# Chapter 1

# Issues at the Fund Level

## Formation Issues

Private equity funds can take many shapes and sizes. They can be structured as master feeders, side-by-side funds managed by the same sponsor, coinvestment funds that tag along with established sponsors, fund-of-funds, or funds with aggregating vehicles.[1] The reader can find many diagrams on the Internet depicting these structures.[2] Moreover, funds, or separate entities composing a fund, can be formed in several different jurisdictions that offer a great array of different entity choices. While many practitioners gravitate toward established jurisdictions and forms such as Cayman Islands exempted companies or exempted partnerships, many alternatives exist, and sometimes it can be quite overwhelming deciding where and how to set up a fund. Breaking down the different tax issues and factors that go into solving this formation problem and ultimately making a decision could be helpful to many practitioners tasked with setting up a fund.

The tax issues of fund formation should be solved by taking into account the tax goals of the various fund participants. A fund usually is comprised of the following players: U.S. taxable investors, U.S. and/or foreign tax exempt investors, foreign taxable investors and a sponsor/manager/GP. Fund structures can get complicated when tax practitioners try to juggle the varying interests of all of these parties. Some of the key goals of these parties include the following:

- Achieve one level of tax and character preservation for U.S. taxable investors and the sponsor
- Avoid unrelated business tax (UBTI) for U.S. tax exempt investors
- Protect foreign taxable investors from attribution of U.S. trade or business and effectively connected income

1. Fund sponsor is usually used interchangeably with fund manager. A coinvestment fund usually invests alongside an established sponsor. Coinvestments are welcomed when the lead sponsor wants to have a limited exposure to a particular portfolio company.

2. E.g., Eurekahedge, Hedge Fund Monthly, http://www.eurekahedge.com/news/04apr_archive_Sidley_master_feeder.asp. For some common structures, see the Worksheets in ANDREW W. NEEDHAM, PORTFOLIO 735-1ST: PRIVATE EQUITY FUNDS (BNA Tax & Accounting Online).

- Maximize use of capital gain exit and the portfolio interest exception
- Optimize deductibility of fund related expenses
- Minimize federal income tax reporting requirements for foreign investors

The following is a discussion of some of the more relevant tax issues which should be tackled by keeping in mind the above goals.

### *Corporation Versus Pass-Through Entity*

For many foreign funds with minority U.S. investors and little U.S. investment exposure, the question of whether a fund should be treated as a partnership or a corporation for U.S. tax purposes has little materiality. In fact, U.S. investors who for some reason end up being participants in such funds are often subject to detrimental U.S. tax consequences as a result of this indifference.[3] However, for funds that have a large U.S. investor base or are otherwise investing in the United States, deciding whether to set up the fund as a corporation or pass-through for U.S. federal income tax purposes is one of the most important tax choices at the time of formation. It is important because it addresses two of the key tax considerations that investors and sponsors are affected by: single layer of tax and preservation of the character of the income earned by the fund. Unfortunately, there are hardly any set formulas for making this choice. Some choices are obvious; for example, you never set up as an S-corporation due to the limitations on the number and type of shareholders. Other choices are not so obvious. While due to the single layer of tax and character preservation many practitioners would intuitively choose a flow-through form for U.S. tax purposes, this is not always the most advantageous choice. One common example is of inbound foreign funds organized as blockers in foreign jurisdictions such as the Caymans. Another example is a foreign outbound fund with U.S. investors that is organized as a passive foreign investment company (PFIC) whereby the investors make a qualified electing fund (QEF) election. This particular structure could have the benefit of optimizing fund-related deductions available to the investors and mitigate some of the 2% floor concerns that usually plague those investors.[4] Similarly, U.S. tax exempt investors would prefer to invest in a corporate/blocked fund in order to avoid UBTI issues.

Lastly, imagine a fund composed of predominantly U.S. taxable and tax-exempt investors that want to invest in foreign jurisdictions. Assume in addition that many of the operating companies (opcos, for short) the fund will invest in are per se corporations in a high-tax jurisdiction (per se entities cannot "check the box" under Treas. Reg. § 301.7701-3(c) and

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3. Often such minority investors would not be able to obtain PFIC covenants and PFIC Information Statements and will thus be subject to the very disadvantageous section 1291 excess distribution rules (discussed generally at "CFC and PFIC," in Chapter 1 and "The Application of the Antideferral Provisions" in Chapter 4 *infra*).

4. For some of the benefits of setting up a foreign fund as a PFIC see Philip Gross, *Tax Planning for Offshore Hedge Funds—the Potential Benefits of Investing in a PFIC*, Journal of Taxation of Investments (January 2004). The article discusses hedge funds but the principles are equally applicable to private equity funds and venture capital funds.

be treated as transparent for U.S. purposes).[5] As in most outbound setups, two of the key goals of the fund will be to minimize local taxes and afford a tax-advantageous exit to its U.S. investors. The fund in the above example would face two significant issues—first, the operating companies cannot check the box to be treated as flow-through entities, and second, unless there is some other special arrangement that minimizes local tax, the fund and its investors will be subject to high local taxes.

If the fund sets up shop as a flow-through in the Cayman Islands, the U.S. investors have a tax problem. Imagine that all the fund does is invest in the operating company and after some time it sells the shares. Meanwhile the operating company pays local taxes at 35 percent. Let's assume that due to a high aggregate number of U.S. investors the operating companies are controlled foreign corporations (CFCs). At the time of sale by the fund of the operating company stock, assuming the company was profitable, the U.S. investor would likely be subject to a deemed dividend tax under section 1248[6] (generally taxed at 35 percent unless it is a qualified dividend or the limitation for individuals applies). In addition, the U.S. investor (usually an individual investing directly or through a U.S. flow-through entity) would have indirectly borne the economic burden of the local taxes. The problem the U.S. investor has is that it cannot take the indirect foreign tax credit for all the foreign taxes paid in the high-tax jurisdiction by the operating companies (i.e., the local taxes paid by the portfolio CFC).[7]

Now, let's compare the fund from the above example to a U.S. fund formed as a corporation. When the corporate fund sells the operating company stock, the U.S. investor will have taxable income, but contrary to the previously discussed scenario, foreign tax credit for the foreign taxes paid by the operating company may be credited against the U.S. tax generated by the fund, assuming the credits are not limited by section 904 of the Internal Revenue Code.[8] Let's say that the U.S. taxable investor's share in the sale proceeds of the operating company stock is $100. In the flow-through fund scenario, the investor would have netted $65 (assume for simplicity that all of the gain is subject to ordinary income tax under section 1248).[9] If the fund was a U.S. corporation, assuming there were sufficient credits and the fund can utilize those foreign tax credits to their fullest extent, the fund would not have been subject to U.S. tax due to the credit offsets for indirect taxes paid in the foreign country. Then, if the U.S. investor redeemed its shares in the fund, it would be

5. In practice this scenario is more likely to materialize for a hedge fund than a private equity fund. Per se entities are usually foreign publicly traded entities, but that is not always the case. As a general rule, hedge funds and not private equity funds invest in publicly traded companies. However, often in contemporary funds this difference may be blurry as funds cross-invest in seeking optimal returns for their investors.

6. This section provides that any gain on the sale of the stock of a CFC by a U.S. shareholder will be treated as a dividend up to the amount of previously untaxed E&P of the foreign corporation.

7. See the discussion in "Setting up the Acquisition Structure" in Chapter 4, *infra*.

8. *See* Treas. Reg. § 1.1248-1(d). Notably, there is significant risk of this happening if the source of income of the portfolio company is active. However, that is not always the case. For instance, the portfolio company may be engaged in real estate projects and generate rents.

9. In fact, this ordinary treatment may be limited by section 1248(b), but for the illustrative purposes let's ignore this for now.

subject to a 15 percent tax[10] and pocket $85 instead of $65. While this example is simplistic and encumbered with a lot of assumptions and generalities, its main point is nevertheless valid, that is it is worthwhile to put considerable thought in deciding whether to form the fund as a corporation or a partnership for U.S. tax purposes. Many practitioners blindly rush into a transparent flow-through setup that sometimes proves perilous.

An additional question that is worth ruminating over is "corporation or partnership within the meaning of what jurisdiction?" Intuitively, practitioners pose this question within the framework of U.S. tax law. However, when adding the foreign jurisdiction to the mix, four combinations exist that can affect the tax exposure of the fund and its investors. The fund could be (1) taxed as corporation for U.S. and foreign law purposes, (2) taxed as a corporation for U.S. purposes but as flow-through for foreign law purposes (a reverse hybrid entity), (3) taxed as a flow-through for U.S. purposes but as a corporation for foreign law purposes (a hybrid entity), or (4) taxed as a flow-through for both local and foreign law purposes. The choice regarding these combinations can affect the operating, distribution, and exit taxes of the fund. The choices also could affect withholding and treaty benefits.[11] The choice could be even more complicated if one considers the following jurisdictions: (1) the United States, (2) the home jurisdiction of the fund (if different from the United States), (3) the investors' jurisdiction (if different from the United States), and (4) the target operating company's jurisdiction. It is particularly useful to pay great attention to the investor base of the fund. For example, a U.S. limited liability company (LLC) fund set up in Delaware with predominantly U.S., U.K., and Netherlands investors should account for the fact that while the fund will be a pass-through entity for U.S. purposes, it might nevertheless be viewed as a nontransparent entity for U.K. and Netherlands "tax" purposes.[12] Unnecessary surprises could arise if the lawyer does not carefully examine the effects of these alternatives.

### *Series LLC—Do or Not Do?*

As of the time of this writing, series LLC, a relatively new structure, is available to U.S. funds that are seeking flexibility. This form was first introduced in Delaware and later was adopted by several other states. The key highlight of the structure is that for state law purposes the LLC is a single entity, while for federal income tax law purposes, it is likely that each series of the LLC will be treated as a separate entity. The apparent advantage of this setup is flexibility and reduction of organization and administrative cost. Separate series could be established for each portfolio company or each class of portfolio company (domestic, flow-through, etc.). Thus, investors can choose relatively easily what project to participate in. For example, instead of insisting on protective covenants or the formation of

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10. At the time of publication of this book, qualified dividends for individuals are subject to a 15 percent rate. *See* I.R.C. §§ 1(h)(1)(C), 1(h)(11). The highest ordinary income rate is 35 percent. I.R.C. § 1(i)(2). Both of these rates could be subject to change.

