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REPORT

PRIVATE FUND INDUSTRY UPDATE

THE KEY TAX DEVELOPMENTS THAT SHAPED 2023

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PRIVATE FUND INDUSTRY UPDATE: THE KEY TAX DEVELOPMENTS THAT SHAPED 2023

2023 saw a number of key tax developments that may affect the private fund industry going into 2024, from key US Tax Court opinions and updates to Internal Revenue Service (IRS) Forms, to new regulations proposed by the IRS and the US Treasury Department (Treasury). Private equity funds, hedge funds, and other private investment funds, as well as their investors and advisors, should be aware of these developments. Below we highlight some of the biggest developments affecting these stakeholders.

YA GLOBAL

The Tax Court Opinion

In a much-anticipated opinion released on November 15, 2023,[1] the United States Tax Court (Tax Court) held that a Cayman Islands fund was engaged in a US trade or business during the 2006 through 2009[2] taxable years as a result of attribution of the activities of the fund's US manager to the fund, rendering the fund liable for withholding taxes under Section 1446[3] for the portion of its US effectively connected income (ECI) allocable to its foreign partners.[4]

The facts of the case, described below, are somewhat unusual. The opinion nevertheless may have significant impact across the asset management industry as there is limited precedential guidance regarding what might constitute a US trade or business for private investment funds.

US Trade or Business

YA Global Investments, LP, a Cayman Islands partnership, was the master fund in a master-feeder fund structure during the years at issue. Investors could invest in YA Global through a Cayman Islands feeder fund, meant primarily for non-US and certain tax-exempt investors, or a US feeder fund, meant primarily for certain US investors. YA Global and the US feeder fund were treated as partnerships for US federal income tax purposes, while the Cayman Islands feeder fund was treated as a corporation for US federal income tax purposes.

YA Global entered into an investment management agreement (IMA) with Yorkville Advisors LLC, a US-based fund manager that was also YA Global's sole general partner. Pursuant to the IMA, Yorkville acted as YA Global's agent and attorney in fact and was authorized to buy, sell, and otherwise transact in securities on behalf of YA Global. The IMA allowed YA Global to impose restrictions on Yorkville's

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[1] 161 T.C. No. 11. The court issued its opinion as a Tax Court Opinion. The Tax Court instructs that a Tax Court Opinion is generally issued when the Tax Court believes the case involves a sufficiently important legal issue or principle. A Tax Court Opinion can be cited as legal authority, and the decision can be appealed. *See* US Tax Court, Guidance for Petitioners, Things That Occur After Trial.

[2] The Tax Court addressed certain issues for YA Global's taxable years ended 2006 through 2008. YA Global's 2009 taxable year raises additional issues that the parties are briefing after taking into account the Tax Court's opinion.

[3] All Section references are to the Internal Revenue Code of 1986, as amended.

[4] The Tax Court made several other holdings related to computation of tax and penalties that are outside the scope of this report.

investment decisions by providing appropriate notice. Yorkville was compensated for its services by an annual management fee equal to 2% of YA Global's assets and a 20% incentive fee based on YA Global's profits.

YA Global provided funding to portfolio companies in the form of convertible debentures, standby equity distribution agreement (SEDAs), and other securities. The terms of the convertible debentures provided YA Global the ability to acquire stock of the issuer, upon conversion, at a discount. YA Global typically exercised its conversion rights only when it was ready to sell the underlying stock. The portfolio companies paid structuring and transaction fees to Yorkville and YA Global in connection with the convertible debenture transactions.

The SEDAs provided YA Global the ability to purchase a specified dollar value of a portfolio company's stock at a discounted price over a fixed period. YA Global would sell stock purchased pursuant to the SEDAs to the public at market price. Additionally, SEDAs typically required the portfolio companies to pay Yorkville and YA Global various fees upon the execution of the SEDA and additional fees upon each advance of funds.

