

NOTE

THE PARTNERSHIP AUDIT RULES OF 2015: THE IMPLICATIONS FOR MISVALUED PRIVATE FUNDS AND NEW PARTNERS

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Abstract

This Note takes an interdisciplinary approach by analyzing new Partnership Audit Rules' effects on misvalued private funds from Securities Law and Tax Law perspectives. First, the funds' valuation regulations are examined; second, the new Partnership Audit Rules are reviewed; and finally, implications for new investors and private funds are examined.

This Note suggests that marketability of private funds, which are ineligible for an opt-out option, would decrease. Especially serious negative effects may be anticipated for private funds with a history of misvaluation administrative proceedings. Nevertheless, several protective measures are available for new partners who want to continue taking advantage of pooled investment vehicles. Finally, there is a potential positive effect on the private funds' valuation techniques and, consequently, on the number of the SEC administrative proceedings relating to misvalued funds.

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I. INTRODUCTION

Modern investors are presented with a wide array of investment vehicles. Which vehicle is the right one for a particular investor may depend on many factors. Significant factors often include minimal regulatory and legal requirements as well as beneficial tax consequences. These factors played an important role in attracting wealthy individuals and institutions to private funds, which may be hedge funds, private equity funds, or liquidity funds.

There are, nevertheless, some disadvantages in holding an investment in a private fund. One of them is the possibility of misvaluation of the assets. Since hedge funds frequently hold hard-to-value securities, misvaluation may take place either accidentally or intentionally. Some Securities and Exchange Commission (“SEC”) administrative proceedings involving misvaluation become widely publicized because of outrageous conduct by the managers. Through enforcement of federal laws and issuance of various publications, the SEC attempts to guide the valuers how to deal with hard-to-value securities. Additionally, hedge funds are required to make disclosure statements about the valuation techniques they implement. Finally, the Dodd-Frank Act imposes advisers’ registration requirement for hedge funds advisers, which were previously exempted from registration.

The possibility of misvaluation is no longer the only serious concern for potential investors in private funds. In 2015, Congress amended the Internal Revenue Code (“Code”) and changed the way partnerships are being audited. Generally, private funds are organized as partnerships because of the beneficial pass-through tax treatment, where all the taxes flow from the partnership to its partners, so there is no double taxation as under the corporate form of organization. Starting January 1, 2018, the Partnership Audit Rules of the Bipartisan Budget Act of 2015 (“Partnership Audit Rules”) have gone into effect. There are negative implications for both new partners and for private funds. The Partnership Audit Rules would allocate former partners’ tax underpayment to the most current taxable year, in which partners’ base may have entirely changed, and therefore new partners might become liable for tax underpayments from past years unless they locate former partners. There is, however, a potential incidental effect on improvement of valuation techniques because of private funds’ possible intention to attract new partners. By improving their valuation techniques, private funds might attempt to assure new partners that they use credible valuation methods and would not expose new partners to tax overpayments.

Section II of this Note describes various funds, elaborates on regulatory and legal frameworks for the valuation of private funds, and references several current news-making instances of misvaluation. Section III reviews the Partnership Audit Rules and addresses certain unresolved issues related to new partners in private funds, including misvalued funds. Section IV highlights potential effects of the Partnership Audit Rules on private funds’ marketability, elaborates on protective measures available for new partners, and suggests a potential positive effect on valuation techniques for private funds.

II. FUNDS AND MISVALUATION ISSUES

This Section reviews various investment vehicles available to investors, the problem of misvaluation of the funds' assets, and the federal laws which attempt to protect investors from the funds' managers' intentional or unintentional errors in valuation.

A. Funds Overview

Today's investors, both individual and institutional, have many choices regarding where to invest their money. Common investment vehicles include mutual funds, private funds (such as hedge funds, private equity funds, and liquidity funds), and pension funds. Mutual funds "gather money from numerous investors and invest in a diversified portfolio of assets," including "stocks, bonds, and/or other mutual funds," through continuous public offerings and redemptions at net asset value determined by their price at the markets in which these portfolio investments trade, or at prices determined by the fund managers and directors if there is no active public market.¹ Hedge funds "invest the assets of high-net-worth individuals in a way that is designed to earn above-market returns" through incorporation of "high-risk strategies such as short selling, derivatives and leverage."² Hedge funds often "rely on active trading, which is a practice in which investment positions are changed with high frequency – sometimes to maintain a desired risk-return profile as market prices fluctuate, and sometimes to profit from short-term changes in prices."³ Pension funds can be both private and public; however, there are not many traditional pension plans left in the private sector.⁴ Private investment funds have certain advantages over publicly traded funds because of relatively more flexible regulatory and legal requirements.⁵ For example, in *Goldstein v. S.E.C.*, the court noted that "[w]hile mutual funds ... must register with the Commission and disclose their investment positions and financial condition, hedge funds typically remain secretive about their positions and strategies, even to their own investors."⁶ Nevertheless, starting from the enactment of the Dodd-Frank Act, there are much more rigorous disclosure requirements for private funds.⁷ This Note focuses primarily on private funds since the new Partnership Audit Rules affect mostly private funds due to the misvaluation issues which are frequent in these funds and which potentially result in over-taxation of new funds members.

¹ *Fund*, <https://www.investopedia.com/terms/f/fund.asp> [https://perma.cc/9D6L-NQZP] (last visited Nov. 8, 2018).

² *Id.*

³ David M. Schizer, *Constructive Ownership Under Section 1260*, BNA Portfolio: Financial Instruments: Special Rules, Chapter IV, n.1, 2002 (internal quotations omitted).

⁴ See *How Do Pension Funds Work?*, <https://www.investopedia.com/articles/investing-strategy/090916/how-do-pension-funds-work.asp> [https://perma.cc/764N-K3MG] (last visited Nov. 8, 2018).

⁵ See *Private Investment Fund*, <https://www.investopedia.com/terms/p/privateinvestmentfund.asp> [https://perma.cc/93UZ-R77E] (last visited Nov. 8, 2018) (A private fund must meet one of the exemptions outlined in the Investment Company Act of 1940. The most frequent exemptions are under Section 3(c)(1), "fund can have up to 100 accredited investors," and under Section 3(c)(7), "fund can have a soft limit of around 2,000 qualified investors." An accredited investor is required to have "more than \$1 million in net worth without counting their primary residence and/or \$200,000 in annual income for an individual and \$300,000 for a couple." A qualified investor is required to hold assets in excess of \$5 million.).

⁶ *Goldstein v. S.E.C.*, 451 F.3d 877, 875 (D.C. Cir. 2006).

⁷ The Dodd-Frank Wall Street Reform and Consumer Protection Act. Pub.L. 111-203, H.R. 4173 (eliminating the Investor Act's Section 203(b)(3) "private investment adviser" exemption and adding significant reporting requirements).

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B. Legal and Regulatory Framework of Funds' Valuation

Especially relevant legal and regulatory issue that concerns both registered and unregistered funds is valuation of the assets in their portfolios. Valuation, or more precisely misvaluation, often results from the conflicts of interests between a manager's "incentive to increase the value of portfolio assets in order to reap more handsome fees" and to promise "more attractive returns to prospective investors" and an investor's incentive to have the fund receive maximum market returns.⁸ Significantly, "compensation schemes for institutional investors are frequently tied to annual investment return."⁹ Consequently, some managers may implement questionable valuation techniques in order to increase their own compensation, which is in large part based on the percentage of net assets.