11. See the discussion of withholding in "Withholding" in Chapter 3, *infra*.

12. A few interesting decisions on this point include Supreme Court of the Netherlands No. 40,919 and the U.K. First-tier Tribunal's decision in *Swift v. HMRC*. Discussions about the decisions and the issue in general can be found in the following *Worldwide Tax Daily* (WTD) articles: "Dutch Tax Court Rules on Qualification of U.S. LLC," 2004 WTD 65-7; "New Dutch Guidance Addresses Foreign Entities Classification, Participation Exemption," 2004 WTD 250-14; "U.K. Notes Tribunal Decision on U.S. LLC Tax Treatment," 2010 WTD 98-54.

special-purpose-vehicle below-the-fund blocker companies, a foreign investor concerned with U.S. trade or business exposure can simply choose to participate in those series that do not engage in the undesirable type of business. Since each series would likely be treated as a separate entity for U.S. tax law purposes, conceivably the activities of that series would not spill over to the other series and expose the investors to income from undesirable sources.

The most pressing issue at the time of the publication of this book regarding series LLC is the lack of clear-cut Internal Revenue Service (IRS) guidance. Nevertheless, in recent announcements, the IRS has pronounced that it is looking into the federal income tax treatment of series LLC.[13] Thus far these efforts have culminated in a proposed series LLC regulation project that treats the separate series as separate entities.[14] Unfortunately, many open questions still remain. For example, there is confusion as to whether the series should have joint and several liability for their federal tax obligations.[15] Once the IRS comes up with definitive guidance and some of these issues are ironed out, practitioners should consider this option in earnest when setting up a fund.[16]

➤ **Useful Reading**

John A. Biek, *IRS and Massachusetts Rule on the Income Tax Classification of a Delaware Series Limited Liability Company—But Questions Still Abound*, 11 J. Passthrough Entities 13 (2008).

Michael Mooney, *Series LLCs: The Loaves and Fishes of Subchapter K*, Tax Notes, Aug. 20, 2010.

Craig A. Gerson, *Taxing Series LLCs*, 45 Tax Mgmt. Memorandum (BNA) 75 (2004).

Terence F. Cuff, *Series LLCs and the Abolition of the Tax System*, Bus. Entities, Jan.–Feb. 2000.

H. Karl Zeswitz Jr., *Classification of Series Entities*, 49 Tax Mgmt. Memorandum (BNA) 531 (2008).

## *Forced Corporation Treatment: The PTP Rules*

Even if a fund desires to operate as a flow-through entity for U.S. tax purposes, it may be prevented from doing so by operation of law. Section 7704 of the Internal Revenue Code generally provides that publicly traded partnerships (PTPs) will be treated as corporations for U.S. federal income tax purposes.[17] To many funds and their investors or managers, this could be very disadvantageous. First, due to the layer of tax at the fund level, less cash is available for distributions. Second, the managers of the fund would generally not be able to obtain profits interest treatment for their share of the profits of the fund. Third, tax cost will be incurred on the fund's worldwide income (compare a U.S. flow-through fund whose investors are only subject to withholding on U.S. effectively connected income and

13. *See* Fred Stokeld, "Series LLC Guidance Coming Soon, IRS Official Says," TNT, Mar. 8, 2010; "IRS Examining Whether Series LLCs Sub Accounts Are Separate Entities," BNA Daily, Mar. 9, 2009.

14. *See* Reg-119921-09, I.R.B. 2010-45 (November 8, 2010) .

15. "Series LLCs May Have Joint and Several Tax Liability, Official Says," 2010 TNT 189-3.

16. This is not to say that some funds do not utilize the structure even now. One example of such series LLC fund is the venture capital pool investment fund NCD Investors based in California. See its Form-D SEC filing at http://www.sec.gov/Archives/edgar/data/1503037/000150303710000001/xslFormDX01/primary_doc.xml.

17. I.R.C. § 7704(a).

U.S.-source fixed and determinable income such as U.S.-source interest and dividends).[18] Generally, publicly traded funds will try to avoid the application of section 7704 by qualifying for the so-called 90/10 exception in section 7704, which provides that funds that generate 90 percent or more in qualifying income (usually passive income) will not be treated as a corporation.[19] As with most topics discussed in this book, it is important to follow from inception any introduced legislation that can affect the outcome of a specific issue. For example, in June 2009 Rep. Peter Welch introduced H.R. 2762, which would disallow the 90/10 exception to entities that provide investment advisory services.[20] If this or similar legislation passes, it could have a material effect on many PTP funds.[21]

Sometimes there may be a genuine question as to whether the fund is publicly traded in the first place. Obviously this question does not stand before funds that are traded on established securities markets such as NASD. Aside from publicly traded funds or their sponsors such as KKR, Blackstone, and Fortress, many private equity funds may not even consider the issue. Some may consider it and obtain a legal opinion on the matter. However, many times this legal opinion will be quite succinct and boilerplate, and simply will consist of few paragraphs of a cookie-cutter analysis.

The thinking is as follows: In order to be a PTP under I.R.C. § 7704, the interest in the fund has to be treated as readily tradable on an established securities market or on a secondary market (or the substantial equivalent thereof). For most private equity funds this is inconceivable because there are significant limitations on the transferability of fund interest. However, things change and so does the market for private equity interest. Platforms have been developed to list and trade private equity interest outside the public market and securities exchanges. Such markets, for example, include Goldman Sachs Tradable Unregistered Equity (GSTrUE) and SecondaryNet maintained by Secondcap. These systems may maintain bids or offers in funds and operate akin to an exchange. Fund sponsors should be very careful when offering interest on such quotation systems and should heed the PTP rules. If there is any chance that the fund's interest may fall within the purview of a readily tradable interest and the fund does not qualify for the 90/10 exception, the fund sponsors should closely examine whether the interest falls within some of the exceptions in Treas. Reg. § 1.7704-1. Some of the potentially applicable exceptions include the private placement safe harbor, the 2% safe-harbor or the qualified matching service safe harbor.

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18. The United States taxes U.S. persons on income "from whatever source derived." *See* I.R.C. § 61(a). On the other hand, generally, nonresidents are taxed only on U.S.-source income. *See* I.R.C. §§ 871, 881.

19. I.R.C. § 7704(c)(2). A separate issue here is to determine whether the income the fund is generating is qualifying income. The term "qualifying income" is defined in section 7704(d). It is helpful that the IRS issues rulings regarding this issue. *See, e.g.*, IRS E-Mail Chief Counsel Advice 200919019. Some specialized funds such as energy funds have an express provision that they can rely on for qualifying income purposes. *See* I.R.C. § 7704(d)(1)(E) (the mining and exploration exception).

20. 2009 TNT 127-18.

21. The PTP rules are further discussed in "Fund Is a Domestic PTP—Satisfying the 90/10 Test" in Chapter 4, *infra*.

➤ **Useful Reading**

Lynn E. Fowler, *Publicly Traded Partnerships*, ch. 218-1 *in* TAX LAW AND PRACTICE, 921 PLI/TAX 218-1 (PLI 2010).

Joel Scharfstein & Brian Kniesly , *Section 7704 and Publicly (or Non-Publicly) Traded Partnerships*, ch. 219-1 *in* TAX LAW AND PRACTICE 921 PLI/Tax 219-1 (PLI 2010).

Robert S. Bernstein, *Use of Foreign Publicly Traded Partnerships and the Lazard IPO*, ch. 135 in Tax Law and Practice, 706 PLI/Tax 135 (2006).

## *Domestic Versus Foreign*

In addition to the transparent or nontransparent nature of the fund, its jurisdiction of formation can also have various tax consequences to the fund itself and its investors (both U.S. and non-U.S.). Usually tax is not the driving jurisdictional consideration, but nonetheless a low-tax location is usually preferred. Thus, in the author's experience, most funds are organized in tax haven jurisdictions such as the Cayman Islands, Bermuda, Cyprus, and Mauritius. This is not necessarily always the best choice, however. When deciding where to form the fund, the following choice of jurisdiction tax issues should be considered.

### Operating, Exit, and Withholding Taxes of the Jurisdiction of Organization

As suggested above, this is one of the key tax considerations for setting up a fund. If the local tax is high and noncreditable, it can decrease the fund's bottom line as much as 30–40 percent, depending on the jurisdiction. The principal issue here is to choose a jurisdiction in which the fund will be subject to minimal tax on its income. Then when money is distributed to the investors and managers there will be no tax, and when investors sell or redeem their investment in the fund, again, no tax will be imposed by the fund's jurisdiction. One of the primary advantages of the above-enumerated tax haven jurisdictions is that all of these factors align favorably for the fund and its investors. Conversely, local tax minimization could still be achieved even in a high-tax jurisdiction as long as the fund is transparent for purposes of that specific jurisdiction.

### Primary Jurisdiction of the Investee Operating Companies of the Fund

The jurisdiction of the operating companies can affect the choice of jurisdiction of the fund. For example, a fund that will operate in Eastern Europe, for example in Ukraine, Bulgaria, or Romania, may be advised to set up shop in Cyprus instead of the Cayman Islands. By the same token, a fund that will invest primarily in India may be formed in Mauritius or the United Arab Emirates instead of the Bahamas. And a fund that will invest in countries in Latin America, for example Brazil, may be advised to avoid formation in tax havens since that may prevent it from using certain local vehicles such as Fundos de Investimento em Participações (colloquially known as FIPs) for minimizing local taxes.

The gist here is that certain countries have preferential tax regimes with some countries but not others (via tax treaties or other bilateral agreements). Setting up the fund in a non-favored jurisdiction, without later using a special purpose holding company for investing in the chosen operating companies, could increase taxes on distributions and exits from the

operating company.[22] For example, in Ukraine, a 15 percent withholding rate applies on the disposition of property such as real estate and securities. However, under the 1982 USSR–Cyprus double tax treaty, capital gains on such dispositions are not subject to withholding.[23] Thus, if a fund intends to carry on investment activities predominantly in Ukraine, it may be advisable to set up in Cyprus instead of the Cayman Islands. Is a fund investing in Eastern Europe at a disadvantage if it is set up in the Caymans and then uses a Cyprus holding company to invest in the particular Eastern European country? Likely not. However, the fund runs the risk of having the shell holding company fail the residency or any limitation of benefits (LOB) provisions of the particular treaty country, whereas such risk might have been smaller if the fund was actually operated from a country such as Cyprus.[24]

### PFIC Exposure

Setting up the fund offshore could have some negative consequences to U.S. taxable investors if the fund is treated as a corporation for U.S. purposes. The reason is that it is very likely[25] that the fund will fall within the category of a passive foreign investment company (also known as PFICs) and be subject to the antideferral regimes in sections 1291–1298. While the effect of the PFIC regime can be somewhat ameliorated by qualified electing fund (QEF) elections, in most circumstances it is preferable that these rules are avoided altogether. For this, among other reasons, most foreign funds with a significant U.S. investor base set up as flow-through entities for U.S. purposes.[26]

### CFC Exposure to U.S. Investors

If the fund intends to invest in non-U.S. operating companies, any taxable U.S. investor can be exposed to the U.S. CFC antideferral regime. The choice of the fund's jurisdiction can have a direct bearing on the likelihood of the applicability of the CFC rules. A U.S. partnership can be considered to be a U.S. shareholder for purposes of subpart F of the Internal Revenue Code (i.e., there is no look-through to its individual investors who may be U.S. or foreign persons).[27] As such, if the fund is organized in the United States, foreign portfolio companies controlled by the fund (i.e., more than 50 percent owned) will be treated as CFCs,[28] potentially causing an unexpected, premature tax liability for U.S. investors. Conversely, if the fund is organized in a foreign jurisdiction, the determination of whether

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22. Whether an SPV holding company (holdco) could be set up in these jurisdictions is one of the considerations that the fund must take into account. Some jurisdictions may not be accommodating toward shell entities and it may be preferable for the fund to set up shop in the particular jurisdiction instead of relying on a fund-holdco structure.