Yorkville identified, sourced, negotiated, conducted due diligence on, and structured and managed these transactions. Yorkville used the fees received from the portfolio companies to pay its expenses and remitted remaining amounts to YA Global.

While YA Global filed an IRS Form 1065, U.S. Return for Partnership Income, for each year at issue, it did not file an IRS Form 8804, Annual Return for Partnership Withholding Tax (Section 1446), for any year at issue, taking the position that it was not engaged in a US trade or business and thus did not earn any ECI subject to withholding under Section 1446.

The Tax Court first examined whether Yorkville's activities could be attributed to YA Global for purposes of determining whether YA Global was engaged in a US trade or business. The Tax Court determined that Yorkville acted as YA Global's agent and not as a mere service provider in managing the partnership's assets. The Tax Court focused on YA Global's ability to restrict Yorkville's discretion in managing the partnership's assets as well as its retained level of control over Yorkville as indicia of an agency relationship.

The agency relationship between Yorkville and YA Global was critical to the Tax Court's determination of whether YA Global was engaged in a US trade or business. Absent an agency relationship, the activities of Yorkville would not have been attributed to YA Global, likely insulating YA Global from being engaged in a US trade or business by virtue of Yorkville's activities.

After determining that Yorkville acted as YA Global's agent, the Tax Court next examined whether YA Global was engaged in a US trade or business as a result of Yorkville's activities. The Tax Court held that YA global was engaged in a US trade or business, finding Yorkville's activities (1) to be continuous, regular, and engaged in for the primary purpose of income or profit, (2) not limited to the management of investments, and (3) not covered by the applicable safe harbor for trading stocks or securities.

The parties did not dispute the first determination, that Yorkville's activities were continuous, regular, and engaged in for the primary purpose of income or profit. With respect to the second determination, the Tax Court held that Yorkville's activities were not limited to investment management because the portfolio companies received value from Yorkville above the capital received from YA Global. The payment of fees by the portfolio companies did not depend on YA Global putting its capital at risk. Some of the fees required per the terms of the convertible debenture and SEDA transactions were payable upon execution of the relevant agreement before the portfolio companies sought advances.

Similarly, with respect to the third determination, the Tax Court concluded that Yorkville's activities were not limited to trading in stocks or securities. The income that YA Global earned from the portfolio companies went beyond returns on invested capital, distinguishing the partnership from investors and traders.

Having determined that YA Global was engaged in a US trade or business, the Tax Court further determined that the income of the YA Global was ECI and should have been subject to withholding.

Dealer Status

The Tax Court further held that YA Global was a "dealer in securities" under Section 475(c)(1)(A) because it regularly purchased securities from "customers" in the ordinary course of its trade or business. Under Section 475(c)(1), a securities dealer is defined as a taxpayer that either "(A) regularly purchases securities from or sells securities to its customers in the ordinary course of a trade or business or (B) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business."

The Tax Court found that the portfolio companies were YA Global's customers. The Tax Court looked to the Treasury Regulations promulgated under Section 475 for the definition of the term "customers." Those Treasury Regulations provide that, for purposes of Section 475(c)(1)(B), a taxpayer's customers are those with whom the taxpayer does what it "regularly holds itself out" to do. The Tax Court indicated that it saw no grounds for giving the term "customers" a different meaning for purposes of Section 475(c)(1)(A) as compared to Section 475(c)(1)(B).

The Tax Court explained that YA Global held itself out as being willing and able to provide capital to portfolio companies, and Yorkville had a reputation that led portfolio companies to contact it directly. According to the Tax Court, because YA Global and Yorkville held themselves out as ready to enter into transactions involving YA Global's purchase of debt securities and stock issued by portfolio companies, the portfolio companies were YA Global's customers. This holding is of importance because status as a dealer disallows a non-US fund from qualifying for the so-called "trading safe harbor" unless it acts through an independent agent.

