



Morgan Lewis

**ADVANCED TOPICS IN
HEDGE FUND PRACTICES
CONFERENCE**

Manager and Investor Perspectives

NEW YORK

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Tax Updates

Speakers



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Overview of Recent Tax Developments

Enforcement trends and priorities – IRS audit resources and campaigns regarding investment funds

SECA Campaign – Status

IRS Littlejohn data breach – IRS letters to funds and their managers

YA Global and ECI exposure for non-US investors

Focus on carried/profits interest structuring

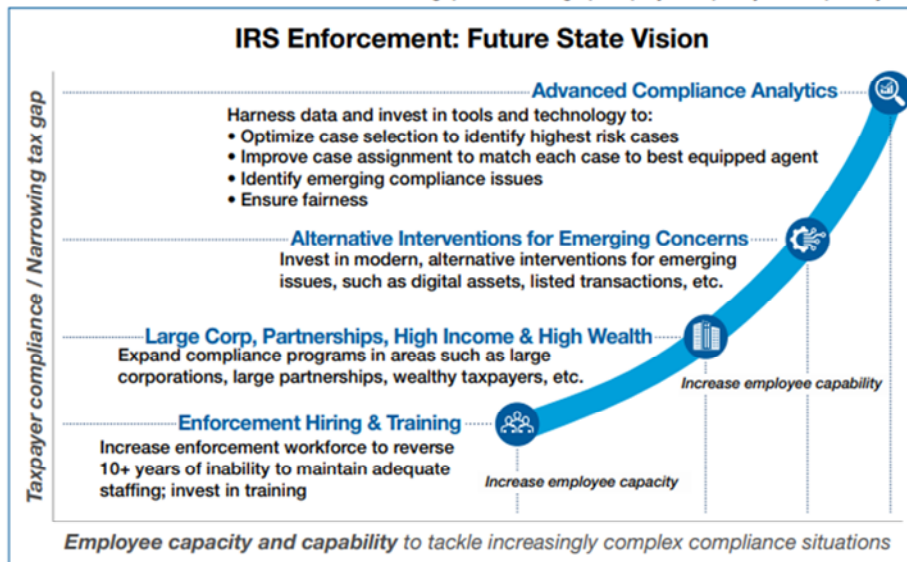
State and local tax planning matters

Withholding matters relating to non-US partners

Enforcement Trends & Priorities: Understanding IRS Initiatives

- Significantly increase audit rates of partnerships with assets of more than \$10 million;
- Leverage audit initiatives and campaigns to drive specific results:
 - ✓ Pursue multimillion-dollar partnership balance sheet discrepancies;
 - ✓ Bolster the Self-Employment Tax Initiative;
 - ✓ Focus on treatment of specific assets, and industries, that generate deductions and losses;
- Strengthen efforts for collection and enforcement of high-income individual taxpayers; and
- Utilize artificial intelligence (AI) and robots and increase the scope and number of staff.

Exhibit 2: Transformation initiatives narrow the tax gap while driving up employee capacity and capability



Enforcement Trends & Priorities: Initiatives Impacting the Industry

"The IRS will: Increase audit rates by nearly ten-fold on large, complex partnerships with assets over \$10 million."

– IRS IRA Strategic Operating Plan (Apr. 2024).

New unit focused on pass-through entities

- Housed in the LB&I division but leverages all resources available
- IRS working to fill 3,700 new positions nationwide to work in this unit

Examinations of the 76 largest US partnerships underway

- AI used to identify these potential risks for noncompliance
- Cross-section of industries including hedge funds and investment firms
- Used as a learning tool to prepare to expand reach

Continued Leverage of Campaigns & Initiatives

- Sports Partnership Campaign (Jan. 2024)
- Aircraft Campaign (Feb. 2024)
- Outreach on balance sheet discrepancies between years – 480 compliance alerts as of Oct. 2023

High-Net-Worth Focus

- High-income, high-wealth individuals who have not filed returns or paid tax debt
- Sent 125,000 letters and recovered \$520 million from ~1,600 people

SECA Campaign – Status

Current Pending Cases

- *Denham Capital Management LP v. Commissioner*, No. 9973-23
 - Tried in Boston, April 23, 2024
- *Sirius Solutions L.L.P. v. Commissioner*, No. 11587-20
 - Requested entry of decision in favor of Commissioner so that it might contest the holding in *Soroban*, 161 T.C. No. 12 (Nov. 28, 2023) in the Fifth Circuit
- *Soroban Capital Partners LP v. Commissioner*, Nos. 16217-22, 16218-22
 - Parties working on stipulations
 - Petitioner-taxpayer may submit the case under Rule 122 (submission without trial)
- *Point72 Asset Management, L.P. v. Commissioner*, No. 12752-23

Other Developments

- Many cases pending in Exam and Appeals
- Proposed regulatory guidance to be issued soon according to the IRS

The Aftermath of *Loper Bright*: Anticipating the Impact on Chevron Deference & IRS Regulations

- The D.C. Circuit and the First Circuit upheld a National Marine Fisheries Service regulation requiring vessels to pay the costs of federal monitors providing enforcement services
- Both cases were argued on January 17, 2024
- Major themes in the oral argument:
 - Role *Chevron* plays in judicial decision-making
 - Alternative approaches if *Chevron* is overruled
 - Potential consequences of overturning *Chevron*
- Supreme Court will issue an opinion by late June
- What will the impact be?