23. Notably, at the time of the publishing of this book, a new Ukraine-Cyprus tax treaty awaiting ratification in Ukraine could likely change the result obtainable under the old USSR treaty.

24. For limitation of benefits and residency provisions, see "The Effect of Foreign Treaties" in Chapter 4, *infra*.

25. Unless the fund owns a sufficiently high percentage in each operating company in its portfolio, in which case the PFIC look-through rules apply. Under the look-through rules, an otherwise passive entity is not a PFIC if the entity owns at least 25 percent of an operating entity. *See* I.R.C. § 1297(c).

26. For a more detailed discussion about the PFIC rules, see "CFC and PFIC" in Chapter 1, *infra*.

27. *See* I.R.C. §§ 957(c), 7701(a)(30).

28. I.R.C. §§ 951(b), 957(a).

the portfolio company is a CFC will be made at the partner (i.e., investor) level.[29] Thus, formation of a foreign fund is generally preferable where there are likely to be foreign corporate portfolio investments. To give an example, a fund has 50 percent U.S. investors and 50 percent foreign investors. The fund sets up shop as a U.S. LLC, for example in Delaware. The fund acquires 100 percent of a foreign start-up treated as a corporation for U.S. purposes. Since for purposes of the CFC rules the fund itself is viewed as a single U.S. shareholder, the start-up company is viewed as 100 percent owned by a U.S. person, and thus falls under the CFC rules. Conversely, if the fund was set up offshore, the start-up portfolio company will not be a CFC because no U.S. shareholder owns more than 50 percent of the stock in the portfolio companies.[30]

### Reporting Obligations

As more fully described in "Fund Reporting Issues" below, foreign funds have less U.S.-related reporting obligations compared to U.S. funds. While domestic funds will have to file income tax and various information returns regardless of whether they have generated any income during the year, less stringent requirements apply to foreign funds.[31] This could be particularly important to some foreign investors who are averse to disclosing their identity to the IRS.

### Possible Changes in U.S. or Foreign Law

It is always advisable to plan for changes in law. The reason is that changing the fund's home jurisdiction via reorganizations following the change of law may lead to foreign or U.S. tax cost and reporting cost. To illustrate, while today setting up a Cayman Island fund may be advantageous, if legislation similar to the Stop Tax Haven Abuse Act of 2009[32] is adopted by Congress it may not be advantageous because the Cayman Islands is on the tax haven blacklist.[33] Such legislation could cause funds that are formed in the Cayman Islands and currently treated as partnerships for U.S. purposes to be treated as U.S. corporations. This could introduce unanticipated tax consequences to both domestic and foreign investors under local law. Furthermore, moving the fund to a different jurisdiction could potentially have negative U.S. consequences such as additional reporting or tax under the foreign-to-foreign reorganization rules of section 367.[34] The conventional wisdom here is to comprehensively survey proposed legislation that could affect the fund before choosing a particular jurisdiction. Talk to local counsel; find out what is current and what is expected in the future. If possible, the probability of enactment of such legislation should also be assessed. This way the fund and its investors could avoid unpleasant surprises in the future.

29. In those instances the look-through proportionality rule for ownership through foreign entities applies. *See* I.R.C. §§ 951(b), 958(a)(2).

30. For a more detailed discussion about the CFC rules, see "CFC and PFIC" in this chapter, *infra*.

31. Under section 6031 of the Internal Revenue Code, most foreign funds with U.S. investors that do not have U.S.-source income or U.S. trade or business income will not have to file a U.S. income tax return or send K-1s to investors.

32. *See* H.R. 1265, 111th Cong. § 101(b) (2009).

33. *See id.*

34. Section 367 is discussed in more detail in "Foreign Reorganization Issues" in Chapter 4, *infra* and in Appendix D.

### Nontax Considerations in Choosing Jurisdiction

There are many nontax considerations that factor in making the determination whether to set up the fund in the United States or abroad. In fact, as mentioned, usually nontax considerations are driving the ultimate jurisdiction choice. These issues are not detailed in this book; tax lawyers should work hand-in-hand with corporate lawyers in choosing the proper jurisdiction. For example, many funds will attempt to avoid the Investment Company Act of 1940—if the fund is established in the United States, non-U.S. investors will be counted toward the 100-person threshold under the Act, whereas if the fund is formed abroad they will not—and this consideration may have greater weight than some tax issues.

➤ **Useful Reading**

Daniel M. Dunn, *Venturing Afar: Structural Tax Considerations in Cross-Border Joint Ventures*, ch. 281-1 in Tax Law and Practice, 923 PLI/TAX 281-1 (2010).

Arturo Requenez II & Timothy S. Shuman, Tax Law and Practice, *U.S. Private Equity Funds Making Cross-Border Investments*, 890 PLI/TAX 1469 (2009).

James H. Lokey. Jr. & Donald E. Rocap, *Selected Tax Issues in Structuring Private Equity Funds*, 919 PLI/Tax 191-1 (2010).

## *Fund of Funds; Funds Investing in Other Funds*

For various reasons, one fund may be set up with the purpose of investing in another fund. The more typical scenario here is for small investors who cannot meet the initial capital requirements for a particular fund to first pool their capital into a smaller fund and then invest in the larger fund. However, sometimes already-formed mature funds will invest in another fund, just as they would invest in a portfolio company. The main reason is usually diversification. If a fund invests in a series of other funds, ultimately it acquires a more diversified portfolio than it could have otherwise acquired. These funds are usually referred to as fund of funds, or FoFs for short. Counsel should be particularly cautious in these circumstances because the ultimate structure, taking into consideration both funds and all their satellite companies, could be overly elaborate and could create traps for inattentive counsel. One can imagine the following scenario. A foreign master-feeder fund has a domestic feeder and a foreign feeder. This fund invests in a U.S. fund. That U.S. fund can in turn have both U.S. and foreign investments. An overzealous counsel representing the foreign master feeder may require the U.S. fund to provide covenants that are typical for a foreign fund. For example, the master feeder may require the U.S. fund to provide PFIC information, if it is expected that the U.S. fund is investing, or will invest, in PFICs, or require that the U.S. fund set up a blocker in case it invests in U.S. companies with effectively connected income (ECI). In these complex structures, communication and scrupulous review of the applicable rules can often save the day. For example, setting up a blocker below the U.S. investee fund could be grossly ineffective. When one takes the whole structure of both funds together, there is a doubling-up of blockers. The foreign master feeder will usually already have a foreign blocker in place. Layering another blocker below the

U.S. fund creates an inefficient tax structure that could subject the master feeder's U.S. shareholders to double tax and U.S. withholding.

In addition, the master feeder should be cautious about the type of PFIC covenants it asks the U.S. fund to sign. The master feeder should make sure that it asks the U.S. fund to warrant that it will make a QEF election for any foreign PFICs the U.S. fund may be invested in. Not doing so could put the foreign master feeder's U.S. investors at a significant tax disadvantage. The reason is that a QEF election could be made only by the first-tier U.S. partnership that holds shares in the PFIC.[35] If the investee U.S. fund does not make a QEF election, the U.S. investors of the investor master-feeder fund are open to section 1291 "excess distribution" taxation and a host of other adverse PFIC rules, more fully described in other sections of this book. Again, counsel should be particularly cautious when funds are layered in and out of the United States. This creates awkward structures where a U.S. investor may be indirectly invested in a U.S. portfolio company through layers of foreign and U.S. vehicles that could lead to significant tax inefficiencies.

### *General Partner/Manager Issues—Interest for Services*

The formation issues regarding general partners (GPs) and managers generally revolve around the character of the income derived by the manager and the deductibility of any compensation for services to the fund. The manager of a fund traditionally receives what is often called a "2 and 20"—a 2 percent fee as compensation for services, taxable at ordinary income rates,[36] and a 20 percent interest in the net gain on the fund's portfolio investments. If the fund is treated as a partnership for U.S. federal income tax purposes, the 20 percent interest (also called "carried interest" or "carry") is generally treated as a profits interest, which is not taxable to the manager as the time of issuance and which results in capital gain treatment to the manager as portfolio investments are sold.[37] If the fund is treated as a corporation for U.S. purposes, an exact analogue to this "2 and 20" carry interest is not possible simply because corporations are not pass-through entities and they cannot issue profits interest to their shareholders. Nevertheless, a similar economic and tax result may be achieved if the fund is a foreign PFIC with a QEF election and the manager receives a fixed differential stock. The stock participates in profits only to the extent of the excess over the capital contributions of the investors in the fund. If the stock is valued based on the liquidation approach, the value of the stock at time of issuance will presumably be low, and

35. *See* Treas. Reg. § 1.1295-1(d)(2)(i)(A).

36. The fee is sometimes paid to a separate pass-through entity, an investment manager, which shares overlap of ownership with the GP.

37. *See generally* Rev. Proc. 93-27, 1993-2 C.B. 343. Note, however, that if Notice 2005-43 and the regulations thereunder are adopted, this result may somewhat change. Rev. Proc. 93-27 relies on the liquidation method for discerning the value of the carry. Under Notice 2005-43 generally section 83 FMV principles apply unless the fund meets the safe harbor provided for in the Notice.

the manager should be able to participate in future appreciation of the fund's investments at capital gains rates.[38]

A separate issue that used to be more prevalent is whether the manager should be viewed as a shareholder/partner in the fund. To ensure that the manager is treated as a GP for tax purposes and the resultant favorable treatment of the GP's carried interest, some practitioners advise that the GP contribute a nominal amount of capital to the fund. However, since pure service partners are clearly contemplated by current law,[39] the necessity of a capital contribution by the GP is questionable.

If the fund is treated as a corporation, the usual approach is that any 20 percent interest in the fund is compensatory and issued for services. The manager will make a section 83(b) election at the time of receipt to close the compensation element and to assure capital gains treatment at the time of unwinding of the fund.[40] Several strategies can be implemented to minimize the inclusion at the time of the 83(b) election, such as convertible debentures, fixed formula convertible stock, book value shares, and recourse loans from the fund to the manager.