Statute of Limitations

The Tax Court also held that the filing of IRS Form 1065 by YA Global for each of the years at issue did not begin the statute-of-limitations period for assessing Section 1446 withholding tax. The Tax Court explained that because YA Global was liable for Section 1446 withholding tax for the years at issue, YA Global was required to file an IRS Form 8804 in addition to its IRS Forms 1065. The Tax Court dismissed YA Global's argument that IRS Form 8804 is simply a supplement to IRS Form 1065, finding that the filed IRS Forms 1065 did not advise the IRS of YA Global's potential liability for Section 1446 withholding tax.

Takeaways

While the unusual facts in YA Global could limit its applicability, the decision raises questions for many private funds regarding agency relationships and proper fee characterization that are more broadly applicable. Many private funds and their advisors may be able to distinguish their facts from the ones in this case, but a careful review of non-US funds that invest in the United States, and their activities and contractual relationships, as well as which parties in the fund complex receive fees (directly or passed through from a manager) warrant particular attention. Private funds and sponsors should consider these issues as applied to their structures and activities.

Additionally, private funds (and in particular foreign standalone funds or feeder funds that are taxable as partnerships for US federal tax purposes) may consider filing protective IRS Forms 8804 where there is potential risk of being treated as engaged in US trade or business and generating ECI subject to withholding. Such a protective filing would start the clock on assessment of any Section 1446 withholding tax and possibly protect funds against the imposition of penalties.

LIMITED PARTNER EXCEPTION TO SELF-EMPLOYMENT TAX – SOROBAN CAPITAL PARTNERS

The Tax Court Opinion

In *Soroban Capital Partners LP v. Commissioner*,[5] a New York hedge fund (Soroban) filed a motion for summary judgment asking the Tax Court to determine whether limited partners in a state law limited partnership were exempt from Self-Employed Contribution Act (SECA) tax on their annual distributive allocations for 2016 and 2017 under the limited partner exception provided in Section 1402(a)(13) (which excludes a limited partner's distributive share of income from the partnership's calculation of net earnings from self-employment).

For the years at issue, Soroban reported as net earnings from self-employment its guaranteed payments to its limited partners plus the general partner's share of ordinary business income. The IRS adjusted Soroban's net earnings from self-employment by increasing it to include the shares of ordinary business income allocated to the limited partners, arguing that they were limited partners in name only. On November 28, 2023, the Tax Court issued its opinion,[6] holding that a functional analysis test must be used to determine whether such state law limited partners can utilize the limited partner exception.

Section 1401(a) imposes a tax on self-employment income of individuals. Section 1402(a) defines net earnings from self-employment tax. The Code generally requires partners to include their distributive shares of partnership income as net earnings from self-employment. The limited partner exception under Section 1402(a)(13) generally excludes a limited partner's distributive share of partnership income or loss from self-employment tax. Section 1402(a)(13) states that "there shall be excluded the distributive share of any item of income or loss of a *limited partner*, *as such*, other than guaranteed payments described in section 707(c)" (emphasis added).

In its decision, the Tax Court held that the limited partner exception does not apply to a partner who is limited in name only, but rather that it applies only to a limited partner who is functioning as a limited partner. Noting that "limited partner" was not defined for purposes of the limited partner exception, the Tax Court examined legislative history and engaged in statutory interpretation in an attempt to decipher Congress's intent regarding the type of taxpayer that may utilize the exception.

Specifically, the Tax Court focused on the phrase "limited partner, as such," highlighting that Congress would not have included "as such" if it were intended that a limited partner under state law would automatically be included under the limited partner exception. Instead, according to the Tax Court, the use of the phrase "as such" demonstrates that Congress intended the exception to apply to limited partners acting as passive investors.

Ultimately, the Tax Court determined that when applying the limited partner exception a functional analysis test must be used to determine whether a partner was acting as a limited partner or if the partner instead is a partner who is limited in name only.

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[5] 161 T.C. No. 12.

[6] The court issued its opinion as a Tax Court Opinion.

