Morgan Lewis

ADVANCED TOPICS IN HEDGE FUND PRACTICES CONFERENCE

Manager and Investor Perspectives

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Tax Updates

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Federal Tax: The State of Play

5 things you need to know

New IRS Commissioner

Commissioner Danny Werfel is now in place as 50th Commissioner of the IRS after a 54-42 Senate confirmation vote on March 9, 2023.

New Strategic Plan

The IRS unveiled its strategic plan in April with its top enforcement focus placed on wealthy individuals, large corporations, and partnerships.

Funding Remains High

Although $21 billion of the $80 billion in IRS funding was cut as part of the Biden-McCarthy agreement to suspend the debt limit and cap spending, spending in the next three years will likely not be negatively impacted.

Hiring Push

Looming worker shortages and increased funding means a push to hire, with the IRS planning to hire 20,000 new employees.

Tax-Focused White House

The Biden administration's FY 2024 budget includes proposals to increase IRS funding, close "loopholes," and expand partnership audit procedures.

"It makes sense to focus our initial Inflation Reduction Act implementation efforts exclusively on increasing our capacity to assess compliance of high-income and high-wealth individuals, complex partnerships and large corporations."
– Commissioner Werfel

IRS Enforcement

5 initiatives impacting the hedge fund industry

All new audits of partnerships are now conducted under the centralized partnership audit rules, enacted in 2015 to make it easier for the IRS to examine and collect deficiencies and raise $9.3 billion in revenues.

The IRS has implemented a "Large Partnership Compliance Pilot Program," which focuses on partnerships with more than $10 million in assets, starting with audits of the 2019 tax year.

The IRS has initiated a trio of enforcement "campaigns" focusing on transactions that relate to partners' bases in their partnership interests, the partnership loss limitation rules and the application of the basis rules to the calculation of gain.

The IRS is scrutinizing compliance with withholding tax information reporting forms, Forms 1120-F, adequacy of FIRPTA reporting, and satisfaction of documentation rules for applying nonresident alien treaty exemptions.

The IRS continues its pursuit of self-employment tax adjustments on limited partners' distributive shares of partnership income, an enforcement campaign that has grown increasingly aggressive post-pandemic.

"We will focus enforcement resources on hiring accountants, attorneys, engineers, economists and data scientists needed to pursue high-income and high-wealth individuals, complex partnerships and large corporations that are not paying the taxes they owe." – Commissioner Werfel

The IRS SECA Campaign

Launched in 2018, this campaign focuses on limited partnerships operating in the asset management, financial services, private equity, and hedge fund industries.

The IRS asserts that the limited partners in the partnerships provide services and should be subject to SECA taxes (currently 15.3%) on their annual allocations of partnership earnings.

While the Tax Code provides an exception for limited partners, the IRS takes the position that the partners are more akin to a general partner and the exception does not apply.

The IRS focuses on the activities of certain limited partners and the presence and amounts of capital contributions and ignores the partnership's specific facts, business operations, and other regulatory or contractual realities that guide decision-making and partnership structuring.

Two docketed cases, *Soroban Capital Partners LP v. Commissioner* and *Sirius Solutions LLLP v. Commissioner*, are currently pending before the US Tax Court and their outcomes will impact current and future audits.

The IRS has publicly committed to continuing these audits and continues to open new examinations solely focused on making this adjustment.

Selection for Partnership Audit

5 actions you need to take immediately

1 Identify who your Partnership Representative is and decide if you should make a change.

2 If you elected out of the partnership audit rules, decide if you want to revoke that election.

3 Review your partnership agreement to determine whether you have audit-related obligations or restrictions.

4 Review the partnership's tax return under examination and decide whether you need to file an Administrative Adjustment Request.

5 Consult with tax counsel, because even if you intend to have your accounting firm take the lead, you'll want to protect any privileges you have.

"…sustained, multi-year funding is so critical to the agency's ability to make the investments needed to pursue a robust attack on the tax gap by targeting… high-net-worth individuals and complex pass-through…" – Secretary Yellen

Entity Level Tax – Pass-Through Entity Tax

- In reaction to the addition of a $10,000 cap on individual federal income tax deductions for state and local taxes, a majority of states have adopted pass-through entity tax (PTET) regimes.
- In general terms:
  - a PTET is imposed by a state on a pass-through entity, such as an entity treated as a partnership (e.g., an LLC) or an S corporation;
  - the pass-through entity claims a deduction against its taxable income for the PTET, reducing the taxable income allocated by it to its individual owners; and
  - the individual owners can claim a tax credit, for state purposes, against their liability for personal income tax, reflecting PTET paid by the pass-through entity reflecting their share of ownership.
- In Notice 2020-75, the IRS effectively signed off on the approach, announced proposed regulations would be forthcoming, and permitted taxpayers to rely on the notice until regulations become effective.
- Procedures for electing into and complying with the PTET vary from state to state, as does the ability of an individual to claim state tax credits in his or her home state reflecting PTET paid to other states.
- Appropriate revisions should be made to LLC and partnership agreements to reflect, among other things, that the PTET may be inapplicable with respect to, or elected out of by, particular owners.