Lastly, when setting up the fund, practitioners need to think about what managerial expenses will be deductible and how those expenses will be allocated (i.e., who should be entitled to deduct the expenses.) Also, at this stage, the investors should be told that any carry distributions are not deductible and would not offer a direct tax benefit to the investor (preferably, this should be disclosed in the fund's private placement memorandum).[41] On the other hand, if the fund is treated as a corporation these issues are not as prevalent because the deductions do not pass to the investors.[42] Some particularly interesting expense deduction issues may come up if the investors in the fund invested through a fund of funds. These issues are discussed in Mark Leeds' article cited below.[43]

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38. As suggested earlier, in many areas of private equity taxation it is worth paying close attention to upcoming legislation. At the time of the publication of this book, for example, there has been an ongoing effort by Democrats to subject the carry to ordinary income treatment. As of now, these efforts have been unsuccessful in both the 110th and 111th Congress, but if enacted, treating the carry as ordinary income would significantly change the tax landscape for fund managers. In parallel to federal legislation, practitioners should also follow state legislation, which sometimes could provide for a different tax treatment from its federal analog. For example, in 2010, The New York State Assembly was considering proposed legislation that would have taxed carried interest for out-of-state managers of in-state investment funds as compensation for services (S.B. 6610-C, referred to the Finance Committee on January 19, 2010). If such legislation is adopted at the state level while its federal analog is not adopted by Congress, this could create a disparate tax treatment and could potentially be a trap for the unwary.

39. Rev. Proc. 93-27.

40. Section 83 of the Internal Revenue Code generally provides that property transferred in connection with the performance of services will be treated as ordinary income up to the excess of FMV over the price paid for the property. *See* I.R.C. § 83(a). Often such inclusion is postponed by some risk of forfeiture that burdens the property. Since the usual expectation is that the property will go up in value, service providers will usually make an 83(b) election, which affords an inclusion in the year of transfer notwithstanding any risk of forfeiture encumbrances of the property.

41. Any tax benefit associated with the carry that the investor might have is manifested as a lower inclusion of income, since 20 percent of the gain on the disposition of the investment is allocated to the manager. This should be explained to investors to avoid stress and questions down the road.

42. This is true even for foreign funds with QEF elections. *See* I.R.C. § 1293, which generally provides only for income inclusion.

43. *See also* Rev. Ruls. 2008-38, 2008-39.

➤ **Useful Reading**

Prop. Treas. Reg. §§ 1.83-3, 1.704-1, 1.706-3, 1.721-1, REG-105346-03, 70 FR 29675-01 (May 24, 2005).

I.R.S. Notice 2005-43, 2005-24 I.R.B. 1221 (2005).

Rev. Proc. 93-27, 1993-2 C.B. 343 (1993).

Rev. Proc. 2001-43, 2001-2 C.B. 191 (2001).

Rev. Rul. 2008-38, 2008 WL 2612168 (2008).

Rev. Rul. 2008-39, 2008 WL 2620251 (2008).

ANDREW NEEDHAM, PORTFOLIO 735-2ND: PRIVATE EQUITY FUNDS, at VI.A. The Grant of the Carried Interest (BNA Tax & Accounting Online).

Howard E. Abrams, *Taxation of Carried Interests*, 116 TAX NOTES 183 (2007).

Howard E. Abrams, *A Close Look at the Carried Interest Legislation,* 2007 TNT 233-35.

Cong. Res. Serv., *Taxation of Private Equity and Hedge Fund Partnerships: Characterization of Carried Interest*, *reprinted in* 2008 TNT 46-26.

James H. Lokey, Jr. & Donald E. Rocap, *Selected Tax Issues in Structuring Private Equity Funds*, 919 PLI/Tax 191-1 (2010).

Darryll K. Jones, *Debunking the Carried Interests Myths*, 2007 TNT 167-41.

Monte A. Jackel & Robert J. Crnkovich, *Partnership Deferred Compensation and Carried Interests*, 2009 TNT 74-9.

Lee Sheppard, *Hedge Fund Managers' Year-End Tax Planning*, 121 Tax Notes 1216 (2008).

Lee Sheppard, *What Can Hedge Fund Managers and Investors Deduct?*, 2008 TNT 136-3.

Mark Leeds, *IRS's One-Day Trifecta Impacts Hedge Funds, Funds of Funds*, BNA DAILY, July 21, 2008.

## *Compensatory Options*

Above we discussed profits interests, the usual manner in which the manager of the fund is rewarded for its performance. Sometimes, however, instead of issuing a profits interest, the fund may issue compensatory options. Usually the tax planning reasoning is that the service provider may postpone the recognition of the income associated with the provided services. To illustrate, if a manager is to receive a 20 percent performance bonus when an investment is sold, the manager recognizes income on that amount. Naturally, the manager also gets paid. However, a manager who has an option to acquire interest in the fund sometime in the future would not be treated as a partner (unless for example the option is reasonably certain to be exercised) and thus, no income will be allocated to the manager.[44] Aside from the economic question of whether the manager is willing to defer the cash receipt associated with the 20 percent carry, the key tax questions that a manager would want to ask about the options route include the following: Is the issuance of the option taxed? If

44. See, for example, the 2005 compensatory partnership interest regulations, Prop. Treas. Reg. §§ 1.83-3 , 1.704-1, 1.706-3, 1.721-1, REG-105346-03, 70 FR 29675-01 (May 24, 2005). Those generally treat the exercise of the option as the issuance of partnership interest.

not, is the exercise of the option taxed and what is the character of the income? What is the amount of income, and how does this compare to issuing profits interest up front?

There is no single authority that expressly addresses the treatment of compensatory options. Here is a brief history of what is available. In the year 2000, the Service issued I.R.S. Notice 2000-29. In that notice the Service requested comments regarding the exercise of partnership compensatory options. Among the most notable responses to this request for comments was the New York State Bar Association (NYSBA) report regarding the taxation of partnership options.[45] The report in essence suggested that the compensatory partnership options should be governed by section 83 principles (i.e., as corporate compensatory stock options) but with a subchapter K twist to fix the instances when those principles are incongruous with subchapter K. Regarding the treatment of the exercise of compensatory partnership options, the report stated:

> Section 83(a) requires the holder to include in income (as ordinary income), at exercise, the excess of (i) the value of the partnership interest on the exercise date (discussed further below) over (ii) the sum of the option exercise price plus any option premium paid. It is not clear how the value of the partnership interest should be determined for this purpose. Section 83 uses the fair market value (FMV) approach but this approach conflicts with subchapter K principles as embodied in Rev Proc 93-27 and Rev Proc 2001-43.[46]

Further, in the report, the New York bar reasoned that the value of the interest received on the exercise of the compensatory option should be determined under the liquidation approach. This report was published in 2002. A year later, the IRS issued the famous non-compensatory option proposed regulations.[47] Those proposed regulations (which are still in proposed form) specifically provide that they do not apply to compensatory options. Instead, the proposed regulations announced that the IRS is working on future guidance that will address the federal income tax consequences of compensatory options and invite comments. In response to the second request for comments, the New York bar came out with a second report in 2004.[48] In that report, the NYSBA reiterated what they said in the prior report: that the exercise is treated as a direct issuance of compensatory interest at time of exercise and the option holder would recognize ordinary income equal to the excess of the liquidation value of the capital interest over the sum of the exercise price and any option premium paid. The NYSBA also explored an alternative approach under which the exercise of the option would not be taxable if at the time of grant the optioned interest was only a profits interest. However, in the end, it did not endorse this alternative approach and stuck to its section 83 approach. Finally, the report added that as a result of the exercise, the service provider will generally have a full liquidation value capital account.

Contrary to some expectations, the IRS did not then come out and address the treatment of compensatory options head-on, and probably it will not in the future. In May 2005 the IRS issued the second piece of guidance in this area, the famous partnership

45. 2002 TNT 21-24.
46. *Id.*
47. Reg-103580-02, 68 FR 2930 (2003).
48. 2004 TNT 16-81.

interest-for-services proposed regulations.[49] While these proposed regulations do not directly address the taxation of partnership compensatory options, they provide that "a compensatory partnership interest is an interest in the transferring partnership that is transferred in connection with the performance of services for that partnership (either before or after the formation of the partnership), *including an interest that is transferred on the exercise of a compensatory partnership option*."[50] In other words, the IRS is saying that it will treat the exercise of a compensatory option as the issuance of compensatory partnership interest and will tax it under these regulations when this happens. This is confirmed by a statement by Treasury Department Attorney-Adviser Matthew Lay, who said about compensatory options, "We don't anticipate new rules. This is it . . . in general, the same rules apply in the option area as in the non-option area."[51]

All of this means that the issuance of the option by the fund is not taxed and the fund manager is not treated as a partner until the time of exercise of the option, at which time the manager is taxed under the general rules for issuing partnership interest for services. Under the proposed regulations the result is relatively clear. The preamble to the proposed regulations provide that

> these proposed regulations would allow a partnership, its partners, and the service provider to elect to treat the fair market value of a partnership interest as equal to the liquidation value of that interest. If such an election is made, the capital account of a service provider receiving a partnership interest in connection with the performance of services is increased by the liquidation value of the partnership interest received.[52]

In other words, if the partnership makes an election and meets the safe harbor to value the interest under the liquidation method, take the liquidation value allocable to the service partner and increase its capital account by that amount. If no election is in place, things are less clear because general section 83 principles apply, which means that FMV will be determined under common law principles and ultimately could differ from the value as determined under the liquidation approach espoused by the regulations. To summarize all of the above, under the proposed regulations, the compensatory option is taxed at exercise and is treated as if the service provider receives partnership interest at that time. The service provider is taxed at ordinary income rates on the value of the interest, which value is determined under the liquidation method if there is an election in place.

These regulations, however, are still in proposed form and are not binding. Until they are finalized, the general rules for issuance of capital interest for services should apply to the exercise of a compensatory option. Here is generally how those rules work. Willis's partnership treatise succinctly addresses the current state of the law regarding issuance of capital interest for services. For purposes of this book it suffices to quote him:

49. Reg-105346-03, 68 F.R. 2930 (2003).
50. *Id.* (emphasis added).
51. 24 TMWR 1530, Oct. 2005.
52. Reg-105346-03, 68 F.R. 2930 (2003).