Generally, it is easy for a manager to discern an actual value of the investment. However, managers frequently rely on investment strategies which incorporate "thinly traded bonds, derivative instruments, and other securities that do not have transparent market price."¹⁰ In order to prevent potential abuse in relation to funds valuation, several federal securities laws respond to these concerns. These laws include the Investment Company Act of 1940 ("Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act"). Additionally, investors can turn to "the courts' interpretation of the federal securities antifraud statutes."¹¹ This resort, however, is generally not successful for individual investors because the provisions of anti-fraud statutes do not sufficiently address problematic valuation techniques used by the advisers.¹²

The Investment Company Act applies to the registered funds. In Section 2(a)(41), it defines "value:

(A) as used in sections 3, 5, and 12 of this title, (i) with respect to securities owned at the end of the last preceding fiscal quarter for which market quotations are readily available, *the market value at the end of such quarter*; (ii) with respect to other securities and assets owned at the end of the last preceding fiscal quarter, *fair value at the end of such quarter, as determined in good faith* by the board of directors; and (iii) with respect to securities and other assets acquired after the end of the last preceding fiscal quarter, *the cost* thereof; and (B) as used elsewhere in this title, (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined by the board of directors. (emphasis added).¹³

⁸ Salvatore Massa, *Outside a Black Box: Court and Regulatory Review of Investment Valuations of Hard-to-Value Securities*, 8 WM. & MARY BUS. L. REV. 1, 3 (2016).

⁹ James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis*, 67 NOTRE DAME L. REV. 971, 996-99 (1992).

¹⁰ Massa, *supra* note 8, at 3.

¹¹ *Id.* at 5.

¹² *See id.*

¹³ Investment Company Act § 2(a)(41), 15 U.S.C. § 80a-2(41) (2012).

Thus, if market quotations are “readily available” for the securities, the Act directs reliance on them; if there is no readily available market price, however, the Act authorizes the fund’s board of directors to determine the value “in good faith.” The latter approach is generally referred to as a fair value approach. It can be utilized for foreign securities, where the market is closed for holidays, and for hard-to-value securities.¹⁴

The SEC further elaborated upon the fair value approach. In Accounting Series Release No. 113 (“ASR 113”), the SEC applied the “current sale” test to fair value restricted securities and stated that the board’s obligation “to determine fair values of restricted securities, in good faith, entails continuous review of propriety of valuation methodology, consideration of relevant factors and retention of information on which the Board has relied.”¹⁵ Additionally, the SEC authorized the board to delegate “calculation of fair values pursuant to board approved methodologies.”¹⁶

In Accounting Series Release No. 118, the SEC addressed the valuation of hard-to-measure securities and stated that “value can be determined fairly in more than one way for unlisted securities traded regularly in the over-the-counter market.”¹⁷ Furthermore, the SEC highlighted that there is no single standard to determine the fair value of a security or other asset “because fair value depends on the facts and circumstances of each situation.”¹⁸

Finally, the SEC elaborated on the fair value method in the SEC Interpretive Letter to the ICI Regarding Valuation Issues (“Letter”).¹⁹ In the Letter, the SEC included the list of factors that can be taken into account by funds’ boards:

the value of other financial instruments, including derivative securities, traded on other markets or among dealers; trading volumes on markets, exchanges, or among dealers; values of baskets of securities traded on other markets, exchanges, or among dealers; changes in interest rates; observations from financial institutes; government (domestic or foreign) actions or pronouncements; and other news events.²⁰

This list shows how much flexibility fund managers and valuation companies have in determining what information to rely on when determining the value of the assets. This, however, may lead to disparities in value of similar securities held by different funds. Although the Letter does not state that all the factors should be taken into account by the valuers, this conclusion is preferable because taking as many factors as possible into

¹⁴ See Massa, *supra* note 8, at 9.

¹⁵ Statement Regarding “Restricted Securities,” Investment Company Act Release No. 5847, Accounting Series Release No. 113 (Oct. 21, 1969), <https://www.sec.gov/divisions/investment/icvaluation.htm> [<https://perma.cc/G8C2-ND7J>] (last visited Nov. 15, 2018).

¹⁶ *Id.*

¹⁷ Accounting for Investment Securities by Registered Investment Companies, Investment Company Act Release No. 6295, Accounting Series Release No. 118 (Dec. 23, 1970), <https://www.sec.gov/divisions/investment/icvaluation.htm> [<https://perma.cc/E5FG-Q7ZM>] (last visited Nov. 15, 2018).

¹⁸ *Id.*

¹⁹ Craig S. Tyle, Division of Investment Management: December 1999 Letter to the ICI Regarding Valuation Issues (Dec. 8, 1999) (on file with author).

²⁰ *Id.*

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consideration would more likely lead to the determination of the fair value of hard-to-value securities.

Section 34(b) of the Investment Company Act prohibits “disclosing materially misleading information in any required Commission filing.”²¹ The SEC utilizes this provision to institute administrative proceedings against registered funds which implemented inadequate or inaccurate valuation techniques or did not follow “a fund’s stated valuation procedures.”²² Additionally, the SEC relies on Rule 22c-1(a), which is promulgated pursuant to Section 22(c) of the Act, to institute administrative proceedings against funds which inaccurately reflect the funds’ current net asset value.²³ For example, in *In the matter of Jon D. Hammes*, the SEC identified misvaluation techniques and charged the board with five types of misconduct: (1) failure to monitor the liquidity of the securities; (2) passive reliance on valuation committee valuations; (3) failure to review financial statements; (4) failure to follow up on the requests for information; and (5) improper application of “a generic haircut to securities in lieu of conducting a fair value estimation.”²⁴ As a result, the SEC found a violation of Rule 22c-1(a) of the Investment Company Act and issued an order to cease and desist.²⁵

The problem of misvaluation is exacerbated by the fact that private funds are generally not required to register under the Investment Company Act because they operate in accordance with one of the exemptions – Sections 3(c)(1), 3(c)(7), or 7(d).²⁶ The SEC is still able to track private funds valuation techniques through disclosures under the Advisers Act and under the Dodd-Frank amendments of registration requirements.²⁷ Under Section 202(a)(11) of the Advisers Act, an investment adviser is “any person or firm that: (1) for compensation; (2) is engaged in the business of; (3) providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications.”²⁸ Although the definition is broad and attempts to cover as many potential advisers as possible, all three criteria must be satisfied.

The Advisers Act’s anti-fraud Rule 206 “prohibits untrue statements of material facts to investors or prospective investors in ‘pooled investment vehicles,’ omissions to state material facts and other fraudulent, deceptive or manipulative conduct.”²⁹ The Advisers Act applies to both

²¹ Massa, *supra* note 8, at 17-18 (citing 15 U.S.C. § 80a-33(b) (2012)).

²² *Id.*

²³ *See id.* at 24.

²⁴ *Id.* at 25.

