Be Prepared: New US IRS Partnership Representative Rule Deadline is Approaching

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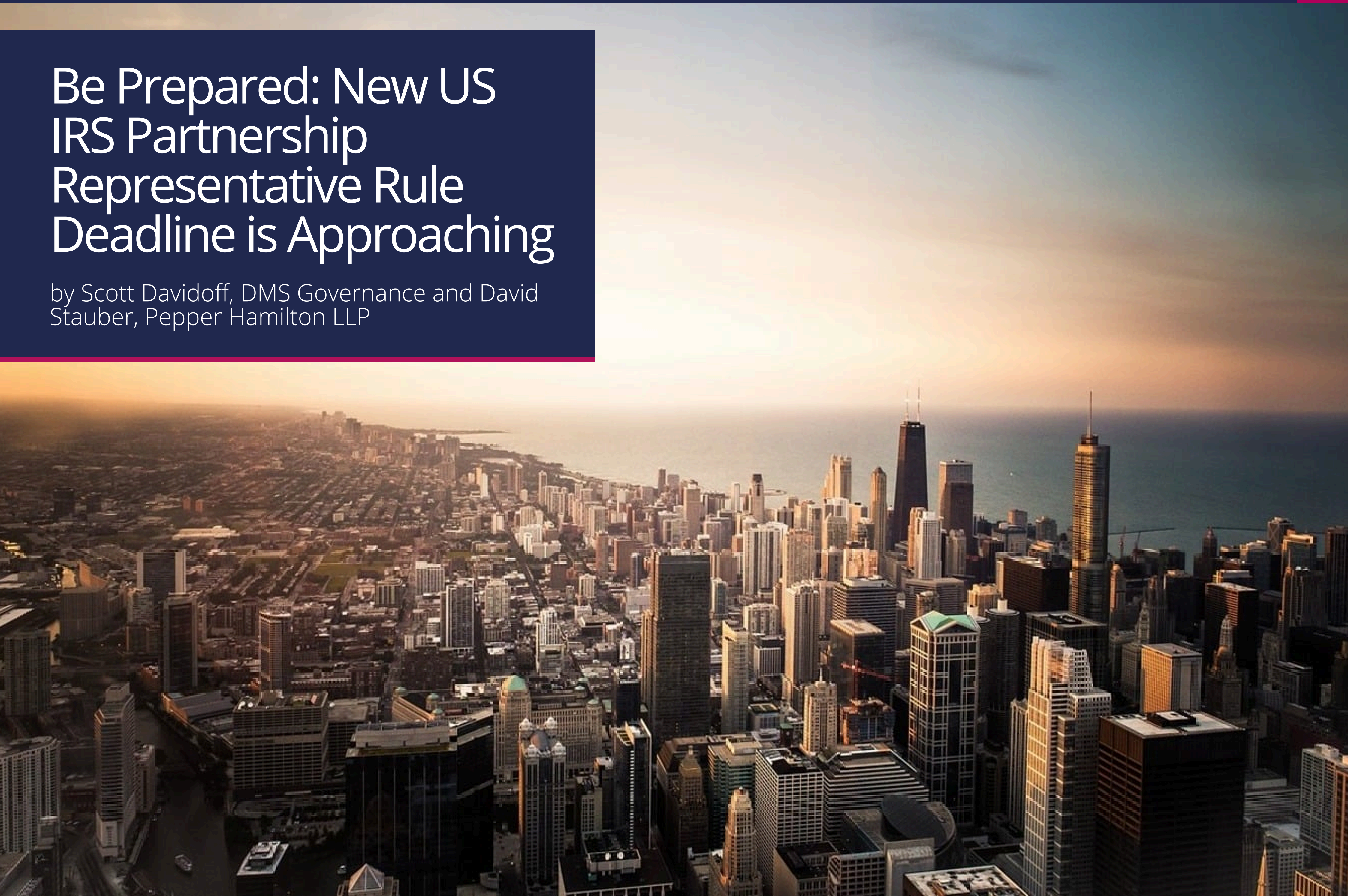

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Overview of the New Partnership Tax Audit Regime