> A partnership capital interest received as compensation for services rendered to the partnership clearly is taxable to the recipient as ordinary income, either under Regulation § 1.721-1(b)(1) and Code § 61 or under Code § 83. There is some uncertainty over which provision applies.[53]

In few words, similar to the proposed regulation, the option should be taxed at the time of exercise as ordinary income. The more interesting question under current law, however, is how much income must be included at time of exercising the option and how the capital account is affected by the issuance of the interest. The problem is that under current binding law (disregarding the proposed regulations), there is some controversy over what constitutes capital interest and what the value of this interest is (this has a direct import on how much income is taxed to the service partner because a service partner is taxed on the receipt of capital interest but not profits interest). The controversy emanates from Treas. Reg. § 1.721-1(b)(1). That regulation provides that

> [t]o the extent that any of the partners *gives up any part of his right to be repaid his **contributions*** (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest ***in such** partnership capital* so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is *the fair market value of the interest in capital so transferred*, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services.[54]

This plainly suggests that capital interest equals the forfeited amount of any original capital contributions. Also, this regulation clearly puts the emphasis on the fair value of the capital interest but does not elaborate how to measure this fair value. Moreover, to further confuse things, the fair market value could be based on the value at the time services are performed in the future (the last clause of the quote). Under the above regulation's language, one may argue, for example, that unrealized appreciation is not a capital interest, and thus, it should not be taxed. However, the regulation's formulation of capital interest contradicts other guidance. For example, Treas. Reg. § 1.704-1(e)(1)(v) defines a capital interest as any interest in the assets of the partnership to which the partner is entitled upon withdrawal from, or the liquidation of, the partnership. A similar liquidation approach is utilized by Rev. Proc. 93-27. Under this liquidation approach, the definition of capital interest and the value of that interest are tied to the amount the partner would receive in a deemed liquidation. Under that approach, the compensation would equal the amount the manager would receive on liquidation, which in turn means that 20 percent of any unrealized appreciation that is due to the efforts of the manager is included in the amount of compensation. Then, the partner's capital account is increased by that amount under the so-called "circular flow of cash" theory, that is, the partnership is treated as compensating

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53. AUTHUR B. WILLIS & PHILIP F. POSTLEWAITE, Regulation § 1.721-1(b)(1), in PARTNERSHIP TAXATION ¶ 4.05[3][a] (Thomson Reuters/WG&L, 1997-2010, with updates through February 2011).

54. Treas. Reg. § 1.721-1(b)(1) (emphasis added).

the service partner with cash up to the amount the partner recognized in income, and the partner is treated as contributing back the cash in exchange for partnership interest. This makes sense, at least to the author.

The same approach is adopted by the 2005 proposed regulations, at least to the extent there is an election to use the liquidation approach. It could be reasoned that the view that a capital interest is measured only by the value of the relinquished right to contributions is very narrow and is probably due to an anomaly in the regulations (i.e., it appears that the regulations address capital interest and compensation issues arising only *at the time of formation of the partnership*; conversely, an option that the manager receives at the formation of the fund and exercises later on would lead to the receipt of partnership interest not at the time of formation of the fund). Regarding the issue of liquidation approach versus 721 regulations approach to capital interest, most practitioners favor the liquidation approach; coincidentally, that is the approach espoused by the NYSBA both in compensatory reports and by the 2005 proposed regulations (at least when there is an election). Admittedly, the theory that unrealized appreciation should not be included in compensation is specious. That said, however, the liquidation approach to capital interest may not always be warranted, as when the service partner has no right to the appreciation until the property is sold.[55] Coincidentally, that is the case for most private equity funds. The upshot is that under current law it is not entirely clear what the tax result to a manager would be when exercising the option. That fact is important to some managers because it creates tax uncertainty. It is also important because it may offer planning possibilities.

In summary, under the proposed regulations the treatment of the exercise option is relatively clear, and the result is as described above. Disregarding the proposed regulations, the result is a bit more uncertain due to some ambiguities in the definition of capital interest. The view of many practitioners is that the more cogent result is the one espoused in the proposed regulations, that is, using the liquidation approach and taxing liquidation value as ordinary income and adding that amount to the capital account of the service partner.

The bottom line of this lengthy discussion is that the road to making an educated choice between a profits interest and a compensatory option is not straightforward but sinuous. Some not-so-obvious factors such as the ambiguities of the current state of the compensatory options law must be considered. In addition, there are other layers of complexity because the fund manager must consider the capital gain/ordinary income differential, the length of time before the option is exercised, the availability of a deduction for the portion treated as compensation, and so on. If counsel is advising a particular manager and wants to tackle this choice, it is prudent to run sample scenarios and make some basic assumptions such as (1) that the IRS would not disagree with the taxpayer if the taxpayer chooses to apply the proposed regulations, (2) that the option is most likely to be exercised in [x] years, (3) that the profits of the fund are estimated to grow at [x] percent, and (4) that the capital gains/ordinary income arbitrage will remain at [x] percent. While these may be big assumptions and the failure of one assumption could lead to drastically different tax results

55. Willis, in his partnership treatise, advances this reading and reasons that in those cases it is more difficult to argue that the amount of unrealized appreciation is a capital interest and taxable. Willis, ¶ 4.05[2] Unrealized Appreciation.

from those anticipated initially, the assumptions and the scenarios would help the client quantify the benefit of going one way or another. Lastly, there is no reason why a manager cannot be compensated with a combination of profits interest and compensatory partnership options.

➤ **Useful Reading**

NYSBA, REPORT ON THE TAXATION OF PARTNERSHIP INTERESTS RECEIVED FOR SERVICES AND COMPENSATORY PARTNERSHIP OPTIONS (January 23, 2004).

BNA Weekly Report, *No Compensatory Options Project Planned After Final Partnership Equity Regulations*, 24 TMWR 1530 (2005).

Karen C. Burke, *Taxing Compensatory Partnership Options*, 2003 TNT 184-47.

### *The Inadvertent Partner*

Funds and their managers, particularly large ones, hire employees, including some key persons and professionals. Sometimes these professionals receive a profits interest or options to acquire such an interest. As a result, either at the inception of the fund or down the road when interest vests or options are exercised, an employee may end up also being a partner (if not for state law purposes, certainly for tax law purposes).[56] The problem here is that the two concepts are incongruous in the eye of the tax law.[57] Any compensation received by the employee/partner will not be treated as wages. This presents a problem to the fund employee for at least two reasons: first, the employee will be subject to self-employment tax instead of employment tax (the big difference being that a self-employed person pays 100% of social security/Medicare tax whereas an employee pays half; the other half is paid by the employer) and second, benefits available only to employees will be lost (e.g. fringe benefits). The IRS has announced that no relief will be provided for any persons who find themselves in this position.[58] To avoid any ambiguity and unanticipated issues, partner/employees may arrange their interest so that the partnership interest is held through another entity such as an S corporation. In deciding how to proceed here tax advisors should also look at the implications for the fund. It may be more beneficial to the fund to have the particular person treated as a partner instead of an employee (e.g. less employment taxes, less fringe benefit cost).

### *Type and Structure of the Fund: Blockers and Other Issues*

As mentioned, funds can be structured in many different ways. There are several typical structures such as master feeders, parallel funds, fund of funds, and so on. The choice of a particular structure must take into account many considerations, but one of the most important tax considerations is tied to the type of investor (foreign, domestic, sovereign fund,

56. Many agreements would have express language that service partners that have been granted profits interests do not have rights of a state law partner.

57. Rev. Rul. 69-184, 1969-1 C.B. 256.

58. "Taxpayers Can Rely on Limited Partner Employment Tax Regs, IRS Official Says," 2010 TNT 10-2.

exempt or nonexempt) that participates in the fund. Foreign and tax-exempt investors will generally seek to avoid investing directly in a flow-through fund to avoid any attribution of a U.S. trade or business from the fund,[59] in the event the fund is found to be engaged in a U.S. trade or business. As such, a foreign "blocker" corporation will be embedded in the fund structure to insulate other income of these investors from being tainted by a U.S. trade or business. Additionally, if the fund is not prohibited from investing in U.S. flow-through portfolio companies, these investors will be even more insistent on the use of a blocker entity because the U.S. trade or business of these operating companies would ultimately be attributed to these investors under the rules of section 875 of the Internal Revenue Code. While the use of a blocker does not increase the after-tax return of these investors on their fund investments,[60] because the blocker will bear the tax that would otherwise be borne by these investors, the use of a blocker does carry the added benefit of minimizing the reporting obligations of the foreign and tax-exempt investors, which will be borne by the blocker.

The blocker entity can be integrated into the fund structure in a number of places. There are three typical alternatives. In a "master feeder" structure, the blocker is interposed between the foreign and tax-exempt investors and the master fund. In a parallel fund structure, the foreign feeder fund could be a blocked fund itself, or the blocker could be interposed between the foreign parallel fund and the portfolio companies.

If the fund decides to interpose a blocker in its structure, it should also consider the implications of the branch profits tax (BPT).[61] If possible, the foreign blocker entity should be used without increasing the risk of triggering the BPT. If the BPT applies, it can raise the overall effective U.S. tax liability of the foreign investor to an excess of 50 percent. For a further discussion on blockers, see "Blocker or No Blocker" below.

Aside from these blocker considerations, the fund structure may often have to accommodate specific requirements of foreign investors imposed under their own country's local law. These issues should usually be worked out with foreign counsel, but having familiarity with the makeup of the funds' investors and asking whether there are any local requirements is the first step in getting it right. For example, there may be some special considerations for German investors. To comply with the German Foreign Investment Act, German investors may have to coinvest in the fund through a special entity such as Gesellschaft mit

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59. Tax counsel should be particularly sensitive to the tax-structuring issues pertinent to foreign sovereign investors. Those investors would generally have their own SPV subsidiary that is designated for investments in the United States, which subsidiary will usually only invest in a blocker entity. The reason is that U.S. trade or business activities could taint an otherwise tax-exempt income of the sovereign fund under section 892 of the Internal Revenue Code. This section of the Code exempts U.S.-source income received by "foreign governments" from U.S. tax. Foreign governments include "integral parts" of the government and its "controlled entities." The problem for many sovereign funds such as the Abu Dhabi Investment Council is that the fund is classified as a controlled entity and is subject to the so-called "all or nothing rule," which causes the fund to lose its exemption under section 892 if it engages in any commercial activity around the world. Due to the severity of this rule, it is paramount for sovereign-fund investors to participate through a blocker entity.

60. However, it will reduce the overall U.S. tax liability of such investors if the attribution of the fund-level and/or portfolio-level trade or business would taint other income of the investors.

61. BPT is discussed in more detail in "U.S. Trade or Business Rules" and "Branch Profits Tax Issues" in Chapter 3, *infra*.

beschränkter Haftung (GmbH).[62] U.S. counsel should not assume that the foreign investor is familiar with its local country requirements, and in any case, raising the issue builds good rapport between the fund and investors.

➤ **Useful Reading**

ANDREW W. NEEDHAM, PORTFOLIO 735-1ST: PRIVATE EQUITY FUNDS, at VII.D (BNA Tax & Accounting Online).

Andrew W. Needham, *A Guide to Tax Planning for Private Equity Funds and Portfolio Investments*, 95(8) TAX NOTES 1215 (2002).