²⁵ *See Hammes*, Administrative Proceeding File No. 3-11351, Order Instituting Cease-and Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 9(f) of the Investment Company Act (2003), <https://www.sec.gov/litigation/admin/33-8346.htm> [<https://perma.cc/LNV3-LC8L>] (last visited Nov. 24, 2018) (finding that “Heartland Advisors, the investment adviser of the Funds and the principal underwriter of Heartland Group’s securities, violated Rule 22c-1(a) by selling, redeeming and repurchasing Fund shares at NAVs calculated using bond prices that were not based on the bonds’ fair value as determined in good faith, as discussed above, which resulted in incorrect NAVs for the Funds”).

²⁶ *See* Nora Jordan, *Private Fund Overview*, Davis Polk & Wardwell 1, 4, 9 (Nov. 17, 2015) (unpublished presentation).

²⁷ *See id.*

²⁸ *Who is an Investment Adviser?*, <https://www.sec.gov/divisions/investment/iaregulation/memoia.htm> [<https://perma.cc/B4SG-Z99W>] (last visited Nov. 16, 2018) (the definition is broadly interpreted).

²⁹ Jordan, *supra* note 26, at 13; *see* Anti-Fraud Provisions, <https://www.sec.gov/divisions/investment/iaregulation/memoia.htm> [] (last visited Nov. 16, 2018) (citing S.E.C. v.

registered and unregistered advisers.³⁰ Importantly, there is no scienter requirement, but also no private right of action; only the SEC can enforce this Act.³¹ The Dodd-Frank Act eliminated the Section 203(b)(3) “private investment adviser” exemption, which used to permit the investment advisers to avoid registration if they “(i) had fewer than 15 clients during the preceding 12 months and (ii) did not hold themselves out to the public as investment advisers.”³² There are still many exempted advisers, which include venture capital fund advisers, some private fund advisers (assets under management must be less than \$150 million), foreign private advisers, CFTC registered advisers that advise private funds, and family offices.³³

Furthermore, all registered advisers are required to make disclosures about private funds: (i) “substantial reporting requirements” which generally include “census data, investment strategy, gross asset value, approximate number of beneficial owners”; (ii) “reporting of private fund service providers,” such as “auditors, prime brokers, custodians, administrators and marketers”; and (iii) “fair value reporting of private fund assets (including illiquid securities).”³⁴ Thus, the Advisers Act provides at minimum disclosure requirements of valuation techniques to deter the misvaluation of hard-to-value securities.

Finally, the investors can bring private actions by relying on anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. The investors may allege that “an adviser’s inaccurate portfolio valuations may become material misstatements of fact.”³⁵ In *Virginia Bankshares, Inc. v. Sandberg*, for example, the Supreme Court of the United States “acknowledged that opinion statements can be misleading.”³⁶ The decision, however, resulted in a narrow interpretation of the “misleading opinion” term because subsequent decisions by the Second and Seventh Circuits distinguished “pure opinions from quantifiable and verifiable facts” concerning valuations.³⁷ Thus, the current regime is not advantageous for the investors’ private actions.

C. Current Instances of Misvalued Funds

Despite the federal laws and judicial precedent, misvaluation of funds remains a significant problem especially in funds that are not subject to the Investment Act. Misvaluation of funds is especially a big problem where general partners, for example, in hedge funds and pension funds, in order to keep up with increased pension liability, politically appointed boards and state or municipal officials seek increased yields in more risky and non-readily marketable securities.

Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (holding that “under Section 206, advisers have an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to their clients, as well as a duty to avoid misleading them”).

³⁰ See Jordan, *supra* note 26, at 13.

³¹ See *id.*

³² *Id.* at 16.

³³ See *id.* at 18.

³⁴ *Id.* at 34.

³⁵ Massa, *supra* note 8, at 41.

³⁶ *Id.* at 42-43 (citing *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991)).

³⁷ *Id.* at n.293-96 (citing *Fait v. Regions Fin. Corp.*, 655 F.3d 105 (2d Cir. 2011); *Fulton Cty. Emps. Ret. Sys. V. MGIC Inv.*, 675 F.3d 1047 (7th Cir. 2012); *In re Barclays Bank PLC Sec. Litig.*, No. 09 Civ. 1989 (PAC), 2011 WL 31548 (S.D.N.Y. Jan 5, 2011)).

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One of the news-making examples involved a portfolio manager at a New York hedge fund, Stefan Lumiere, who was found guilty in 2017 of inflating bond prices in Visium Asset Management's ("Visium") credit fund and hid those losses from investors.³⁸ His sentence included a \$1 million fine as well as three years of supervised release.³⁹ This case of misvaluation was considered as "one of the most notable" in the recent years because Visium hedge fund attracted billions in assets, including from public pensions and endowments, and at its peak, it managed \$8 billion.⁴⁰ The misvaluation case did not only result in an enormous fine, but also in distancing of the Wall Street players.⁴¹

Another recent misvaluation case involved Daniel Thibeault, who falsely reported fake loans as assets of GL Beyond Income Fund, and Gemini Fund Services (the manager), who continued to calculate net asset value on all of loans until GL Beyond Income Fund was finally dissolved.⁴² The SEC imposed \$561,000 fine against Gemini Fund Services and stated that "fund managers must verify that all of the fund's assets actually exist by comparing the records of the fund's holding to the records of other services providers."⁴³ The SEC also advised that "[i]f the books don't match, don't strike another NAV [net asset value] until the discrepancy is fixed."⁴⁴ This case did not result in as big fine as the Visium's case did; nevertheless, the SEC expressed its expectations of high scrutiny of valuation techniques and bookkeeping by fund managers.

Finally, in a recent *New York Times* article, Donald Trump's father allegedly hid dozens of millions of tax dollars through misvaluation of real estate assets held under various organizational forms.⁴⁵ Despite these instances of misvaluation of real estate assets to hide millions of tax dollars, no Internal Revenue Service ("IRS") action has followed. Although investors in these vehicles did not suffer from the problems of investment private fund misvaluation, the motives in real estate assets misvaluation are similarly perverse because of tax evasion, and tax consequences of either private funds or real estate funds are significant for both private investors and general public.

Thus, misvaluation has been a recurring problem despite various federal laws and judicial precedent. In addition, it has been a problem for tax purposes since some investment vehicles may use questionable valuation techniques to evade taxes. As a result, misvaluation can harm investors

³⁸ See *United States v. Lumiere*, 249 F. Supp. 3d 748 (S.D.N.Y. 2017).

³⁹ See *A One-Time Portfolio Manager at a Top New York Hedge Fund Has Been Sentenced to 18 Months in Prison*, BUSINESS INSIDER, <https://www.businessinsider.com/visiums-stefan-lumiere-sentenced-2017-5> [https://perma.cc/TJL2-3BKW], June 14, 2017.

⁴⁰ *Id.*

⁴¹ See *id.*

⁴² See *Gemini Fund Services LLC*, Admin. Proc. File No. 3-18348 ("On January 22, 2018, the Commission simultaneously instituted and settled a cease and desist proceeding (the 'Order') against Gemini Fund Services, LLC ('Gemini').... The Trustees of the GL Fund have agreed to make payments to those victim investors, provide a written report and evidence of such payments to Commission staff, and return any undistributed funds to the Commission.").

