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Commentary: Are tax-exempt investors really tax exempt?

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Tax-exempt investors need to address potential tax liabilities in investment funds as IRS audits could leave them with a surprise tax bill.

Call us old-fashioned, but we think of tax-exempt institutions as exempt from taxes.

Under a federal law that took effect in 2018, however, the IRS may audit investment funds structured as limited partnerships, limited liability companies or other pass-through vehicles and collect any resulting underpayments of the investors' income taxes from the fund itself. Unless its governing documents say otherwise, the fund may pass along the bill to its investors, including tax-exempts, however it sees fit, even though none of the tax is attributable to the tax-exempt investors. Plus, if the fund is unable to obtain reimbursement from a taxable investor for its share of the tax, the other investors, including tax-exempts, could be required to pony up. Unfortunately, the contracts we have seen so far leave the door open for these outcomes.

We note some possible fixes below. If left unaddressed, the potential tax liability in investment funds is a ticking time bomb for tax-exempt investors. Until such time as fund documents evolve toward provisions more favorable to tax-exempt investors, it is essential that tax-exempts and their advisers be aware of the implications of the new tax audit rules and the possible solutions to the significant problems they raise.

Background

Tax-exempt institutions generally bear no federal income tax on their investment income and gains except for a tax on "unrelated business taxable income," which, in this context, applies to the extent the investor or the fund uses leverage and certain penalty excise taxes.

Investment funds, whether organized as limited partnerships or LLCs, are typically treated as pass-throughs for federal tax purposes. This means that the fund itself is not subject to federal income tax, and all profits and losses flow through from the fund to the investors, which are subject to tax (or not) on their shares of these fund items. While the IRS can audit funds, prior to the enactment of the new law the IRS' only remedy upon discovering a tax underpayment was to go after each investor.

The new tax audit rules

To address this difficulty for the IRS, the Bipartisan Budget Act of 2015 provided that where a fund (whether organized in the U.S. or an offshore fund with U.S. investors) is audited for a tax year beginning after 2017 and it is determined that additional taxes are owed by the investors, the IRS may generally collect those taxes directly from the fund. The law also gives the "partnership representative" designated by the fund extremely broad authority to bind the fund and the investors in connection with the audit, with limited obligations to consult with or even notify the investors.

Why is this change significant for tax-exempt investors? Because once even a dollar of tax is collected from the fund itself as opposed to its investors, the economic burden of that tax, like that of any other expense of the fund, will be borne by all of those who are partners in the fund (including tax-exempt investors) in the year the audit is completed and the tax is paid, unless the fund's governing documents say otherwise.

Worse still, unless otherwise addressed in the documents, the fund may allocate tax audit liability across its current investors rather than only those who were investors in the prior year under audit. This might arise, for example, in a hedge fund where investors come and go over time. Naturally this compounds the risk for tax-exempt investors — they may be liable not only for the current taxable investors' tax but also for the tax of former taxable investors who have since left the fund.

And if the fund cannot obtain reimbursement from a current or former taxable partner of the partner's share of a tax audit adjustment because, for example, the partner is bankrupt or cannot be located, absent a prohibition in the fund's contract, the fund typically can "socialize" the liability among the other taxable and tax-exempt partners.

For these reasons, unless one or more of the possible solutions described below are employed, the new partnership audit rules seem inherently unfair to investors who are exempted from most taxes due to their public-interest missions. In addition, they are inconsistent with the traditional concept that an investor's liability to the fund is limited to its capital account and may well be applied in a manner that is inconsistent with the institutions' fiduciary duties.

This puts the tax-exempt investor and its counsel in the uncertain position of having to quantify, in advance, the magnitude of its potential future tax liability. To date, most counsel to the funds' general partners appreciate the risk this creates for tax-exempts but do not wish to add language to the fund documents that would reduce or limit the GP's options to make and recover tax payments in the event the fund is ever audited and underpayments are determined. Indeed, it is currently the market standard for funds to have no duty even to inform investors of a tax audit or to allow tax-exempt or other investors to be heard.

Possible solutions

What can be done to preclude tax-exempts from bearing tax liability of other investors? Solutions include the following:

- If eligible, the fund can elect out of the new audit rules. This isn't possible, however, if the fund has more than 100 investors or has even one investor that is itself a partnership, an LLC, a trust or a disregarded entity.
- The fund/partnership representative can "push out" the audit liability to the prior-year partners. While this eliminates the partnership-level tax payment and thus solves the above problems for tax-exempts, it comes at a cost of a 2-percentage-point increase in the interest rate the IRS will charge on the partners' audit adjustments, to compensate the IRS for the additional cost of collecting the tax from the partners rather than the partnership.

- The fund/partnership representative can ask the IRS to reduce the amount of tax to be paid by the fund to take into account the tax-exempt status of the investors and any payments of the taxes owed via amended tax returns filed by the investors. However, absent language in the fund documents allocating the economic burden of the fund's tax payments away from the tax-exempts, this solution does not ensure that tax-exempt investors will receive the benefit of the reduction. Plus, as noted, if the taxable investors to whom a tax payment is allocable will not pay or cannot be located, the fund may decide to pass their burden onto the other investors, including the tax-exempts. These problems could be avoided with clear contractual language, but so far GP lawyers tend to offer non-committal provisions to preserve GP flexibility.
- Establish a side-by-side fund for tax-exempt investors. Subject to regulatory issues, this solution could simplify matters as the tax-exempt fund could opt to either elect out of the new audit rules entirely (if all of the tax-exempt investors are organized as corporations rather than trusts); push out tax adjustments to the investors since they will at most owe only their allocable portions of UBTI arising from fund leverage, if any; or ask the IRS for a modification of any audit adjustment (to zero) to reflect the tax-exempt status of 100% of the investors. Perhaps the GP would seek a small stake in the tax-exempt fund, but presumably it would indemnify the fund for taxes attributable to its interest.

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