Robert D. Blashek, *Investments in "Pass-Through" Portfolio Companies by Private Equity Partnerships: Tax Strategies and Structuring*, 870 PLI/TAX 1213 (2009).

Arturo Requenez II & Timothy S. Shuman, *U.S. Private Equity Funds Making Cross-Border Investments—Primary Tax* Considerations, 890 PLI/TAX 1469 (2009).

Kimberly S. Blanchard, *Cross-Border Tax Problems of Investment Funds*, 923 PLI/TAX 281-1 (2010).

### *Contributions Contingent on Approving the Investment*

Funds often provide for contributions to capital based on the fund's investment objectives and availability of suitable portfolio companies. These contributions are often called capital commitments and are called periodically by the manager when funds are needed. Sometimes an investor will bargain for making future contributions contingent on the investor's approval of the prospective investment. This usually happens when the investor has significant bargaining power and the fund is not oversubscribed. Aside from the threshold issue of whether such an obligation is enforceable under general principles of contract law, what is the tax effect of these obligations? If the fund is a corporation, assuming that in all likelihood the obligation will be viewed as an unenforceable illusory obligation, it will not be treated as property for tax purposes. Conversely, if the obligation is a noncontingent obligation of the fund's shareholder, it may qualify as property under the *Peracchi*[63] and *Lessinger*[64] line of cases. Whether the obligation can be viewed as property can affect the analysis under section 351, if applicable.[65] If there are other investors who are contributing property, for example appreciated stock, failing to meet the "stock in exchange for property" requirement could fail the 80 percent test and cause section 351 not to apply to those property transfers, which in turn could trigger taxable gain to the property-contributing investors.

In addition, the fact that such obligation is not treated as property could result in a disproportionate receipt of stock. For example, A and B agree to make a $50 contribution each

62. The GmbH is one of the most widely used entity forms for private equity investments by German residents. The reasons are many, including the fact that the German resident investor may be able to sell the shares without running afoul of German taxation if certain conditions are met.

63. Peracchi v. Comm'r, T.C.M. 1996-191 (1996), rev'd, 143 F.3d 487 (1998).

64. Lessinger v. Comm'r, 872 F.2d 519 (2d Cir. 1987).

65. Section 351 generally provides that the contribution of property to a controlled corporation is not subject to tax.

to a corporate fund in exchange for 50 shares of stock. A is going to make a contribution in marketable securities and B is going to make a contribution of his personal note to pay $50 in installments. In this instance there is a proportionate receipt of stock because the installment obligation is respected as a bona fide obligation. However, if B's contribution of the note did not count because it was viewed as an illusory obligation, his 50 shares become a disproportionate receipt of stock. The question is whether the receipt of such stock will be taxable to A, B, or both. The section 351 regulations generally contemplate disproportionate distributions; however, they also stipulate that each transaction will be given tax treatment in accordance with its true nature. Thus, it is advisable to be mindful of this if such setup comes up before the practitioner.[66]

If the fund was a partnership, the results are relatively clear. The investor would not get a capital account for the note or contingent contribution obligation. This result is the same as in the corporate fund context. Contrary to the corporate context, however, even if the note was a bona fide noncontingent obligation, the contribution would not have a tax effect until the actual cash is funded (i.e., when the commitment is funded and the cash is transferred to the fund).[67] Thus, as a result, the investor entering into the contingent obligation will be viewed as a partner, but in all likelihood it will be only receiving a profits interest and its outside basis in the fund's shares will be zero.[68] One of the most important consequences to the fund's investor in this situation is that the investor will not be able to take any losses while the contingent obligation is outstanding.[69]

➤ **Useful Reading**

Peracchi v. Comm'r, T.C.M. 1996-191 (1996), *rev'd*, 143 F.3d 487 (1998).

Treas. Reg. § 1.351-1(b)(1).

Rev. Rul. 76-454, 1976-2 C.B. 102 (1976).

### *Phantom Income Issues*

In tax parlance, "phantom income" describes a situation whereby the investor or the fund has to recognize income but has no corresponding cash receipt attributable to the income to pay the tax. Phantom income issues are dreaded by most taxpayers and could occur at both the investor and the fund level. The investors' expectations are that the fund would not generate phantom income. Thus, when setting up the fund, practitioners should address this issue up-front and provide for some mechanic that assures the investor will have cash when it accrues a tax liability associated with income from the fund. One typical mechanic (discussed below) is a tax distribution section in a partnership fund. Another is a mandatory

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66. The likelihood of this setup is admittedly not great, but it is nevertheless possible. These considerations may come into play, for example, when U.S. investors invest in a domestic or foreign corporate fund (not a usual, but possible occurrence).

67. Treas. Reg. § 1.704-1(b)(2)(iv)(d)(2).

68. Contrary to the corporate context, a partner's obligation or note has zero basis. *See, e.g.*, Gemini Twin Fund III v. Comm'r, T.C.M. 1991-315 (1991).

69. Losses are generally limited to outside basis, and the contingent obligation would not count toward outside basis. *See* I.R.C. §§ 704(d), 722. *See also* Oden v. Comm'r, T.C.M. 1981-184 (T.C. 1981).

distribution on a liquidity event such as a sale of a portfolio company. In either case, not having such a mechanic expressly provided for in the fund's agreement could lead to unhappy investors, and unhappy investors tend to withdraw their cash.

### *Employment Tax Issues*

Many U.S. taxpayers do not consider their employment and self-employment tax exposure. The reason is that for many Americans the tax is a given and it does not add to a sufficiently large dollar amount to worry about. However, to most managers of private equity funds the issue is significant. Particularly, the concern is with the Medicare portion of the tax, which is not capped, but imposed on the total earnings of the manager. Thus, depending on how the fund and manager are structured, and the employee/independent contractor relationships among and within them, the manager may be subject to either 1.45 percent (employment tax)[70] or 2.9 percent (self-employment tax) on its services income—that is, the 2 percent management fee.[71]

Usually managers are not concerned with this aspect of the Medicare tax. To them, the issue is more pressing when it arises in respect of their performance return (i.e., the 20 percent carried interest). The issue is whether the Medicare tax would apply to this 20 percent carried interest. The application of the Medicare tax could very much depend on how the fund and manager are structured and on the legal characterization of the 20 percent interest. The manager's owners could be subject to different self-employment tax rules, depending on whether the manager is formed as an S corporation, a limited partnership (LP) (or limited liability partnership or limited liability limited partnership), or LLC. Moreover, the consequences can differ depending on whether the fund is a partnership or a corporation, and whether the fund is a foreign or domestic entity.

If the manager is an S corporation, the owners are not liable for employment tax with respect to any distributions paid by the corporation, so long as the owners are paid reasonable compensation by the S corporation.[72] If the manager is organized as an LP, its owners will not be taxed on their distributive share of the manager's earnings, to the extent the distributive share does not consist of guaranteed payments and assuming the owners can meet the definition of limited partners in Prop. Treas. Reg. § 1.1402(a)-2(h).[73] If the manager is organized as an LLC, owners may argue that the rules applicable to LPs apply with equal force to LLCs; however, LLCs are not literally covered by those rules, and the owners of an LLC may be liable for Medicare tax on their entire distributive share. These issues are not that prevalent for managers compensated with partnership interest as opposed to a fee (most private equity managers are compensated by partnership profits interest). In that instance, the manager and its partners will rely on the IRC Section 1402(a)(3)(A) exception

70. If the manager is an independent contractor, as often is the case, the 2.9 percent rate applies.

71. These are the rates without social security tax. With this tax, the rate of self-employment tax is 15.3 percent. For rates, see I.R.C. § 3101.

72. Section 1402(a)(2) excludes payments in respect of stock from the definition of "net earnings from self employment." Naturally, the reasonable compensation portion will be subject to such tax.

73. Note that falling within the definition is fact specific. Some of the owners might, but others may not, meet this definition depending on their rights and obligations under the agreement.

for capital gains and the 1402(a)(2) exception for interest and dividends. When dealing with these employment tax issues, an overarching rule of thumb for the practitioner should be that artificially low compensation paid to the manager could be attacked by the Service and should be avoided (in other words, do what's fair).

➤ **Useful Reading**

I.R.C. § 1402(a)(13).

Treas. Reg. § 1.1402(a)-1(a)(2).

Prop. Treas. Reg. § 1.1402(a)-2(h)(5).

Westerbrook v. Comm's, T.C.M. 1993-634.

Dunn & Clark, P.A., 93-2 T.C. ¶ 50,447 (D. Idaho 1994).

Boles Trucking, Inc. v. United States, 1995 U.S. Dist. LEXIS 854 (D. Neb. 1995).

Charles Herbst, *Self-Employment Tax Uncertainties Remain for LLCs*, J. PASSTHROUGH ENTITIES, Jan.–Feb. 1999.

Robert R. Keatinge, Self-Employment Tax Issues in LLCs Taxed as Partnerships (Suffolk University Law School Research Paper No. 07-33, September 18, 2007).

Thomas C. Lenz, *What a Long, Strange Trip It's Been: Net Earnings from Self-Employment Tax for Partnerships and LLCs*, J. PASSTHROUGH ENTITIES, Jan.–Feb. 2007.

Burgess J. W. Raby & William L. Raby, *Self-Employment Income of LLC "Partners,"* 2003 TNT 108-49.

CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 4.10 (Reuters/WG&L 1994 & Supp. Nov. 2010).

Claire Y. Nash, *Ending De Facto Self-Employment Tax Holiday for LLC Members*, 2010 TNT 178-7.

### *Is the Cash Method of Accounting Available to the Fund?*

Partnerships can generally choose their accounting method without approval from the IRS.[74] Thus, funds may sometimes provide for the cash method of accounting in their operating agreements without giving too much thought to the issue. The Internal Revenue Code, however, has some express rules dealing with the matter. For example, section 448 denies the cash method of accounting to all C corporations *and certain partnerships with a C corporation as a partner*.[75] Notably, the term "C corporation" includes real estate investment trusts, regulated investment companies and tax-exempt entities inasmuch as they have unrelated business taxable income (UBTI).[76] Notably, tax-exempt entities are common fund investors. Moreover, they often invest through a blocker (i.e., a C corporation). Thus, a fund can run into a problem under this rule. Notably, however, there is a $5 million gross receipt exception in I.R.C. § 448(b)(3) and Treas. Reg. § 1.448-1T(f). For practical purposes this means that a fund with more than $5 million in annual gross receipts is prohibited from using the cash method of accounting. However, even funds with less

74. I.R.C. § 446(c)(1).
75. Treas. Reg. § 1.448-1T(a)(3).
76. *Id.*

than $5 million dollars of gross receipts could be prevented from using the cash method of accounting. PLR 9426030 illustrates this issue. The PLR focuses on the tax shelter carve out under Section 448. Under this carve out private equity funds cannot rely on the cash method of accounting because of Section 448(a)(3). That section provides that tax shelters cannot use the cash method of accounting. For this purpose, pursuant to Section 448(d)(3) tax shelter has the meaning set forth in Section 461(i)(3)(B). In turn, that section includes a syndicate within the meaning of Section 1256(e)(3)(B), which includes any partnership fund that allocates more than 35% of its losses to its limited partners (note, however, that the same logic and limitation may not apply to the GP/Manager of the fund due to the active participation exception set forth in 1256(e)(3)(C)). The point here is to not blindly draft for the cash method of accounting but carefully examine the investor base and leave some wiggle room, for example, "the fund shall use the cash method of accounting for Federal income tax purposes if permissible under section 448 and the regulations thereunder."