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Takeaways

This decision represents a victory for the IRS stemming from its SECA compliance campaign, which attempts to address what it perceives as the improper use of the limited partner exception. Please see our thought leadership for discussion regarding the court's decision and the potential implications of the term "as such" in the statute.

While the decision has the potential for far-reaching impact on the amount of self-employment income claimed by partners in a limited partnership structure (both historically and in the future) and the use of such structures, it does not resolve this issue with finality. The decision simply confirms that state law limited partners are subject to a functional analysis, something that partners in non-limited partnerships had been subjected to in prior cases.

The decision does not articulate what this functional analysis should consider. Additionally, there remains a possibility that this decision will be appealed and that an appeals court would find fault with the lower court's statutory interpretation, especially the business-friendly Second Circuit, where an appeal of this case would lie.

Further, even if this decision stands, the statutory language clearly contemplates situations where a limited partner can receive income from providing services to a partnership, which would be subject to self-employment taxes, as well as income attributed to its investment in the partnership as a limited partner, which would not. Many firms operating in the asset management, financial services, private equity, and hedge fund industries may have facts that demonstrate that these separate types of income exist for the partnership and its limited partners.

WITHHOLDING QUALIFIED HOLDERS – UPDATES TO FORM W-8EXP

The IRS updated Form W-8EXP, Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting, as well as its instructions, as of October 2023 to reflect final regulations published on December 29, 2022[7] regarding qualified foreign pension funds (QFPFs) claiming an exemption from Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) withholding under Section 1445.

FIRPTA generally treats a foreign person's gain or loss from the disposition of US real property interests (USRPIs), including shares in US real property holding corporations (USRPHCs), as ECI. In addition, Section 897(h)(1) provides a look-through rule that treats certain distributions from certain real estate investment trusts and regulated investment companies as gain from the disposition of USRPIs. Section 897(l) provides that a QFPF, or an entity that is wholly owned by a QFPF, is not treated as a nonresident alien individual or a foreign corporation for purposes of FIRPTA.

Thus, QFPFs (or entities wholly owned by QFPFs) are exempt from FIRPTA withholding with respect to gain attributable to the disposition of USRPIs. The final regulations clarified that a foreign partnership that is wholly owned by a "qualified holder" (generally, a QFPF or entities wholly owned by a QFPF) is not subject to FIRPTA withholding. The final regulations provide that a qualified holder (or a foreign partnership that is wholly owned by qualified holders) may certify its status as a "withholding qualified holder" (WQH) that is not subject to withholding under Sections 1445 and 1446.

A WQH is generally required to submit a certification of nonforeign status to a withholding agent or transferee for purposes of avoiding FIRPTA withholding under Sections 1445 and 1446. The final

[7] 87 Fed. Reg. 80,042 (Dec. 29, 2022).

regulations clarified that an IRS Form W-8EXP is an acceptable form of certification; however, the IRS Form W-8EXP had not been updated to reflect the required certification.

Prior to the release of the revised IRS Form W-8EXP, WQHs were required to provide to a withholding agent or transferee certification of nonforeign status in accordance with the final regulations—that is, a self-prepared statement that is signed under penalties of perjury that states the transferor is not a foreign person and sets forth the transferor's name, identifying number, and address. There was no form specifically blessed by the IRS or US Treasury Department for this purpose, and so funds often prepared their own forms that may differ to a small or material extent from other market participants' forms.

The October 2023 revised IRS Form W-8EXP (including applicable instructions) is available on the IRS's website.

Takeaways

The ability to certify WQH status on IRS Form W-8EXP should reduce administrative burden and clarify the requirements for certification to one market expectation.

GUIDANCE ON DC REITS AND FIRPTA

For purposes of FIRPTA, interests in a "domestically controlled" US real estate investment trust (DC REIT) are not treated as USRPIs, and foreign persons generally are not subject to US taxation on gain from their disposition of interests in a DC REIT. A "domestically controlled" REIT is a US REIT in which non-US persons hold directly or indirectly less than 50% of the interests in the US REIT. Treasury and the IRS released proposed Treasury Regulations regarding DC REITs on the same date that they issued the final regulations concerning the special rules for QFPFs discussed above.