Partnerships Now Have Backstop Withholding Obligations on Sales of ECI Partnership Interests

Section 1446(f) of the US Tax Code, added as part of the 2017 Tax Cuts and Jobs Act, imposes a US withholding tax obligation on buyers of partnership interests from non-US partners if the partnership interests are in a partnership engaged in business in the US (ECI Partnership Interests).

Section 1446(f) also includes a backstop withholding obligation for the underlying partnership, to the extent the correct US withholding tax was not collected and paid by a buyer of an ECI Partnership Interest, but the application of this provision was deferred.

Beginning January 1, 2023, the partnership backstop withholding obligation is in effect. In addition, regulations under Section 1446(f) require that partnerships obtain appropriate certifications from buyers confirming that the appropriate ECI Partnership Interest withholding and payments were made.

Continuing IRS Campaign Regarding Treatment of Offshore Lenders

On June 10, 2021, the IRS Large Business and International Division announced a campaign focusing on whether foreign investors participating in "inbound" lending transactions were engaged in a US trade or business and generated effectively connected income, or ECI, subject to US tax filing and payment obligations.

This reflects an increased focus on loan origination strategies engaged in by, among others, hedge funds, aimed at avoiding treatment of foreign investors as engaged in a US financing business.

Strategies that may receive increased focus include season and sell, offshore adviser, and tax treaty-based strategies.

State and Local Tax Complications

Increased remote working raises potential state and local tax issues both for hedge fund managers and their employees.

- Potential payroll withholding obligations for managers and filing obligations for employees as a result of remote work.
- Potential nexus and manager-level tax filing and payment obligations as a result of remote work.

Increased application of economic nexus rules also may result in a broader range of state and local tax filing and payment obligations for managers.

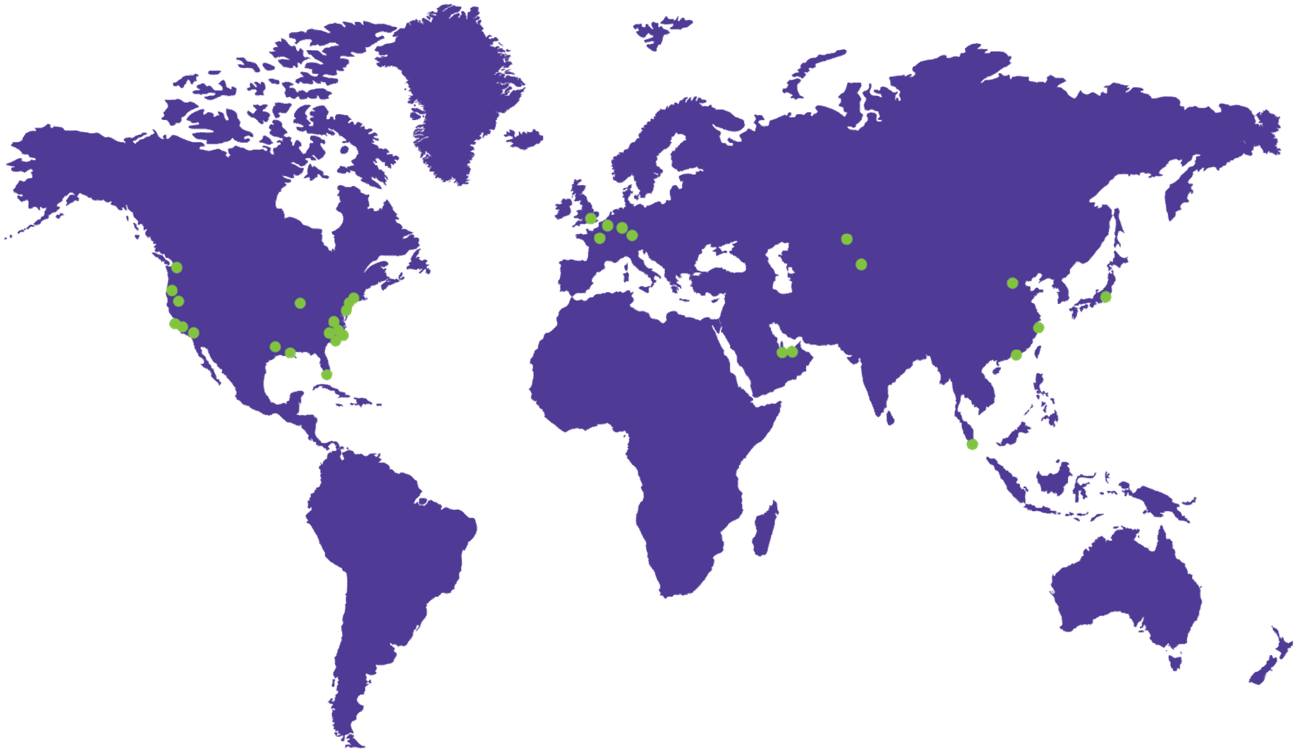
- Potential issues including for non-US based managers.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Astana
Beijing
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong
Houston
London
Los Angeles
Miami
Munich
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Seattle
Shanghai
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



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