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Tax Law Changes Compel Amendments to Investment Fund Agreements

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John Kaufmann, Alan W. Bell, John V. Chase, Stuart Chasanoff, Genna Garver

Significant changes in federal income tax laws may require existing private investment fund agreements to be amended prior to the end of the 2018 calendar year. Investment managers should consult with their fund counsel to ensure that all fund agreements comply with the new tax laws, coordinate proper disclosure regarding the impacts of the new tax laws to investors, and begin implementation of new practices and procedures.

Depending on the extent of the amendments to fund documents that may be necessary, consent from fund investors may be required. Accordingly, we recommend starting your review process now so that the requisite amendments may be finalized before the end of the year.

Key changes to existing fund operating agreements, partnership agreements and other documents may include:

- Designating the fund's "partnership representative" – a designation that provides significant power over the fund and its investors but also exposes the designee to potential liabilities – and the process by which the partnership representative may be removed and replaced;
- Addressing tax audit notification, inspection and participation rights by fund investors;
- Applicability of the eligibility requirements for small partnerships to "opt-out" of the new rules and the necessity for transfer restrictions in order to preserve eligibility;
- Assessment of partnership tax audit adjustments at the fund level;
- Specifying rules for an election to "push-out" partnership tax audit adjustments to fund investors, and for indemnification of the partnership by former partners for tax liabilities resulting from the election; and
- Reviewing and updating current fund marketing materials.

Below we discuss in further detail the key changes with respect to existing fund agreements that may be required by the new partnership audit rules.

Designate the fund's "partnership representative"

Most fund agreements will need to be updated to designate a "partnership representative" instead of a "tax matters partner" and to address the circumstances under which a partnership representative may be removed and replaced.

The partnership representative will have the authority to act on behalf of the fund and bind all partners of the fund in judicial or administrative proceedings on tax matters. In the event that a partnership representative has not been designated, the IRS is empowered to select any person as the partnership representative. The partnership representative does not need to be a partner of the fund and can be any person who has a substantial presence in the United States. If the partnership representative is an entity, the entity must also select a "designated individual" who will be the person authorized to deal with the IRS.

Most funds will also want to provide indemnification for the partnership representative in the event of a dispute with an investor over an election or action taken by the partnership representative.

Address notice and inspection rights to be reserved by fund partners

Under the new partnership audit rules, partners in a fund will not be entitled to receive notice of partnership audits, to raise defenses, or to participate in judicial proceedings or audits, unless the fund agreement expressly provide partners with such rights. Therefore, fund managers must consider whether current fund agreements should be updated in order to (i) require that the partnership representative provide investors with such notice and inspection rights, or updates relating to partnership audits; (ii) provide for investor input or consent, if desired, for decisions relating to partnership audits (for instance, elections or settlements made by the partnership representative); (iii) permit investors to participate in partnership audits; or (iv) impose other restrictions on the activities of the designated partnership representative.

Review eligibility requirements for small partnerships to "opt-out" of the new rules

The new rules provide that partnerships with 100 or fewer partners may opt-out of the new partnership audit rules, provided that all partners in such small partnerships are "qualifying partners," – individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic, S corporations, and estates of deceased partners. Funds with investors that are pass-through entities – including other partnerships, limited liability companies, trusts or individual retirement accounts – will not be eligible to opt out of the new rules even if there are 100 or fewer partners.

Fund managers that wish to opt-out of the new partnership tax rules on this basis should review fund ownership structures and confirm that all investors are indeed qualifying partners. Fund managers may also wish to update current fund agreements to restrict the transfer of fund interests to entities that are not qualifying partners, since such transfers would make the fund ineligible to opt out.

If fund managers believe that a fund is eligible to opt out, current fund agreements should be updated to disclose (i) the right of the fund to opt-out of the new rules, (ii) the fund's obligation to notify each partner of any such opt-out election (which will be required to be made on an annual basis along with a timely filed return of the fund), and (iii) the fund's obligation to provide the IRS with partner names and tax identification numbers.

Assessment of partnership tax audit adjustments at the fund level

The new rules enable the IRS to perform partnership audits at the partnership level and collect tax underpayments and penalties directly from the partnership, instead of from individual partners.

Current fund agreements should be updated to address whether partnership tax adjustments will be assessed at the partnership level, the obligations of partners to contribute funds to the partnership in order to make the partnership "whole" after a partnership tax payment is made to the IRS, and the cooperation of partners and former partners who will bear the actual costs of the underpayment, and how each partner's (current and former) share of any imputed underpayment will be calculated.

Specify rules for electing to "push-out" partnership audit adjustments to fund partners

As an alternative to taking an assessment at the partnership level, the partnership representative may elect to "push-out" the assessment to the partners, thereby requiring partners to take the adjustment into account on their individual tax returns. Fund managers should consider whether to provide the partnership representative authority to push-out any partnership audit adjustments to fund investors, and fund agreements should be amended to disclose the possibility of such an election.

While the "push-out" election generally removes the tax liability from the partnership, it comes with an administrative burden for fund managers. Electing fund managers will be required to (i) make an annual "push-out" election within 45 days after a notice of final partnership adjustment, and (ii) issue statements of the partners' shares of the adjustment (essentially, adjusted Schedules K-1) to the IRS and each partner.

Since in most funds investor interests change over time, fund agreements should be updated to (i) include tax sharing provisions that set forth how taxes or adjustments are shared or are to be allocated among current and former partners, (ii) outline how partners during a reviewed year will be held liable for their share of the partnership tax adjustment even if they are no longer partners during the relevant assessment year, (iii) disclose the possibility that partners may be required to file amended tax returns if they were partners during a reviewed year but are no longer partners during an assessed year, and (iv) include indemnification provisions regarding the taxes paid by the partners.

Review and update of fund's current marketing materials

Fund managers should review and update private placement memoranda and other fund marketing materials in order to disclose the impacts of the new partnership tax audit rules on investors and conform them with changes that have been made in corresponding fund agreements.

Conclusion

As a reminder, most fund agreements require investor consent in order to be amended to make substantial changes. The changes required to comply with the new partnership audit rules are substantial.

Fund managers should speak with their counsel to begin the process of determining which amendments to their fund agreements will be needed, to ensure that the fund manager's interests are properly protected, and to ensure that all necessary disclosures are properly made to investors.

For more information on any of the matters discussed in this Client Alert, please feel free to contact the following members of Dorsey's Investment Funds group:

John Kaufmann (New York)

(212) 415-9328

kaufmann.john dorsey.com

Alan Bell (Salt Lake City)

(801) 933-7361

bell.alan dorsey.com

John Chase (Palo Alto)

(650) 565-2212

chase.john dorsey.com

Stuart Chasanoff (Dallas)

(214) 981-9924

chasanoff.stuart dorsey.com

Genna Garver (New York)

(212) 415-9341

garver.genna dorsey.com

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