### *Book-Tax Conformity at the Fund Level*

Sometimes when drafting the fund documents, and particularly the typical "Accounting Method" section of the agreement, the lawyer may ask whether the fund must use the same method of accounting for book and tax purposes. In other words, assuming the fund is not precluded by section 448 of using the cash method of accounting, for various reasons, it may wish to keep its books on the accrual method, but use the cash method for tax reporting. The basic question here is whether the fund could have this kind of a disparity in accounting. While section 446 suggests that this is prohibited, case law and IRS rulings hold that this is permitted, so long as accurate entries are made reconciling the accrual and cash books.[77]

### *Is Mark-to-Market Available to the Fund and, If So, Should the Fund Use It?*

This section does not discuss mark-to-market accounting (MTM) in detail. The reader should consult some of the sources enumerated below. The purpose of this section is to raise the issue and to alert the reader to consider whether the fund is eligible for MTM, and if so, whether the fund should choose to MTM. Most private equity (PE) funds, contrary to hedge funds, would not qualify for MTM. Generally pursuant to section 475 of the Internal Revenue Code, MTM is available to dealers in securities or traders in securities or commodities. PE funds are usually not traders or dealers but rather investors in private companies. However, as often is the case, there is no bright-line rule. Some funds engage not only in investing but also in trading of securities or commodities (particularly some larger funds and families of funds). In other words, funds could be quasi-private equity funds, having characteristics of both private equity and hedge funds. If such funds elect MTM in respect of their securities trading, they will have to clearly identify property held for investment as specified in section 475 of the Code. Moreover, funds making the election should heed the fact that gains and losses from MTM activities will be generally ordinary as provided under

77. *See* I.R.S. Tech. Adv. Mem. 91-03-001, 91-13-003.

section 475(d)(3). As to whether to make the election if it is available, as one may expect, there are advantages and disadvantages. To a private equity fund the election, even if available, could present one significant disadvantage that could be a deal breaker from the get-go. As noted above, under MTM, gains are treated as ordinary income. While this is not a problem to hedge funds and their investors, who normally would expect ordinary income due to the short-term trading activities of the fund, for private equity investors this could be a significant issue. This issue, however, could be mitigated if the fund clearly identifies each position that has no connection to the activities of the fund as a trader.[78]

➤ **Useful Reading**

OGGIE CAGINALP, PORTFOLIO 543-1ST: THE MARK-TO-MARKET RULES OF SECTION 475 (BNA Tax & Accounting Online).

Peter A. Furci et al, *Certain U.S. Tax Considerations for Organizing U.S. Hedge Funds*, 920 PLI/Tax 203-1 (2010).

## The Private Placement Memorandum

Virtually all fund offerings are accompanied by a private placement memorandum (PPM). Often, the fund would have more than one, for example when there are foreign feeder funds separate from the master fund. The memoranda have many purposes, including to alert the investor to the tax consequences of investing in the fund. Thus, invariably, each PPM for a private equity fund has a tax disclosure section and often a tax risk section. While a detailed discussion about issues that come up in these documents is outside the scope of this book, the following tips may be useful to tax practitioners who work on these documents:

- Clearly state whom the tax section of the document applies to, that is, domestic or foreign and tax-exempt investors.
- If the fund will be structured as a master fund with a blocker feeder, the practitioner should not mix the tax issues, but should clearly segregate them into each separate PPM.
- In the tax risks section, describe tax risks; do not describe tax consequences that generally follow from the investment. For example, if the fund envisions that it will be treated as a partnership but there is a risk that it may be viewed as a PTP and thus treated as a corporation, then this is a tax risk and it should be disclosed in the tax risk section; on the other hand, if the fund anticipates investing in a CFC that will generate subpart F income, this does not present a tax risk and should find its place only in the tax disclosure section.
- In a feeder disclosure, make references to tax concepts from the master disclosure when those tax consequences may affect the bottom line of U.S. tax-exempt or foreign investors. Do not forget that usually the feeder investors will receive a copy of only the feeder PPM.

78. I.R.C. § 475(f)(1)(B).

- When you are writing or reviewing the tax section of the PPM, always ask yourself what tax discussion you would like to see if you are investing in the fund.
- Consult with foreign tax counsel regarding the foreign tax disclosures.
- At a minimum, cover the following topics.
  - *For a master or domestic feeder (i.e., for U.S. taxable investors):* The PPM should cover classification of the fund, the taxation of the fund, taxation of distributions and redemptions from the fund, limitation on losses and deductions, tax filings and transfer reporting requirements, state and local taxes, other taxes (including foreign taxes), and PFIC and CFC rules.
  - *For a feeder blocker (i.e., for U.S. tax-exempt and foreign investors):* In addition to the above discussion, the PPM should also discuss U.S. trade or business and ECI, the trading safe harbor exception, the portfolio interest exception, the capital gains rules for foreign persons, withholding and backup withholding, UBTI, Pension Protection Act and "excess business holdings" rules, EU Savings Directive rules if applicable, and I.R.C. § 892 if the feeder has sovereign fund investors.
- Always check the Security and Exchange Commission's EDGAR database for recent PPMs to see what recent issues other practitioners have added to their PPMs.

### *Tax Opinions*

Tax counsel will often be asked to furnish a tax opinion in relation to the formation of the fund and the PPM sent to investors. Usually the fund will ask counsel to issue an opinion regarding all or some of the following issues: (1) the fund is classified as a partnership and not as an association taxable as a corporation; (2) the fund will not be treated as a publicly traded partnership; (3) upon admission to the fund, an investor will be a member or partner of the fund; (4) each investor will be able to include in the tax basis of the investor's units the investor's share of bona fide fund nonrecourse liabilities; (5) the IRS will not significantly modify the allocations of taxable income and tax loss under the fund's operating agreement; and (6) the tax disclosure of the PPM is accurate.

Some of these opinions could be perceived by counsel as boilerplate and thus not given the necessary attention. For example, as to item (1) there are many exhibits on EDGAR basically reciting the same language or having the same format. Be aware that some of these opinions, despite their seemingly standard form, could be far more complicated than they seem at first blush. As to item (5), in the past counsel might have had an easy task opining on the issue just by looking at the operating agreement and analyzing whether the allocations of the agreement meet the substantial economic effect safe harbor under the section 704(b) regulations. More recently, however, this job has become increasingly difficult considering that many agreements do not liquidate in accordance with capital accounts, and thus by definition do not qualify for the safe harbor. Thus, counsel could be faced with the difficult task of opining whether the fund's allocations meet the economic effect equivalence test or the partner interest in the partnership test of the section 704(b)

regulations.[79] As a general matter, it is advisable to work with a partnership tax expert, instead of approaching the opinion as just another cookie-cutter form.

## The Fund as a Partnership

Most funds are set up as partnerships for U.S. tax purposes. Thus, a good command of partnership taxation is indispensible for the private equity tax attorney. Some of the partnership-specific tax issues that arise for funds and their investors are discussed in this section.

### *Code Section 721 and Contributions to Investment Partnerships*

Section 721 of the Internal Revenue Code provides that contributions of property to a partnership are generally not subject to tax. Most fund investors make cash contributions in exchange for their interest in the fund. Typically, such transactions do not create an issue to the investor or the fund. However, an investor that contributes securities to the fund instead of cash may have to recognize gain on the exchange if the investment partnership rules of section 721(b) apply. If immediately after the contribution, more than 80 percent of the fund's assets consist of marketable securities and the contribution results in the "diversification" of the investor's portfolio, the investor may have to recognize gain. Even if a single investor contributes securities and immediately after the contribution the securities have a value equal to only 10 percent of the value of the fund's assets, the investor still may be required to recognize gain. This is because cash is excluded in applying the 80 percent test and because the investor's portfolio will likely be found to have been diversified, as cash is a "nonidentical asset" for purposes of the diversification test.[80] This issue rarely comes up in pure PE funds. However, it may come up in quasi-PE-hedge funds, or simply the practitioner may be faced with an untypical transaction. Keep the issue in mind.

➤ **Useful Reading**

See ELLIOTT MANNING, PORTFOLIO 711-1ST: PARTNERSHIPS—FORMATION AND CONTRIBUTIONS OF PROPERTY OR SERVICES, at II.B (BNA Tax & Accounting Online), for a more detailed description of this issue.

## Special Methods for 704(c) and "Reverse" 704(c) Allocations

The section 704(b) and 704(c) regulations provide special rules for allocating tax items associated with contributed or revalued property.[81] If the drafters of the fund's operating agreement determine that the fund should comply with the section 704(b) regulations, they will eventually have to decide what method to choose for allocating the items associated with contributed or revalued property (e.g., investments that are booked up after they are

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79. The NYSBA has expressed concern and has sought guidance that target allocations (which are the prevalent norm of allocating profit and loss) could satisfy the safe harbor despite the fact that the entity does not liquidate in accordance with capital accounts. It is not clear as of now whether these concerns will be heeded by the IRS. "NYSBA Tax Section Submits Report on Partnership Target Allocations," 2010 TNT 185-18.

80. *See* Rev. Rul. 87-9, 1987-1 C.B. 133.

81. *See* Treas. Reg. § 1.704-3.

bought). While these allocations are generally required to be made on an asset-by-asset basis, "securities partnerships" may aggregate reverse 704(c) "gains" and "losses." While hedge funds are clearly able to aggregate in this manner, it is not clear whether private equity funds are permitted to use the aggregate method, unless it is reasonably certain that the fund will revalue its assets at least annually.[82] As a practical matter, section 704(c) is usually not a source of controversy at the fund level but it may lead to heated battles at the opco level. One reason is that the fund's assets are composed of nondepreciable/nonamortizable securities. The other reason is that private equity funds usually would not readily admit new partners postclosing and thus there would be no regular book-ups. On the other hand, at the opco level where there is depreciable property and often new partners come in, issues regarding the choice of 704(c) method arise when there is a ceiling rule problem[83] and there is some opportunity to accelerate or delay recognition of income and loss to a particular partner just by virtue of choosing one method over another method.