⁴³ See *SEC to Fund Admins: No Proof, No NAV*, FINOPS REPORT, <https://finops.co/investors/sec-to-fund-admins-no-proof-no-nav> [https://perma.cc/4ABW-S6CE], Jan. 31, 2018.

⁴⁴ *Id.*

⁴⁵ David Barstow et al., *Trump Engaged in Suspect Tax Schemes as He Reaped Riches from His Father*, N. Y. TIMES, Oct. 2, 2018 ("Critical to the complex transaction was the value put on the real estate. The lower its value, the lower the gift taxes. The Trumps dodged hundreds of millions in gift taxes by submitting tax returns that grossly undervalued the properties, claiming they were worth just \$41.4 million. The same set of buildings would be sold off over the next decade for more than 16 times that amount.").

whose return on their investment is decreased as well as it can harm the revenue, where undervalued funds, sometimes intentionally and sometimes through clerical errors, result in collection of smaller amounts of tax.

Today, the Code amendment in relation to the Partnership Audit Rules may become a useful tool to discourage misvaluation occurrences, at least undervaluation. Since vast majority of funds select to be taxed as a partnership, it is especially important for private funds to understand these new rules. The Partnership Audit Rules take an entity approach⁴⁶ to audit partnerships rather than individual partners, so any tax adjustment which results from past taxable years will become the responsibility of the partnership as a whole at the current taxable year. Since misvaluation of funds can be one of the reasons for tax adjustments made by the IRS upon the audit of specific partnership, there may be severe consequences for a partnership, former partners, current partners, and new partners.

III. OVERVIEW OF THE PARTNERSHIP AUDIT RULES

This Section overviews newly enacted Partnership Audit Rules and discusses private funds and misvalued assets unresolved issues, which are inherent in these Rules due to a lack of finalized regulations.

A. The Partnership Audit Rules in a Nutshell

The Partnership Audit Rules have been enacted as a part of the Bipartisan Budget Act (“BBA”) on November 2, 2015.⁴⁷ The BBA repealed previous partnership audit system – the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the electing large partnership rules enacted in 1997.⁴⁸ The TEFRA took a mixed approach to partnership taxation because it used an entity approach “in the examination of partnerships” and an aggregate approach for collection purposes, where adjustments were made on an individual partner’s level.⁴⁹ Due to complicated rules under the TEFRA and rapid growth of number of partnerships, there was a need for an amendment of the Code.⁵⁰

The Partnership Audit Rules shift significantly toward the entity theory of partnerships: “any underpayment of tax resulting from a partnership-level examination will be paid by the partnership itself,” and “the partnership’s liability will be assessed for the tax year in which the examination concludes, and not the partnership’s tax year that was examined.”⁵¹ The effectiveness and efficiency of new rules are supposed to be achieved by “(1) allowing the IRS to collect from

⁴⁶ See generally Rachel L. Partain, *The New Partnership Audit Regime: What We Know, What We Do Not and What Is Next*, 33 REJ Issue No. 04 (2017) (There are two theories how to tax partnership’s income: an aggregation theory, where each partner is taxed individually, and an entity theory, where the partnership as an overall organization is taxed. The Partnership Audit Rules change a previously used mixed aggregate and entity taxation of the underpayment to almost pure entity taxation.).

⁴⁷ See *id.*

⁴⁸ See *id.*

⁴⁹ *Id.*

⁵⁰ See *id.* (“From 2002 to 2011, the number of large partnerships in the United States almost tripled, bringing the total number to over 10,000 distinct large partnerships. Of those partnerships, nearly two-thirds had more than 1,000 direct or indirect partners. The adjusting and collecting from partners in this environment was too great a burden for the IRS.”).

⁵¹ *Id.* (citing U.S.C. § 6221(a); U.S.C. § 6225(b)(1)).

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the partnership any partnership tax adjustment; and (2) requiring the appointment of a partnership representative to act as the point-person and binding decision maker with respect to any IRS audit procedures and related matters.”⁵²

The Partnership Audit Rules, Section 6221(a) provides: “any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner’s distributive share thereof) shall be determined, and any tax attributed *at the partnership level.*”(emphasis added).⁵³ Additionally, under Section 6225, an imputed underpayment should be calculated “by netting all adjustments made in the partnership examination and taking the net adjustment at the highest applicable tax rate,” that is currently 39.6%, under Section 1 or Section 11.⁵⁴ Some authors commented on this tax rate as tending “to punish the current partners for the tax sins of the prior partners.”⁵⁵

There is, however, a way to opt out of the new entity treatment. For example, under Section 6221(b), eligible partnerships may elect to be out of the centralized partnership audit regime.⁵⁶ Partnerships must meet two conditions in order to be eligible to opt out of the centralized regime: (1) “a partnership must have 100 or fewer partners,” and (2) “a partnership must only have eligible partners,” which are “individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic, S corporations, and estates of deceased partners.”⁵⁷ A partnership cannot elect to be out of the new Partnership Audit Rules if any of its partners include another partnership, a disregarded entity, a trust, an estate of an individual other than a deceased partner, or “if an interest in the partnership is held by a person acting as a nominee on behalf of the ultimate beneficial owner.”⁵⁸ If a partnership had successfully elected out, the IRS would collect the resulting imputed underpayment at the partner level.⁵⁹

Additionally, the partners can make a “push-out” election under Section 6226, where “[w]ithin 45 days of receiving a notice of final partnership adjustment, a partnership may make an election to subsequently issue its partners Schedules K-1 to account for their share of the adjustments”; thus, election allows partners instead of the partnership “to pay any additional tax liability” resulting from the audit.⁶⁰ As a result, a partnership that made a valid “push-out” election, will be free from imputed underpayment liability.⁶¹ There is, however, a two per cent higher rate of underpayment interest for the partners who make a “push-out” election.⁶²

⁵² *Are You Ready for the New Partnership Audit Regime?*, Katten Muchin Rosenman LLP (July 12, 2018), <https://katten.com/Are-You-Ready-for-the-New-Partnership-Audit-Regime> [https://perma.cc/QGG5-ZXHD].

⁵³ REG-136118016, 2017-28 I.R.B. 9, https://www.irs.gov/irb/2017-28_IRB [https://perma.cc/5MNS-BDPV] (last visited Nov. 20, 2018).

⁵⁴ Partain, *supra* note 46 (citing 26 U.S.C. § 6225).

⁵⁵ Terence Floyd Cuff & Jerald David August, 75-14 N.Y.U. ANN. INST. ON FED. TAX’N § 14.07 (2018).

⁵⁶ See 2017-28 I.R.B., *supra* note 53.

⁵⁷ *Id.*

⁵⁸ Mary Conway et al., *Expert Q&A on the New Partnership Tax Audit Rules*, Davis Polk & Wardwell LLP, 1, 3 (June 06, 2018).

⁵⁹ See *id.*

⁶⁰ Partain, *supra* note 46 (citing 26 U.S.C. § 6226(a)).

⁶¹ See Conway, *supra* note 58, at 3.

⁶² See Partain, *supra* note 46 (citing 26 U.S.C. §6226(c)(2)).