The proposed regulations clarify that QFPFs are treated as foreign persons for purposes of determining whether a REIT is "domestically controlled," and propose certain changes to the rules regarding DC REITs. The proposed regulations seek to clarify the uncertainty as to the foreign status of QFPFs for purposes of the "domestically controlled" calculation generally arising from the statutory language that provides that a QFPF "shall not be treated as a nonresident alien individual or a foreign corporation."

Thus, for example, if a US REIT is held by US natural persons, US tax-exempt entities, QFPFs, and foreign investors that are not QFPFs, the US REIT would not be a DC REIT if the QFPFs and the other foreign investors collectively hold 50% or more of the value of the US REIT's equity interests.

The proposed regulations also provide a look-through rule for purposes of determining DC REIT status. The proposed regulations would require a REIT to look through any nonpublic domestic corporation if 25% or more of the corporation's stock (by value) is owned by foreign persons. As such, a taxable US corporate blocker established by foreign investors to invest in a US REIT, for example, would be treated as foreign to the extent of its foreign ownership to determine whether the REIT is "domestically controlled."

This look-through approach is contrary to a 2009 private letter ruling that ruled that fully taxable domestic C corporations are considered domestic holders for purposes of determining whether a REIT is a DC REIT, even when they are wholly owned by foreign shareholders. Domestic corporations that are either publicly traded or whose foreign ownership is less than 25% would not be subject to the look-through rule and would be treated as US persons for purposes of testing status as a DC REIT.

Additionally, the proposed regulations would provide that a REIT must look through partnerships that are not publicly traded partnerships. These rules would be effective for transactions occurring on or after the date the regulations are finalized. That said, the preamble to the proposed regulations indicates that the IRS may challenge taxpayers that take a contrary position under current law.

Takeaways

The proposed regulations, together with the preamble, indicate that the IRS and Treasury are concerned that foreign investors may be able to rely on investor groupings or the use of closely held domestic C corporations to achieve DC REIT status to secure at least a partial tax exemption for gains derived from selling equity interests in the DC REIT.

The QFPF rule and the domestic C corporation look-through rule are intended to limit the scope of the FIRPTA exemption that can be obtained through planning for DC REIT status. The market is still reacting to these proposed regulations. The proposed regulations surrounding the determination of a DC REIT could provide obstacles for tax planning of many real estate funds, private equity funds, and non-US investors in US real estate.

Fund sponsors should carefully review existing fund structures that may be relying on DC REIT status in order to assess the impact that the proposed regulations may have on those structures. Additionally, fund sponsors will want to review fund agreements and side letters to determine whether the potential finalization of the proposed regulations would have an impact on any aspects of those agreements.

PROPOSED REGULATIONS UNDER SECTION 892

The proposed regulations issued on December 29, 2022 and discussed above also included regulations under Section 892 that would benefit foreign government investors in private funds and other entities that own US real estate by making it easier for those investors to structure their holdings of such investments in a manner that preserves such investors' eligibility for the Section 892 exemption. The proposed regulations under Section 892 will become effective when finalized. However, the preamble to the proposed regulations indicates that taxpayers may rely on the proposed regulations under Section 892 until the final regulations are issued.

Section 892 generally exempts foreign government investors from US federal income tax on income from investments in stocks, bonds, and other securities. However, any such income that is derived from a "commercial activity" or that is derived by or from a "controlled commercial entity" is not eligible for the exemption. A "controlled entity" of a foreign government (i.e., an entity in which the foreign government owns, directly or indirectly, 50% or more of the value or voting interests or over which the foreign government otherwise has effective practical control) will be a "controlled commercial entity" if it is engaged in any "commercial activity" anywhere in the world.