IRS Littlejohn Data Breach: Background

- Between 2018 and 2020, Charles Littlejohn, a former IRS contractor, accessed and stole tax records while working on an IRS project that permitted his access to IRS data bases.
- He stole tax data on wealthy taxpayers, pulling the top 500 taxpayers by income by year for the last 15 years and provided the data to ProPublica.
- Using this information, ProPublica published nearly 50 articles.
 - By the time of Littlejohn’s sentencing, at least 152 victims have had their tax information published.
- In all, Littlejohn disclosed:
 - More than 8,000 annual income tax returns;
 - Returns related to approximately 7,600 individuals and 600 entities;
 - Tax return information that affected approximately 18,000 individuals; and
 - Tax return information that affected approximately 73,000 businesses.
- This was the largest unauthorized disclosure of tax information in history.

IRS Littlejohn Data Breach: Background

In October 2023, Littlejohn pleaded guilty to one count of disclosure of tax return and return information and in January 2024, he was sentenced to the maximum and received five years in prison and a \$5,000 fine.

The DOJ has specific statutory duties to crime victims, but the DOJ sought and received approval to provide an “alternative notification” by creating a website directed to victims.

Federal law also requires that the Secretary of the Treasury notify affected taxpayers of the inspection or disclosure.

- Notification required as soon as “practicable.”
- Notification must include date of the offense, the events that occurred, and the taxpayer’s rights.

IRS Littlejohn Data Breach: IRS Notification Actions

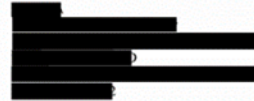
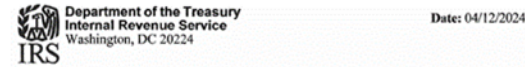
April 2024 Notifications

- No personalized details regarding what specific tax returns or return information was disclosed or the tax years impacted.
- Directed victims to the DOJ website and an IRS email address but provided no additional points of contact, and the letter was unsigned.

May 2024 Supplement

- Identified the limits on its ability to provide full information at this time.
- Provided IRS's next steps for identifying and notifying additional taxpayers.

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Dear [REDACTED]:

We are providing you this letter to notify you that an Internal Revenue Service (IRS) contractor has been charged with the unauthorized inspection or disclosure of your tax return or return information, between 2018 and 2020.¹

We have enclosed copies of Internal Revenue Code (IRC) Section 7431 and the criminal charge with this letter. IRC 7431(a) provides for civil claims for unauthorized disclosure of return information.

The Department of Justice is prosecuting this matter and has provided information about the Crime Victims' Rights Act and the status of this criminal case at [Justice.gov/criminal-vns/case/united-states-v-charles-littlejohn](https://www.justice.gov/criminal-vns/case/united-states-v-charles-littlejohn). If you have any questions about your rights under the Crime Victims' Rights Act, please email the Department of Justice at CRM-PIN.Victims@usdoj.gov.



PRODUCT GOVERNMENTAL
LIAISON AND DISCLOSURE

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

This is a supplement to the 7431 Notification (Letter 6613) that you received from the Internal Revenue Service, which alerted you to the unauthorized disclosure of your tax return information by an IRS contractor. As you may know, the IRS contractor, Charles Edward Littlejohn, pled guilty to the unauthorized disclosure of return information in October 2023 and was sentenced to five years in prison earlier this year.

To begin with, it should be stressed that this incident was unacceptable. Any improper access or disclosure of confidential taxpayer information is unacceptable, and it is completely at odds with the IRS's values and the agency's commitment to taxpayers.

We recognize that this incident has created a difficult situation for many taxpayers, including individuals as well as business entities. We also recognize that it is incumbent on the IRS not only to protect confidential taxpayer information, but also to address matters to the fullest extent possible when any such information is unlawfully disclosed.

We write to you today to update you on our efforts in this regard, and to provide to you what information we can regarding this incident, within the confines of the law. We will update you periodically as additional information becomes available. As noted in our initial letter, you can always contact us with specific inquiries via our dedicated email address for this incident (Notification.7431@irs.gov).¹

IRS Littlejohn Data Breach: Scope of Data Exposed

Tax Returns

- Any tax or information returns, estimated tax statements or refund claims (including amendments, supplements, supporting schedules, attachments or lists) required or permitted to be filed with the IRS.
- Examples of returns include forms filed on paper or electronically, such as Forms 1040, 941, 1099, 1120, and W-2.

Tax Return Information

- Any information besides the return itself that the IRS has obtained from any source or developed itself concerning the potential liability of any taxpayer.
- Includes the taxpayer's name, address, and identifying number as well as names and identification numbers of other persons associated with the taxpayer, including dependents or partners.
- Includes whether a return was filed, whether it has been or will be examined, and whether there have been collection activities undertaken by the IRS against the taxpayer.