If the partnership is subject to the Partnership Audit Rules and cannot opt out or “push out,” then it is required to designate “a partner or other person with a substantial presence in the United States as the partnership representative.”⁶³ This person will have “the sole authority to act on behalf of the partnership.”⁶⁴ The IRS may also choose a partnership representative if the partnership failed to comply with the selection rules.⁶⁵

It is very important for partnerships to implement the new regime in accordance with the rules. To prepare for a new regime, many authors advise review of the partnership agreements and amend them in order to comply with the new Partnership Audit Rules.⁶⁶ These changes may include:

whom to appoint as the partnership representative and procedures for his, her or its replacement; indemnification provisions for the partnership representative; contractual limitations of power on the partnership representative and/or notice requirements to partners with respect to all IRS (and where applicable, state income tax) communications; if it is eligible, whether the partnership should make elections to opt-out of the new regime or to push-out the assessed tax liability to the partners; how to allocate any tax liability that is imposed on the partnership; and the ability of the partnership to obtain, upon request, certain information from its partners necessary for the partnership to modify its tax liability.⁶⁷

It should be noted that the Partnership Audit Rules would require funds to take many changes into consideration in order to avoid over-taxation and investors’ dissatisfaction with their investment decisions.

B. Unresolved Issues: Negative Consequences for New Partners

The Partnership Audit Rules went into effect on January 1, 2018, and some Treasury Regulations have been issued in relation to these new rules.⁶⁸ Nevertheless, many unresolved issues still exist and pose complicated questions for partnerships. One of the problems which the new Rules pose is the risk which new partners bear when they acquire an interest in an existing partnership. Under Section 6225, “adjustments for reviewed years are taken into account in the adjustment year.”⁶⁹ New partners will be required to perform an increased due diligence and to consider negotiating inclusion of indemnity clauses in the partnership interest purchase agreements⁷⁰ until the Treasury issues specific regulations which deal with new partners’

⁶³ 2017-28 I.R.B., *supra* note 53 (citing 26 U.S.C. § 6223(a)).

⁶⁴ *Id.*

⁶⁵ *Are You Ready for the New Partnership Audit Regime?*, *supra* note 52.

⁶⁶ *See id.*

⁶⁷ *Id.*

⁶⁸ *See, e.g.*, Partnership Representative Under the Centralized Partnership Audit Regime and Election to Apply the Centralized Partnership Audit Regime, 26 CFR Part 301, <https://www.federalregister.gov/documents/2018/08/09/2018-17002/partnership-representative-under-the-centralized-partnership-audit-regime-and-election-to-apply-the> [https://perma.cc/8WU3-FYUK] (last visited Nov. 20, 2018).

⁶⁹ Partain, *supra* note 46 (citing 26 U.S.C § 6226(d)).

⁷⁰ *See id.*

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treatment. The fact that the adjustments would have an effect on current partners rather than the reviewed-year partners, including former partners, is one of the most controversial aspects of the Partnership Audit Rules.⁷¹

The New York State Bar Association (“NYSBA”) Tax Section addressed some questions related to former partners in its “Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015” (“NYSBA Report”).⁷² The NYSBA Report, however, does not deal directly with the question of how new partners should seek indemnity from former partners in the continuing partnership. Rather this Report provides information on how to interpret Section 6241(7), that addresses partnerships that ceased to exist or deemed to cease to exist due to insufficient assets. These interpretations are still helpful in understanding how to identify former partners in situations where new partners buy interests in partnership and are audited by the IRS and required to include the underpayment from the past taxable years in current taxable year.

Under Section 6241(7), “if a partnership (i) ‘ceases to exist’ before a partnership adjustment under this subchapter takes effect, then (ii) such ‘adjustment shall be taken into account’ by (iii) the ‘former partners’ of such partnership ‘under regulations prescribed by the Secretary.’”⁷³ The relevant term from this provision is “former partners.” The NYSBA suggests that it could refer to “(a) reviewed year partners, (b) the persons that were partners in the entity just before the partnership ceased to exist, or (c) any and all partners.”⁷⁴ The NYSBA rules out options (b) and (c) and defends the position that “former partners” should mean “reviewed year partners and that the adjustment should be allocated among them in accordance with the partnership agreement for the reviewed year.”⁷⁵ The NYSBA provides its reasons for this conclusion: (1) “the imputed underpayment regime is a collection mechanism”; (2) this conclusion “prevents moving the liability or benefit from the reviewed year partners to other partners, and avoids the double taxation risk”; (3) “as a fairness matter, there is no reason to impose a direct tax liability on a partner for income that was allocated to another person”; (4) “asking dissolution year partners to bear the liability for taxes on income allocable to other partners would negate the limited liability on which partners rely when they invest in most modern partnerships.”⁷⁶

There is, however, one serious consideration which goes against the NYSBA’s conclusion and is especially relevant for the current discussion since it relates to possible actions by current partners who did not obtain indemnity against the former year partners. The NYSBA concedes the weakness of their argument by stating:

interpreting section 6241(7) in this way may encourage the partners in a partnership that is under audit and anticipating a material adjustment to cause that partnership to “cease to exist” to avoid having to bear Section 6225 tax (particularly

⁷¹ Cuff & August, *supra* note 55.

⁷² New York State Bar Association, Tax Section, Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015 (No. 1347) (May 25, 2016).

⁷³ *Id.* at 92.

⁷⁴ *Id.* at 93.

⁷⁵ *Id.* at 94.

⁷⁶ *Id.*

if the partnership or the current partners do not have indemnity rights against the reviewed year partners).⁷⁷

Although the NYSBA acknowledges the weakness of the argument, it still insists that it is very unlikely to become a common problem.⁷⁸ It provides with three reasons for this suggestion: (1) the partnership would decide to “cease to exist” only in most extreme circumstances; (2) partnerships already have an ability to push out the liability to reviewed year partners under Section 6226; and (3) the regulation may include examples of abusive situations, which would be precluded.⁷⁹

As to the last reason, the reference to upcoming regulations, there having already been two sets of proposed regulations⁸⁰ and some final regulations,⁸¹ but no final regulations which are relevant to “former partners” term. The Proposed Regulations of 2018 define “former partners” as “the adjustment year partners (as defined in § 301.6241-1(a)(2)) of a partnership that ceases to exist for the partnership taxable year to which the partnership adjustment relates.”⁸² Section 391.6241-1(a)(2) defines “adjustment year partner as “any person who held an interest in a partnership at any time during the adjustment year.”⁸³ It appears from the Proposed Regulations of 2018 that the Treasury agreed with the NYSBA’s definition of “former partner” term. This, however, does not resolve the problem of new partners not having indemnity against former partners and not being able to locate former partners. Also, it is unclear when and whether these Proposed Regulations will be finalized.

Thus, the Partnership Audit Rules attempt to improve the administrability of partnership taxation, which has become a complicated enterprise due to exponentially increased number of partnerships and partners within them. These Rules, however, are begging for further interpretations by the Treasury. The disincentives to purchase an interest by a new partner is one of the possible negative consequence of the new Rules, which do not address directly the funds’ joining and leaving partners. Since the investment funds’ misvaluations are still happening, there is even higher possibility of over-taxation due to former partners’ underpayments of taxes passed on new partners.