Under a special rule (the Deemed Commercial Activity Rule), a "controlled entity" is deemed to be engaged in a "commercial activity," and thus deemed to be a "controlled commercial entity," if it is a USRPHC. To avoid the impact of the Deemed Commercial Activity Rule, foreign government investors should carefully monitor their direct and indirect US real estate investment holdings.

The proposed regulations relax the Deemed Commercial Activity Rule by providing that a "controlled entity" that would be a USRPHC solely by reason of owning interests in one or more corporations that are not controlled by the foreign government will not be subject to the Deemed Commercial Activity Rule. Thus, under the proposed regulations, a "controlled entity" would be able to benefit from the Section 892 exemption even if most or all of its portfolio consists of minority interests in USRPHC investments, assuming that the only reason that the "controlled entity" would be a USRPHC is the ownership of those minority investments and that the "controlled entity" does not otherwise engage in "commercial activities."

For "controlled entities" that are also QFPFs (or entities that are wholly owned by one or more QFPFs), the proposed regulations provide that the Deemed Commercial Activity Rule does not apply at all.

Takeaways

The market is still reacting to the proposed regulations notwithstanding the fact that the preamble indicates that they may be relied upon. Under the proposed regulations, while foreign government investors would still need to monitor their activities to ensure that their "controlled entities" are not USRPHCs and are not conducting "commercial activities" anywhere in the world, the proposed regulations would allow for greater flexibility in how foreign governmental investors choose to hold their US real estate investments, including minority interests in private equity funds that invest in real estate or infrastructure.

The relaxation of the Deemed Commercial Activity Rule should reduce the administrative burden of monitoring compliance with the rule and may, for certain foreign government investors, permit additional US real estate or infrastructure investments.

Moreover, the IRS and Treasury have taken an important step to harmonize the Section 892 exemption with the separate Section 897(l) exemption for QFPFs and entities wholly owned by QFPFs. The preamble to the proposed regulations acknowledges that, since QFPFs and entities wholly owned by QFPFs are exempt from taxation under FIRPTA, they should not be required to limit their US real estate investments or engage in extensive monitoring and balancing of their US real estate investments in order to maintain their eligibility for the Section 892 exemption on their other income and gains.

IRS INCREASED SCRUTINY OF PARTNERSHIPS AND USE OF AI

With the significant funding allocated to the IRS through the Inflation Reduction Act (IRA),[8] the IRS has taken steps to improve its audit process and increase tax compliance by increasing its compliance employee headcount and leveraging improved technology. These changes are in line with the goals and objectives that the IRS has announced over the last year and are consistent with the objectives outlined in the IRS's Inflation Reduction Act (IRA) Strategic Operating Plan released in April 2023 and the Large Business & International (LB&I) division's Fiscal Year 2024 Strategic Goals.

As relevant here, the IRA Strategic Operating Plan proposes to use tens of billions of IRA dollars to hire and train specialized compliance employees and initiate examinations of high-income and high-wealth individuals, complex partnerships, and large corporations. As part of the implementation of its Strategic Operating Plan, the IRS established in September 2023 a new pass-through organizations unit, housed within LB&I, to focus on large or complex pass-through entities.

Additionally, the IRS also announced that it will be implementing a more aggressive auditing program aimed at high-income individuals and large partnerships, with artificial intelligence (AI) playing an important role in the initiative. By utilizing AI to detect tax evasion, identify emerging compliance threats, and improve case selection tools to avoid unnecessary audits, the IRS states that it will have the bandwidth to tackle complex audits with high-dollar noncompliance amounts, a feat the IRS was not capable of in the past.