IRS Littlejohn Data Breach: Assessing Implications

- Given the limited information available, it is impossible to determine the potential damage to the victims of Littlejohn's crime.
- As personal information including names, taxpayer identification numbers, driver's license information, birthdates, and addresses may have been disclosed, victims may need to evaluate the possibility of tax-related identity theft and whether additional steps to address the risk should be taken.
- It is also impossible to determine whether recipients of the notices have other obligations arising out of this situation.
 - What obligations could exist?
 - What information do you need to ascertain those obligations?

IRS Littlejohn Data Breach: Next Steps

Actions Taken by Victims

- Outreach to IRS via notification.7431@irs.gov
- Outreach to IRS and DOJ via other means
- Notification to investors, customers, other third parties
- Review of records to determine possible extent of disclosure
- Tax-related identity theft controls established
- Outreach to ProPublica regarding records

Actions Taken by Congress

- House Judiciary Committee oversight inquiry in February 2024 to DOJ regarding charging decisions in *United States v. Littlejohn*
- Taxpayer Data Protection Act (H.R. 8292, Jason Smith, R-MO)
 - Increases the maximum penalty to 10 years in prison and fine of \$250,000
 - Disclosure as to each taxpayer is a separate violation
 - Passed by the Ways and Means Committee in bipartisan vote of 40 to 1
 - Awaits full House consideration

***YA Global* and ECI Exposure for Non-US Investors**

On November 15, 2023, the Tax Court released its opinion in *YA Global v. Commissioner*, finding that YA Global, a Cayman fund, was engaged in a US business through its US manager, and was liable for failing to withhold US tax on effectively connected income (ECI) allocated to its non-US investors.

YA Global's activities were found not to be eligible for the broad exemption of non-US persons from US trade or business status for merely investing or trading in stock or securities, including debt securities.

While the facts of the case were unusual, the decision may have implications for other hedge funds, particularly hedge funds that engage in activities that might be viewed as originating debt or otherwise engaging in a financing business.

YA Global and ECI Exposure

YA Global made loans, including convertible loans, and entered into standby equity distribution agreements. It described itself as providing underwriting services, with YA Global itself receiving commitment fees, and entered into hundreds of transactions over the years in question. YA Global's activities were found not to be eligible for the broad exemption of non-US persons from US trade or business status for merely investing or trading in stock or securities, including debt securities.

The decision also focused on the fund manager's status as an agent of YA Global, and concluded that the filing by YA Global of annual partnership tax returns, absent a separate filing of IRS Form 8804 reporting US business activities, did not start the running of applicable statutes of limitations.

YA *Global* and ECI Exposure

The IRS also is continuing its campaign, announced in June 2021, focusing on whether foreign investors participating in “inbound” lending transactions were engaged in a US trade or business and generated ECI, subject to US tax filing and payment obligations.

The IRS campaign may include a continuing focus on more typical strategies with respect to loan origination, potentially including season and sell, offshore adviser, tax treaty-based, and leveraged blocker strategies.

Focus on Carried/Profits Interest Structuring

The Tax Court's memorandum decision in *ES NPA Holding LLC v. Commissioner* upheld profits interest treatment for a taxpayer's receipt of a partnership interest granted in exchange for services, where the grant was made through multiple tiers of partnerships.

The case highlighted the importance of careful structuring and documentation in grants of carried interests and other profits interests, particularly in a tiered partnership structure, and of support for valuations.

The IRS continues to scrutinize on audit various profits interest arrangements, including management fee waiver structures and structuring aimed at increasing eligibility for long-term capital gains treatment under Section 1061.

State and Local Tax-Planning Matters

Pass-Through Entity (PTET) Planning:

- In reaction to the addition of a \$10,000 cap on individual federal income tax deductions for state and local taxes, a majority of states have adopted PTET regimes.
- Typically, a PTET is imposed by a state on a pass-through entity, such as an entity treated as a partnership (e.g., an LLC) or an S corporation, with the pass-through entity claiming a deduction against its taxable income, reducing the taxable income allocated by it to its individual owners, who then claim a tax credit, for state purposes, against their liability for personal income tax.
- In Notice 2020-75, the IRS effectively signed off on the approach, announced proposed regulations would be forthcoming, and permitted taxpayers to rely on the notice until regulations become effective.
- The \$10,000 cap on state and local tax deductions, and thus the impetus for PTET structuring, is scheduled to expire in 2026.

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

Withholding Matters Relating to Non-US Partners

Investment fund partnerships have backstop withholding obligations with respect to transfers of partnership interests by non-US partners, and as a result should ensure receipt of required certifications or other documentation reflecting any secondary transfers.

Investment partnerships with significant US real property holdings should be requiring a new form of documentation from qualified foreign pension fund investors, on IRS Form W-8EXP, to establish eligibility.

New rules regarding eligibility for domestically controlled REIT status also should be considered by investment partnerships with significant US real property holdings and non-US investors.