The overall effect of new Partnership Audit Rules may be a decrease in private funds marketability because uncertain rules and the possibility of over-taxation are strong deterrents for new investors. There is, however, a possible incidental positive effect of these under-interpreted Rules on valuation techniques improvement and consequent decrease in administrative proceedings under the Investment Company Act because in order to attract new investors, funds may consider improving its valuation techniques and by this, assuring new investors that they would not be overcharged in taxes for former partners’ tax underpayments.

⁷⁷ *Id.* at 95.

⁷⁸ *See id.*

⁷⁹ *See id.*

⁸⁰ *See generally* Centralized Partnership Audit Regime, 26 CFR Parts 1 and 301 (published on Aug. 17, 2018).

⁸¹ *See generally* Partnership Representative under the Centralized Partnership Audit Regime and Election to Apply the Centralized Partnership Audit Regime, 26 CFR Part 301 (published on Aug. 9, 2018).

⁸² Centralized Partnership Audit Regime, *supra* note 80, at 227.

⁸³ *Id.* at 220.

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IV. THE IMPLICATIONS OF THE PARTNERSHIP AUDIT RULES FOR MISVALUED PRIVATE FUNDS AND NEW PARTNERS

Although the instances of misvaluation which frequently result from conflicts of interests between general and limited partners in funds, investing in funds, especially private funds, is still a lucrative and therefore appealing enterprise. For this reason, it is necessary to evaluate how investors can continue taking advantage of investment opportunities and at the same time protect themselves from negative consequences of new Partnership Audit Rules. This Section addresses how the Partnership Audit Rules may affect the investors' incentives to continue investing in private funds and overall private funds marketability, taking into account past instances of misvaluation effects on new partners, various options which may be available for new investors in order to protect themselves from over-taxation under the new audit rules, and possible positive effects on valuation technique improvements within private funds.

A. Private Funds' Marketability under the Partnership Audit Rules

The Partnership Audit Rules apply to all partnerships and entities which elect to be taxed as partnerships.⁸⁴ Many private funds are structured as partnerships because this structure provides funds with an opportunity "to pool money from investors in a manner that preserves, to the extent practicable, tax neutrality for those investors when compared to investing directly in capital markets."⁸⁵ The investors are both tax-exempt and taxable institutional investors, which seek "the professional risk management, portfolio diversification, and other benefits provided by managers of private investment funds."⁸⁶ Unlike operating partnerships, in investment fund partnerships, there is only one level of tax that is imposed on the investor, solely in respect with that investor's investment.⁸⁷

It is important to note that in private funds, the investors' base changes all the time, where new investors come into the fund, while the earlier investors leave.⁸⁸ The taxation of the partnership as an entity creates serious negative implications for funds' marketability since "investors would face the potential to indirectly bear tax obligations from a period prior to their investment in the fund."⁸⁹ Application of the new Partnership Audit Rules may result in disincentive to invest into private funds because these rules create a disadvantage private funds' investors "compared to investors in other asset management structures."⁹⁰ This would affect the entire market of private funds and might result in a decrease of new investors' interest in investing

⁸⁴ See Monica Gianni, *New Rules for Audits of Partnership Returns*, 6 TAX DEV. J. 50, 52 (2016).

⁸⁵ Donald B. Susswein & Miriam L. Fisher, *New Partnership Audit Rules: What You Need to Know and Do Now*, ALICLE, SY004 ALI-ABA 189 (2016); see also Goldstein v. S.E.C., *supra* note 6, at 876 (noting that "domestic hedge funds are usually structured as limited partnerships to achieve maximum separation of ownership and management").

⁸⁶ Susswein & Fisher, *supra* note 85.

⁸⁷ See *id.*

⁸⁸ See *id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

into private funds. New investors might prefer investing into other asset management structures since partnership fund structures no longer provide with a pass-through tax benefit.⁹¹

Additionally, most institutional investors owe a fiduciary duty to their investors and therefore may be precluded from investing into private funds, where high risk of over-taxation exists.⁹² A risk of losing the partner's total investment might be considered too great because it is based on another partner's failure to fully pay taxes, so the fiduciary duty would likely preclude investments in the funds which are taxed under the new Partnership Audit Rules.⁹³ Decrease of institutional investors' interest in investing into private funds can lead to dramatic drop in private funds' marketability since institutional investors constitute "the largest force behind supply and demand in securities market" and therefore comprise the biggest investors at the market.⁹⁴

Furthermore, because many new partners would not want to be covered by the new Partnership Audit Rules, they may start investing solely into eligible for an opt-out option private funds which consist of one hundred or less partners and comply with other requirements for electing out.⁹⁵ As a result, marketability of private funds with more than one hundred people would decrease because new partners would not want to be audited under the Partnership Audit Rules and to bear risk of over-taxation.

Finally, as noted in Section II,⁹⁶ despite the federal securities laws, the instances of misvaluation of private funds are still frequent in the market. This creates significant concerns for new investors into private funds. The tax on partnership's misvalued funds would likely eventually be reassessed, and new investors would feel disincentivized taking a high risk of possible overpayment due to past valuation errors. Additionally, the imputed underpayment is taxed at the highest rate, so new investors not only possibly bear the tax consequences of former partners due to misvaluation but bear these consequences at the highest possible rate.⁹⁷ Consequently, new partners would likely stay away from private funds which are ineligible to opt out and which have had any occurrences of misvaluation, whether due to clerical errors or malign intentions.

In order to prevent negative consequences for new investors into private funds, some authors suggest that "it's critical for Treasury and the Service to implement sections 6225 and 6226 in a way that imposes post-audit tax liabilities as closely as possible to partners' tax liabilities outside of the audit context."⁹⁸ They add that "investment activity is likely to be distorted" if the new Partnership Audit Rules "impose additional tax liabilities on investors that they do not rightfully owe to the government, impose double taxation, or shift tax liabilities from investors to other investors."⁹⁹ One of the possible distortions may include investors' new expectation that

⁹¹ Pass-through or flow-through benefit is generally achieved by the entity through electing into being taxed as a partnership. After such an election, tax will be paid by individuals after the partnership furnishes K-1 form to its partners. The Partnership Audit Rules approach takes away part of this benefit by taxing a partnership as an entity for the previous years' underpayments.

⁹² See Susswein & Fisher, *supra* note 85.

⁹³ See *id.*

⁹⁴ *Institutional Investor*, <https://www.investopedia.com/terms/i/institutionalinvestor.asp> [https://perma.cc/ZN6T-YXXF] (last visited Nov. 24, 2018).

⁹⁵ See 26 U.S.C. § 6221(b).

⁹⁶ For funds and misvaluation issue, see Section II.

⁹⁷ See 26 U.S.C. § 6225(b)(1)(A).

⁹⁸ Susswein & Fisher, *supra* note 85.

⁹⁹ *Id.*

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managers will provide separate account structures instead of pooled funds.¹⁰⁰ This, however, will eliminate many purposes, including efficiency, which pooled vehicles provided before the new Partnership Audit Rules.¹⁰¹ Another possible distortion is investors' new choice "to invest through passive foreign investment company structures."¹⁰² This will permit investors "to avoid investment funds structured as entities treated as partnerships" and therefore to avoid potential over-taxation under the Partnership Audit Rules.¹⁰³ Furthermore, the partnerships would likely attempt to become eligible for an opt-out option under Section 6221(b).¹⁰⁴ This would result in another distortion because the partnerships will have to consist of one hundred or less partners and satisfy another requirement of who may be a partner to an eligible opt-out partnership.¹⁰⁵ All these actions motivated solely by new tax regime will result in economic inefficiencies.