Before the IRA was enacted, the nation witnessed some of the lowest IRS audit rates in history. In a report published in July 2023, the US Government Accountability Office (GAO) found that between 2002 and 2019 the number of large partnerships (i.e., with more than $100 million in assets and 100 or more

[8] Pub. L. No. 117-169, 136 Stat. 1818 (2022).

partners) increased almost 600%.[9] Yet, since 2007, the IRS audit rate for large partnerships dropped to less than 0.5%.[10]

While in previous years the IRS did not have enough resources to address large partnerships with complicated structures and tax issues, the IRA funding signals the start of a new era for the IRS. IRS Commissioner Daniel Werfel has stated that he is "committed to reversing this trend, making sure that the new funding [from the IRA] will mean more effective tax compliance efforts on the wealthy[.]"[11]

To achieve this goal, the IRS has increased its hiring of agents who have partnership tax expertise, restructured its examination function as it relates to the examinations of partnerships, and collaborated with data scientists to create new AI programs intended to detect potential compliance risks and tax evasion threats in partnership tax, general income tax and accounting, and international tax.

Leveraging these new resources, and consistent with its ongoing efforts to increase examinations of pass-through entities, at the end of 2023 the IRS had opened examinations into 76 of the largest partnerships in the United States, encompassing a variety of industries including hedge funds, real estate investment partnerships, and publicly traded partnerships. On average, these partnerships each have more than $10 billion in assets. On January 12, 2024, the IRS reported that its ongoing enforcement push has raked in more than $500 million from wealthy taxpayers.[12]

Takeaways

When auditing partnerships, the IRS will use specialized issue-based partnership examinations that are generally subject to the centralized partnership audit regime enacted as part of the Bipartisan Budget Act of 2015 in an effort to make the examination, assessment, and collection processes easier for the IRS in the partnership context. Applicable for tax years beginning in 2018, these audits are just getting underway. Under this audit regime, the IRS now has the authority to determine, assess, and collect tax on partnership underpayments at the partnership level.

While the mechanics and intricacies of the AI technology currently being employed by the IRS in these audits has not yet been disclosed to the public, the IRS's goal of focusing its efforts on partnerships and high-income taxpayers has been made clear.

Given the increase in enforcement funding focused on the hiring of partnership audit personnel, coupled with IRS's leverage of the centralized audit regime and AI technology, high-net-worth taxpayers and large partnerships should ensure that they are prepared for the possibility of an IRS examination and expect to see an increase of audits over the next year.

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[9] *See* GAO-23-106020, Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships (publicly released July 27, 2023).

[10] *Id*.

[11] *See* IR-2023-166, IRS Announces Sweeping Effort to Restore Fairness to Tax System with Inflation Reduction Act Funding; New Compliance Efforts Focused on Increasing Scrutiny on High-Income, Partnerships, Corporations and Promoters Abusing Tax Rules on the Books (Sept. 8, 2023).

[12] *See* IR-2024-09, IRS Ramps Up New Initiatives Using Inflation Reduction Act Funding to Ensure Complex Partnerships, Large Corporations Pay Taxes Owed, Continues to Close Millionaire Tax Debt Cases (Jan. 12, 2024).

CLIMATE-FOCUSED FUNDS

The ability of certain funds to monetize credits attributable to investments in renewable energy and other projects and technologies that address climate change through transfers of tax credits under Section 6418 or direct payment under 6417, as applicable, continues to take shape through the market's reaction to provisions enacted under the IRA. For more details, please see our Inflation Reduction Act of 2022 webpage for our firm's discussions of the IRA and related tax guidance issued by the IRS and Treasury.

PROFITS INTEREST IN TIERED STRUCTURES

The Tax Court's decision in *ES NPA Holding LLC v. Commissioner*[13] provides taxpayers with guidance on how to structure grants of profits interest in tiered arrangements. For more details, see our LawFlash Taxpayer Victory in US Tax Court Highlights Needs for Properly Structuring Partnership Profits Interests for our discussion regarding the Tax Court's decision.

CONCLUSION

These 2023 developments may affect the tax planning of private equity funds, hedge funds, and other private investment funds, as well as their managers and investors. We will continue to closely monitor additional developments as well as other IRS enforcement activities and initiatives impacting the asset management, financial services, private equity, and hedge fund industries. Please contact the authors if you would like to discuss any implications of the issues discussed in this report.

[13] T.C. Memo. 2023-55.

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