith Crow are members of the Executive Committee. Scott will also chair a session on "Hot Topics in M&A." Click [here](#) for more information.

**Managed Funds Association Compliance 2016
New York, New York
May 10, 2016**

Kirkland will sponsor MFA's annual Compliance event, which is designed to provide the education and clarity needed to comply with the many regulatory reforms impacting hedge funds and their investors. Kirkland partner Norm Champ will moderate the lunchtime keynote address with Honorable John Carlin, Assistant Attorney General for National Security, U.S. Department of Justice. Click [here](#) for more information.

**SuperReturn U.S. 2016
Boston, Massachusetts
June 6-9, 2016**

Kirkland is a sponsor of SuperReturn U.S. 2016, which is the largest annual meeting of private equity and venture capital professionals. Kirkland partner Aaron Schlaphoff will speak on the "CCO Response to the SEC Update" panel. Click [here](#) for more information.

Private Equity Practice at Kirkland & Ellis

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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, 2014 and 2015 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland & Ellis was named "Law Firm of the Year" in Mergers and Acquisitions Law by U.S. News Media Group and Best Lawyers in their 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance's* 2014 Legal Awards, "Law Firm of the Year in North America: Fund Formation" at Private Equity International's 2013 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012, 2013, 2014 and 2015, 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, 2014 and 2015*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite," 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."

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