A new federal audit regime for partnerships and other entities classified as partnerships for tax purposes (the "New Audit Rules") are in effect for audits of partnership tax years beginning on or after January 1, 2018. The New Audit Rules are a dramatic departure from the prior rules, known as the "TEFRA rules." Under the TEFRA rules, the IRS was required to allocate any partnership audit adjustments among the partners in the year subject to audit, and assess and collect any underpayment of tax at the partner level. Audits under the TEFRA rules required substantial IRS resources, causing audits of large partnerships, with hundreds, or even thousands, of partners extremely difficult and time-consuming for the IRS. The New Audit Rules change course and allow the IRS to impose any underpayment directly against the partnership. The burden of allocating the adjustments or underpayment among the partners therefore is shifted to the partnership. With the potential for increased efficiency conducting partnership audits under the New Audit Rules, it is anticipated that the IRS will more vigorously pursue large partnership audits.

Because the "imputed underpayment" is assessed directly on the partnership under the New Audit Rules, the partners in the year of the assessment bear the economic burden of the underpayment. This result may be inequitable if the ownership interests of one or more partners in the "reviewed year" differ from their interests in the partnership in the year the audit concludes and the assessment is paid. As an alternative to the partnership bearing the imputed underpayment in the year the audit concludes, the partnership can elect to push the audit adjustments out to the persons who were partners in the reviewed year (the so-called "**Push-out Election**"). When the Push-out Election is made, each reviewed year partner is required to include its share of the audit adjustments in its current year tax return and pay any resulting increase in tax.

Significantly, the New Audit Rules also replace the designation of a tax matters partner under the prior TEFRA rules with the designation of a "partnership representative." Unlike the tax matters partner, the partnership representative need not be a partner in the partnership. Moreover, the New Audit Rules grant the partnership representative broader authority to act on behalf of, and bind, the partnership and its partners than the tax matters partner. Accordingly, the other partners may seek restrictions in the partnership agreement on the partnership representative's ability to make decisions binding on the partners as part of the audit process.

To qualify as a partnership representative, the person designated must have a substantial presence in the United States. If the partnership representative is an entity, the partnership representative must appoint an individual, known as the designated individual, through whom it will act for all purposes under the New Audit Rules. The partnership representative has the sole authority to act on behalf of the partnership, and legally bind the partnership, with respect to federal examinations and audits. No contractual arrangement, including any partnership agreement or state law document, can limit or alter this authority. In addition, other than the partnership representative, no partner or other person may participate in any examination or other proceeding with the IRS.

Drafting/Amending the Partnership Agreement to Account for the New Audit Rules and to Address Potential Conflicts of Interests

A critical issue among the parties to an investment fund is how much authority to vest in the partnership representative, and whether to give the other partners a role in the partnership representative's decision-making process. Particularly if the partnership representative is a partner with effective control of the partnership or management responsibility for day-to-day operations (such as the general partner in a hedge fund or private equity fund), this partner may seek an unfettered right to make decisions with respect to partnership examinations and audits at its sole discretion. In response, investors may request notice of the initiation of a partnership examination or audit, and the right to be kept reasonably informed with respect to these matters by the partnership representative, because these rights are not guaranteed under the New Audit Rules. In addition, the investors may seek the right to consult with the partnership representative on key decisions, determinations and elections related to an examination or audit, and may even ask for a prohibition on certain actions by the partnership representative without the investors' consent. On the other hand, broad consent rights could cause a deadlock among partners, which could delay the orderly administration of a partnership audit or even cause the partnership representative to miss a deadline imposed by the New Audit Rules or the IRS. An alternative approach is to put these key decisions, determinations and elections in the hands of the partnership's board or other governing body, although this may not necessarily eliminate the risk of deadlock or delay.

Another provision of the partnership agreement that is often heavily negotiated is the provision governing the Push-Out Election. As discussed, the Push-Out Election permits audit adjustments to be allocated to the partners in the year under review as an alternative to the current year partners bearing the resulting assessment. The fund sponsor will typically prefer to have full control over the decision to make the election, if not a binding mandate in the partnership agreement to make the election in all instances, rather than being required to seek the consent of, and potentially negotiate with, the investors.

