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Private Equity News

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The Bipartisan Budget Act of 2015

The Bipartisan Budget Act of 2015 (the "Act"), signed into law by President Obama on November 2, 2015, makes major changes to the rules governing audits of partnerships, including limited liability companies taxed as partnerships, and may portend an increase in partnership audits. The changes generally apply to returns filed for partnership taxable years beginning after December 31, 2017, and many questions left open by the revised statute are expected to be answered by regulations issued in the next several years.

The Act essentially repeals the partnership tax audit regime that has been in place since 1982. Under the new regime, the default rule is that adjustments to items of income, gain, loss, deduction or credit of a partnership, and each partner's distributive share of each item, will be determined at the partnership entity level, and taxes shall be assessed against and collected from the partnership (rather than the partners) in the year that the adjustment is made. This means that persons who are partners in the later year but were not partners in the year of the return under audit (called the "reviewed year"), or whose partnership interest has increased since the reviewed year, may bear more of the increased tax liability than expected. The new rules provide procedures for modifying a partnership's imputed underpayment if (i) one or more of its partners is a tax-exempt entity, (ii) the adjustment is a reallocation of the distributive share of any item from one partner to another, (iii) the income is not taxed at the highest rate (e.g., capital gains or income attributable to a partner which is a C corporation) or (iv) one or more partners files an amended return for the reviewed year and takes into account the adjustment on such return.

These new rules will cause concern among buyers of partnership interests about potential liability for tax years preceding the date of purchase and may cause an increase in the thoroughness of tax due diligence, demands for increased purchase price holdbacks and indemnities or both.

The Act also provides for a procedure pursuant to which a partnership may elect to pass through all adjustments to its partners for the reviewed year and provide the IRS specified information about its partners so that the IRS can collect directly from the partners. In such an event, any additional tax is treated as imposed on the partners in the year that the partnership notifies them of the adjustment.

Certain partnerships with 100 or fewer partners are allowed to elect out of the new rules on a year by year basis by filing an election with its timely filed return and notifying the IRS of the identity of each of its partners. This election is not available (unless regulations provide otherwise) to partnerships that have one or more other partnerships as partners, so the election may not be private equity or other investment funds. If the election is made, the partnership and its partners would be subject to the audit rules applicable to individual taxpayers. It seems likely that many partnerships that are eligible to make this election will do so, although such elections will not be required for calendar year partnership until returns are filed in 2019.

The Act will eliminate the familiar tax matters partner in favor of a partnership representative, who is a partner or other person with a substantial presence in the U.S. who will have sole authority to act on behalf of the partnership in tax matters. Non-partner managers will be allowed to serve as the taxpayer representative, which may be useful to many partnerships. If the partnership doesn't designate its partnership representative, the IRS may select one. In light of this change, partnerships should consider amending their partnership agreements to place limits, or at least reporting obligations, on the partnership representative.

The Sheppard Mullin Tax Practice and Private Equity Groups will be following developments closely, and are developing revised language for new or amended partnership and limited liability company agreements to conform the treatment of any tax adjustments to the business expectations of the partners and to require partners to provide to the partnership any information required by it to comply with, or elect out of, the new rules. In addition, we are developing revised disclosure language relating to these new rules that can be incorporated into private placement memoranda and similar disclosure documents.

If you have any questions regarding this development, please contact:

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Our Private Equity Practice

Sheppard Mullin has a thriving private equity practice with a proven track record of serving sponsors and closing deals. Our experienced and dedicated team of legal professionals serve the private equity market all day, every day. We represent private equity and leveraged buyout firms of all sizes, as well as portfolio companies, in connection with acquisitions, divestitures and restructurings, including structuring the transaction and preparation and negotiation of documentation, exit transactions, including initial and follow-on public offerings, going private transactions and other mergers and acquisitions transactions. We provide a complete range of services at all stages of the investment cycle from start-up or "seed" capital to growth capital, mature private equity, and management buyouts. Our smart, business-oriented lawyers prioritize client objectives to deliver results.

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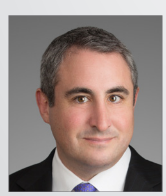

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