Despite the above comments, the Treasury has not addressed the issues of private funds in its Partnership Audit Rules Final Regulations¹⁰⁶ or Proposed Regulations.¹⁰⁷ There are rules which provide for former partners' liability under the rule where a partnership ceases to exist, but there are no guarantees that new partners would not bear the consequences of over-taxation since some of former partners might not be located or might be illiquid. Thus, there is an uncertainty about whether the Partnership Audit Rules would provide new partners with protection against over-taxation resulting from former partners' underpayment. The concern is especially relevant for investment private funds, where the assets are valued by using various, sometimes questionable, techniques, which may lead to misvaluation. New partners are generally aware of possibilities of misvaluation, and they would likely become more cautious after the new Partnership Audit Rules have gone into effect because they bear higher risk to become responsible for former partners' underpayment of taxes of previously misvalued assets.

B. Protections for New Investors in Private Funds

New investors have various options on how to protect themselves from over-taxation under the new Partnership Audit Rules and to continue taking advantage of the pooled vehicles for investments, such as private funds. These options, however, generally impose additional transactional costs on new investors, which is another negative consequence of the Partnership Audit Rules for new partners.

First, the safest option for new partners, especially if it is a purchasing partner, is to negotiate with the partnership to restructure the partnership, so it could comply with the requirements to opt out. As described in a previous Section,¹⁰⁸ to opt out, the partnership should not have more than one hundred partners, and each of the partners must be an individual, a C-

¹⁰⁰ *See id.*

¹⁰¹ *See id.*

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *See* 26 U.S.C § 6221(b).

¹⁰⁵ *See id.*

¹⁰⁶ *See* Partnership Representative Under the Centralized Partnership Audit Regime and Election to Apply the Centralized Partnership Audit Regime, *supra* note 80.

¹⁰⁷ *See id.* at 220.

¹⁰⁸ For an overview of partnership audits rules, *see* Section III.

corporation, an S-corporation, or an estate of a deceased partner.¹⁰⁹ This may be an easy decision for many hedge funds, which have less than one hundred investors and whose members are within the above list of qualified investors for the opt-out option. It is, however, a much more complicated route to take for bigger private funds which can have up to two thousand investors.¹¹⁰ Additionally, where “the partnership agreement satisfies the conditions for opting out of the BBA rules, the partnership agreement may contain provisions prohibiting the partners from taking actions that could jeopardize that status.”¹¹¹ To protect availability of an opt-out option, a partnership agreement may include prohibitions for any partner to convert “into a partnership or disregarded entity.”¹¹² Partnership agreement may also prohibit any partner from “transferring its interest to a person that is not an eligible partner or in a manner that causes the partnership to violate the 100-partner rule.”¹¹³ In general, opting out should always be the first choice to make if this choice is available.

Second, new investors should examine a partnership interest purchase agreement to identify whether it contains indemnity provision or clawback provision. If there are none, new partners should request “an indemnity for pre-closing taxes from the seller.”¹¹⁴ Clawback provisions generally require “former partners who owned interests in the partnership for one or more ‘reviewed years’ be required to pay back to the partnership its pro rata share of any resulting income tax liability resulting in an imputed underpayment.”¹¹⁵ Partnerships start implementing the BBA specific indemnity clauses in response to the Partnership Audit Rules. The indemnity clause may be drafted as follows:

[t]he General Partner shall reasonably determine the portion of an Imputed Underpayment Amount attributable to each Partner and/or former Partner. To the extent feasible, this requirement shall be implemented through adjustments to distributions in accordance with Article VI, but *Partners and former Partners shall be obligated to indemnify and hold harmless the Partnership* to the extent this requirement cannot be so implemented. Any portion of an Imputed Underpayment Amount that the General Partner attributes to a former Partner of the Partnership shall be *an obligation of such former Partner and any third-party transferee or assignee of such former Partner.* (emphasis added).¹¹⁶

¹⁰⁹ See Conway, *supra* note 58, at 3.

¹¹⁰ See Partain, *supra* note 46; see also *Private Investment Fund*, *supra* note 5.

¹¹¹ Conway, *supra* note 58, at 8.

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.* at 9.

¹¹⁵ Jerald David August & Megan L. Brackney, *The TEFRA Partnership Audit Repeal: Partnership and Partner Impacts*, VCXG0523 ALI-CLE 1 (2016).

¹¹⁶ Private Equity Funds Business Structure and Operations Appendix d1, Amended and Restated Agreement of Limited Partnership, <https://advance.lexis.com/document/?pdmfid=1000516&crd=355e08e2-be49-4514-8367-1ab229469d36&pddocfullpath=%2Fshared%2Fdocument%2Fanalytical-materials%2Furn%3AcontentItem%3A5TGF-7WV1-JBR1-Y14M-00000-00&pddocid=urn%3AcontentItem%3A5TGF-7WV1-JBR1-Y14M-00000-00&pdcontentcomponentid=380718&pdteaserkey=sr0&pditab=allpods&comp=5pkLk&earg=sr0&prid=9b9d5b76-d47f-4b26-ab4e-a9984df22a62> (last visited 11/24/18).

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This clause provides new partners with an indemnification right against former partners. Although new partners are provided with this legal right, it may not be the most convenient way to seek former partners' contributions because it adds transactional costs for new partners and uncertainties about potential over-taxation in case former partners cannot be located. Additionally, new partners must take into account a legal obligation which they are acquiring: where "a partner transfers all or any portion of its interest in the partnership, the transferee partner will generally be made jointly and severally liable for any taxes, interest, and penalties attributable to the transferor partner."¹¹⁷ Thus, despite the indemnity provisions, new partners are still exposed to risk of tax overpayments. For this reason, indemnification provision may not be the best option to use because it still exposes new partners to risk of over-taxation and additional transaction costs of including this provision and looking for former partners.

Third, as an alternative to the indemnity or clawback provision inclusion, the partnership agreement may include the clause requiring the partnership "to create a reserve for unpaid taxes."¹¹⁸ The general partner or the manager may be in charge of setting up this reserve.¹¹⁹ The problem with the tax reserve or fund is that investors may become concerned if the managers use too much caution in setting up a tax reserve.¹²⁰ This protective option, nevertheless, is preferable over indemnification clause because "it's impractical for the purchaser to submit an indemnification claim to the partnership and then have the partnership chase after all the former partners."¹²¹ The reserve, on the other hand, is a more convenient option for a new partner and for this reason, new partners frequently require the partnership "to retain a sufficient amount of cash to pay any contingent liabilities," which may include tax underpayments.¹²²

A reserve can be created by contributing to "a trust the amount of cash necessary to cover contingent liabilities."¹²³ As a result, the partners are becoming the beneficiaries of that trust and will be "entitled to receive any of the cash held by it at the end of the trust's term."¹²⁴ Creation of trust would make a general partner liable for any contingent liabilities, including tax underpayments. More importantly, a general partner would not be able to go after the former partners.¹²⁵ Thus, creation of the tax reserve provides with a convenient mechanism for new partners to protect themselves from tax underpayments; on the other hand, the former partners are released from liabilities, so any shortage of funds in this tax reserve would still become new partners' responsibility.