Practical Aspects of Designating a Partnership Representative

A failure to designate (or an ineffective designation of) a Partnership Representative allows the IRS to designate the Partnership Representative in certain circumstances. For example, if the designated partnership representative fails to satisfy the substantial presence requirement, or if the IRS receives multiple revocations of a partnership representative designation within a 90-day period, the IRS will notify the partnership and the most recent partnership representative of the ineffective designation. The partnership will then have 30 days to appoint a successor partnership representative, after which time the the IRS will designate a partnership representative on behalf of the partnership. An IRS designation is irrevocable without the express written consent of the IRS.

In the event of an IRS audit, designating an outside firm as the partnership representative to represent the partnership's interests may prove crucial to good governance. The IRS's core strategy is the centralization of an intermediary function in the form of a partnership representative to interact in real time with the IRS during business hours in the United States. To the extent that a third-party firm is utilized, the partnership representative (or the designated individual if applicable) should be reliable to exercise sound business judgement as substantial powers are vested in the partnership representative. The establishment of partnership representative policies and procedures around IRS communications, information document requests (IDRs), and decisions that impact the tax election treatment of the partnership, should be enshrined in fund documents and a service agreement with an outside firm.

It will be fairly obvious that the "substantial presence" requirement discussed above will necessitate immediate action from foreign investment managers with US partnership entities. The need for action may be less obvious to US-based managers who are familiar with the recently replaced tax matters partner rules and who may assume no significant distinction between the two roles. However, the broad grant of authority to the partnership representative results in a significant potential for conflict, and immediate action should be taken to address this inherent conflict of interests.

An employee of the investment manager may rightfully be wary, and would be well-advised to seek advice from outside counsel, before agreeing to serve as the partnership representative. To illustrate, if a partnership audit determines that one partner should have been allocated more income (or fewer deductions) than was actually allocated to that partner in the partnership's tax return, under the old TEFRA rules the audit adjustment would be a wash and could be handled through internal accounting maneuvering. However, under the new audit rules an adjustment to the distributive shares of the partners would be ignored in an adjustment that imposes the imputed underpayment on the partnership, and not on specific partners. To address the misallocation, therefore, the partners may need to agree to file amended returns to account for the imputed underpayment, which some partners may take issue with. As such, a disinterested third-party partnership representative firm may well be in a better position to provide the arms-length comfort partners are seeking.

In this sense, a third-party service firm may be a valued addition to an investment fund's roster of trusted service providers. Speaking with current accountants and attorneys can ease the task of finding a suitable partnership representative firm. Understanding the partnership representative's role and responsibilities is critical to ensuring proper alignment amongst the service being sought and provided. Practical considerations to ask a third-party Partnership Representative firm include:

- Does your firm currently provide regulatory compliance services? In the US? Globally?
- Will the Partnership Representative maintain a substantial presence in the US?
- Does the Partnership Representative (Designated Individual if applicable) have the requisite knowledge and understanding to act as liaison between the IRS and the partnership?
- Does the Partnership Representative service agreement set for forth the limitations and obligations of the Partnership Representative?
- Is the Partnership Representative required to give prompt notice of audits, audit progress updates and assessments to the General Partner?
- Does the Service Agreement specify that any substantive communications between the IRS and partnership that are required to be acted upon, are done so only with the written consent of the General Partner? Examples include settling an audit or extending the statute of limitations
- In the event of an IRS audit, will the Partnership Representative consult regularly with the General Partner and Advisors concerning the Partnership's audit and to the extent applicable, any subsequent audit litigation strategy?
- Under what circumstances will the Partnership Representative be indemnified by the partnership?
- As per the IRS' Partnership Representative resignation notification requirements, will the Partnership Representative provide at least a 90-day notice before resigning?

The key take-aways are that **Partnership beware**: non-US managers, particularly those that do not have a physical presence in the US, need to appoint a Partnership Representative on the partnership's 1065 tax form by the filing date. Non-compliance with the new audit law may place the partnership in the unenviable position of ceding that decision to the IRS. In addition, all investment managers should review and amend their fund documents to protect current investors from incurring costs relating to an audit not under their purview.