Another important concern in creating a tax reserve is the way to determine the amounts to be charged from partners. One of the possible solutions is to charge audit expenses in the same

¹¹⁷ See Conway, *supra* note 58, at 8.

¹¹⁸ August & Brackney, *supra* note 115.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ Robert M. Kane, *Partnership Terminations: When Does Something Become Nothing?*, Ropes & Gray LLP (2018).

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ See *id.*

ratio as allocations are made in the reviewed year.¹²⁶ This approach represents a sensible solution since it reflects the economics of the business enterprise. Nevertheless, even this allocation-ratio-based approach may lead to too much funding being allocated into the audit reserve. As a result, many investors may be discouraged from investing into the funds which try to set aside a significant amount for audit reserve. At the same time, new investors would not take a risk investing into a fund which provides too little protection. Consequently, some funds, even though offering strong investment strategies, would be avoided for a fear of an audit resulting in over-taxation.

Fourth, new partners should consider requesting existing partners to make a “push-out” election, so they can protect themselves “against the possibility that it will bear taxes that should have been borne by prior partners.”¹²⁷ Where a “push out” election under Section 6226 is made and implemented in a partnership agreement, there may also be an additional requirement for former partners “to keep the partnership of their current addresses.”¹²⁸ This requirement seems to be easily implemented just by including the requirement in partnership agreement, so former partners would update a partnership on their current addresses. One concern here may be whether partners would agree to make a “push-out” election since it imposes an additional fee of two per cent higher rate of underpayment interest.¹²⁹

Finally, under the new Partnership Audit Rules, a buyer of partnership interest should consider conducting a more rigorous due diligence, which is similar to a corporate mergers and acquisition due diligence.¹³⁰ Under the TEFRA regime, the purchasers did not have to conduct this kind of due diligence because each partner was responsible for its underpayments individually.¹³¹ Because of an entity approach of the new Partnership Audit Rules, purchasers should be much more cautious and should familiarize themselves with the partnership agreement provisions related to the Partnership Audit Rules.¹³²

C. Positive Effects of the New Partnership Audit Rules on Valuation Techniques

It is important to note that uncertainty existing in the new Partnership Audit Rules potentially lead to improvements of valuation techniques and to a decrease in the number of administrative proceedings for the SEC. This potential incidental positive effect may result from private funds’ decrease in marketability due to possible over-taxation of new partners instead of former partners and various transactional costs inherent in due diligence process and in negotiating partnership interest purchase agreements.

Because the new Partnership Audit Rules would likely decrease marketability of at least big private funds which are ineligible for an opt-out option, especially funds with a history of misvaluation proceedings, private funds would likely attempt to improve its reputation by using more credible valuation techniques. Private funds would have to find a way to assure new partners-

¹²⁶ See August & Brackney, *supra* note 115.

¹²⁷ See Conway, *supra* note 58, at 9.

¹²⁸ August & Brackney, *supra* note 115.

¹²⁹ See Partain, *supra* note 46 (citing 26 U.S.C. § 6226(a)).

¹³⁰ See Conway, *supra* note 58, at 8-9.

¹³¹ See *id.* at 8.

¹³² See *id.*

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investors that they would not be exposed to a risk of overpayment of taxes due to questionable techniques used in the past. New partners, in their turn, while picking funds to invest would likely conduct a more serious due diligence procedures, through which they can learn whether these funds were a part of any administrative proceedings brought by the SEC and whether the funds were found to be violating the standards for more accurate valuation requirements imposed by the Investment Company Act or anti-fraud provisions of the Securities Act of 1933, the Exchange Act of 1934, and the Advisers Act. As a result, private funds might pay even more serious attention to the valuation methods used. Thus, the potential positive consequence of the present uncertainty under the Partnership Audit Rules may include not only the improved valuation techniques used by private funds, but also decreasing number of administrative actions brought by the SEC under the Investment Company Act, the Advisers Act, the Securities Act, and the Exchange Act.

V. CONCLUSION

The Partnership Audit Rules have only been in effect since January 1, 2018, so it is still too early to evaluate the impact of these Rules on private funds. Nevertheless, some authors have already addressed the potential negative effects on new partners joining private funds. New partners would be discouraged from joining ineligible for an opt-out partnership because new partners would be unwilling to undertake a risk of tax overpayments for previous years. It might also become a nuisance for new partners to chase former partners to pass on a responsibility for tax adjustments.

Nevertheless, strict adherence to honest valuation of fund held securities is vital to the credibility of that market. Plainly dishonest valuation is illegal and may also be criminal. It may also lead to over-taxation of new partners as a result of new Partnership Audit rules. There are many protective measures available for new partners to counter-act these negative effects. The best one is for investors to make sure that the private fund opted out of the Partnership Audit Rules and included clauses in the partnership agreement mandating to comply with the electing out requirements. This is, however, a limited protective measure because many private funds consist of more than one hundred people. Another reasonable solution would be selecting private funds which contain in their agreement a requirement for creating a reserve for unpaid taxes. This reserve would be a guarantee for new partners that they do not have to chase after former partners to obtain previous years' tax underpayments. An indemnity clause, on the other hand, is not as effective even if included in the agreement because new partners will be required to search former partners. Finally, new partners should consider conducting a more serious due diligence examination when investigating interests in a private fund and examining the agreements for various provisions, such as "push out" elections, which should protect new partners from tax overpayments, as well as records of general partners and fund managers' activities regarding valuation of securities, offering documents, and other accounting records.

Overall, it is important to understand that the Partnership Audit Rules may have serious negative consequences for private funds ineligible for an opt-out option, since new investors would likely invest in the funds which are eligible for an opt-out option in order to avoid unnecessary risk of being over-taxed. Additionally, these Rules require further Treasury's interpretation which should address new partners' concerns in joining private funds. Furthermore, misvalued private

funds would likely suffer the most because the misvalued assets would eventually be revalued, and tax deficiency would be reassessed against a private fund as a whole, so new partners risk even more joining a private fund with a reputation of using questionable valuation techniques.

There is, however, a potential incidental positive effect on private funds' valuation techniques. This effect may result from private funds' competition to attract new partners by assuring them that their valuation techniques are unlikely to be questioned by the SEC and the tax is unlikely to be reassessed by the IRS. This may also lead to a decrease in administrative proceedings with the SEC because in order to attract new investors, private funds might choose to use only credible valuation techniques. Greed factor, however, may suppress any positive effects of the new Partnership Audit Rules. Thus, it is more likely that an active SEC initiative to curb misvaluation of assets will be more effective than new Partnership Audit Rules incidental positive effects.

Since the Partnership Audit Rules have been in effect only one year, this topic may be further refined when more statistical evidence becomes available. The useful evidence would include changes in private fund sizes, a decrease in marketability of large funds, an increase in marketability of small funds (under one hundred investors), a decrease of marketability of funds with a misvaluation history, and a very unlikely decrease in administrative proceeding instituted by the SEC in relation to misvalued funds.