➤ **Useful Reading**

Tax Analysts, *NYSBA Report Addresses Aggregation Issues Facing Securities Partnerships*, 2010 TNT 189-25.

Stephen B. Land, *Revaluations Revisited: Partnership Allocations and the Demise of the Ceiling Rule*, 915 PLI/TAX 110-1 (2010).

Barksdale Hortenstine et al., *Section 704(C) and the Regulations Thereunder*, 654 PLI/Tax 239 (2005).

John G. Schmalz et al., *Section 704(C) and Related Issues*, 915 PLI/Tax 106-1 (2010).

82. Treas. Reg. § 1.704-3(e)(3)(iii)(B)(2)(ii). For most private equity funds such revaluation would generally not occur annually. Revaluations are permitted in the following four events: (1) contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner in exchange for partnership interest; (2) in connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership; (3) in connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services; and (4) under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5). The issue here is that for most private equity funds, contributions of money do not occur annually as clockwork. The other problem is that under (4), hedge funds fit comfortably but private equity funds do not. As a practical matter private equity investments are illiquid and not tradable on established securities market.

83. Practitioners refer to a "ceiling rule" when there are insufficient tax items associated with a particular 704(c) property to match the book items that are allocable to a noncontributing member or partner. For example, a portfolio company holds depreciable property X that was contributed to the company by its founder. At time of contribution the property had an FMV of $100 and tax basis of $10. Assume the property is depreciable at 10 percent of its value per year. Each year the property generates $10 of book depreciation and only $1 of tax depreciation. Assume the company has two owners, the contributing founder and the fund. The fund will have to be allocated $5 of book depreciation and $5 of tax depreciation each year. However, only $1 of tax depreciation is available for an allocation to the fund. There is a ceiling problem. The problem is usually solved by remedial allocations under Treas. Reg. § 1.704-3(d). Under this method the entity makes up allocations that remedy the problem. For the ceiling rule, see generally Treas. Reg. § 1.704-3(b)(1).

### *Validity of Stuffing Allocations*

This issue appears to be far more common to hedge funds, but it is not unusual that a private equity practitioner faces the stuffing allocation question from time to time. A lot of private equity funds have lock-in periods during which investors cannot take their money out and cannot redeem or transfer their interests. Ultimately these periods expire and investors sooner or later redeem their interest (or as often is the case, exit on the secondary market). Alternatively, while it is unusual, an investor may be forced out of the fund, for example, for violating the fund's agreement. When an investor is redeemed from the fund, the fund will distribute cash on hand or may have to liquidate an investment to fulfill the investor's request. As the case may be, there will likely be some gain in the year the investor is redeemed (assuming the fund is profitable, of course). The question is how to allocate this gain considering that some investors are being redeemed and others are not. The nonredeeming investors may object if gain is allocated to them but all the cash was distributed to the redeeming investor (as discussed above, this "phantom income" scenario is typical unless preventive mechanics are in place). Since the redeeming investor with a book capital account that differs from its tax basis in the fund is in large part indifferent as to whether it will have gain from the sale of the investment, or from the redemption itself, some funds use "stuffing" or "fill-up" allocations to allocate gain from the sale of the investment first to the redeeming investor, "filling up" its tax capital account until the tax-book difference has been eliminated. This approach of allocating income is favorable to the nonredeeming investor. The question is whether these allocations should be respected under the capital account maintenance regulations of section 704(b). This is a sufficiently technical and esoteric question to which there is no definitive answer. Suffice to say, there was an interesting discussion among practitioners on this topic, prompted by the stuffing allocation article cited below, that concluded that the use of the allocation is reasonable. The discussion can be found on *Tax Notes Today*.

➤ **Useful Reading**

Brian E. Ladin, James M. Lowy & William S. Woods II, *Hedge Fund Stuffing Allocations: A Path Through the Maze*, 2008 TNT 228-34.

Andrew W. Needham, *Writer Differs With Hedge Fund Stuffing Report Conclusion*, 2008 TNT 237-34.

### *Possible Tax Issues for Investors that Do Not Meet Capital Requirements or Meet Requirements Late*

As a fund may not have a set number of portfolio companies to invest in at the time of its inceptions, often the fund's agreement will provide for future mandatory contributions (also known as unfunded mandatory capital calls). If the fund finds a lucrative investment but it does not have sufficient liquid capital to purchase the investment, it calls on its partners to contribute the necessary capital. Often, some partners will contribute and some will not. To provide a deterrent for not meeting capital calls, funds' agreements may provide for dilution provisions such as "super credits." For example, the fund's agreement can provide

something along the following lines: If a partner fails to meet a mandatory capital call, and another partner pays for the defaulted capital call, the paying partner will receive a credit of 125 percent of the contribution it made to the partnership; the capital accounts of the partners will be adjusted accordingly.

Another alternative would be along the same lines, but instead of receiving an additional 25 percent capital account credit, the contributing partner would receive a share of the noncontributing partner's future profits in the fund. In either case, economically, the language is a type of penalty that is designed to deter the partners from not meeting the capital calls. In the former scenario the money comes from already booked capital, whereas in the latter scenario it comes from future profits. For tax purposes, the effect of the language often depends on how the language is drafted. The gist of the issue here is whether any changes in capital or profits due to the nonpayment of the call would lead to a capital shift, which generally is taxable currently to the partners receiving the shift. Again, the answer to this question will likely depend on how the language is drafted, and therefore, the lawyer should be particularly careful when dealing with this type of mandatory call default provisions. Capital call default provisions that penalize the nonpaying partner by shifting some of its already booked capital account clearly cause a capital shift problem. Depending on the particular language of the agreement, it is possible that this sort of income will fall between the cracks and not trigger any tax distributions. On the other hand, provisions that shift either unbooked appreciation or future profits are less prone to this issue. Preferably these issues should be addressed up-front when the agreement is drafted.

What happens if instead of entirely defaulting on its pro rata capital commitment call, the investor simply funds the money late? In those instances, the remaining investors fund the late investor's commitment and the late investor contributes capital sometime in the future. This capital is distributed to the other investors, plus some extra cash that comes out of the late investor's pocket and compensates the investors who fronted the money for the late investor. There are different possibilities regarding the federal income tax treatment of this arrangement—a guaranteed payment, a section 731 tax free distribution, a payment of interest, or a disguised sale of partnership interest.

Andrew Needham has a detailed discussion about this particular issue in Portfolio 735-2nd: Private Equity Funds, III.D "'Disguised Sales' to Late Investors." Mr. Needham is inclined to treat the arrangement as a disguised sale of partnership interest. That may very well be the case. To the author of this book, the arrangement resembles a loan. In fact, in his example, Mr. Needham calls the additional cash that goes to the other investors an "interest charge." Just as the above-discussed capital call default, the precise tax treatment may very well depend on the manner in which the fund agreement is drafted and the rights and obligations thereto. Some agreements may expressly provide that this arrangement is a loan from the contributing partner to the late partner and that the late partner is obligated to repay the contribution with interest. Others may not. What is the main tax difference? Well, if the arrangement is a sale, any gain/loss is treated as short or long term capital gain/loss. If it is interest, there is ordinary income with a corresponding deduction. In the author's view, there is room for structuring here and practitioners should carefully consider the operating agreement language.

➤ **Useful Reading**

Whitmire, Nelson, McKee, Kuller, Hallmark & Garcia: Structuring & Drafting Partnership Agreements: Including LLC Agreements (Thomson Reuters/WG&L, 3d ed. 2003 & Supp. Sept. 2010), 3.06[7] Dilution of Interest.

Manning, Portfolio 710-2nd: Partnerships—Conceptual Overview, III.B. (BNA Tax & Accounting Online).

## *Retroactive Allocations When Partners Admitted Late*

It is not uncommon for a private equity fund to admit new investors after the fund's initial subscription. This could happen for various reasons such as the need for fresh capital, increased popularity, and so on. To reflect this, funds would have some outside admission date during which the GP can schedule additional closings and admit new partners. When this happens, the managers of the fund may attempt to amend the fund's agreement and provide for retroactive allocations, such that income or expenses that were incurred prior to the new partners' admission to the fund are allocated to those partners.

In a typical retroactive allocation scenario, the fund will try to allocate a portion of a loss that was incurred earlier in the year to a newly admitted partner. Similar retroactive allocations may be attempted when existing partners contribute additional cash to the fund. Generally such retroactive allocations are prohibited by the varying interest rules of Internal Revenue Code section 706. That rule provides that if during any taxable year of the partnership there is a change in any partner's interest, each partner's distributive share for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations that takes into account the varying interests of the partners in the partnership during such taxable year.[84] Nevertheless, while the rule disallows retroactive allocations, it does not disallow special allocations achieving similar economic effect. Thus, it is possible to specially allocate a larger portion of postadmission losses to newly admitted partners as long as the allocations meet the substantiality and economic effect tests. In other words, the same tax and economic result could be achieved by special allocations without violating the rule. To caution the tax practitioner, any such allocations should be fully disclosed and coordinated with the remaining partners so to avoid any unpleasant surprises (the remaining partners will likely be displeased to find out that they will be forfeiting a portion of their losses or deductions to someone that comes late in the deal). As a side note, practitioners should distinguish the retroactive allocations discussed here from retroactive allocations between existing investors of the fund without additional contribution of capital. This type of retroactive allocation is generally permitted as long as it is performed within the fund's taxable year.[85]

➤ **Useful Reading**

Lipke v. Comm'r, 81 T.C. 689, 698 (1983).

84. I.R.C. § 706(d).
85. §§ 704(a), 761(c). *See also* Lipke v. Comm'r, 81 T.C. 689, 698 (1983).

ARTHUR B. WILLIS & PHILIP F. POSTLEWAITE, *Retroactive Allocations*, *in* PARTNERSHIP TAXATION ¶ 10.09[1] Thomson Reuters/WG&L, 1997-2010, with updates through February 2011).

WILLIAM MCKEE, WILLIAM NELSON & ROBERT WHITMIRE, *Splitting Allocations of Specific Items Among Partners*, *in* FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS ¶ 11.03[1] (Thomson Reuters/WG&L, 4th ed. 2007 & Supp. Oct. 2010).

Steven E. Klig & Eric B. Sloan, Portfolio 712-3rd: *Partnerships—Taxable Income; Allocation of Distributive Shares; Capital Accounts*, BNA 712 T.M., II.F.1 (BNA Tax & Accounting Online).

### *Tax Distributions*

Tax distributions were mentioned above in the context of "phantom income" (i.e., recognition of income without the receipt of cash). Typically funds will distribute profits when they sell a portfolio company. However, sometimes the fund will not have such a mandatory distribution provision, and the manager will have the right to accumulate profits for future reinvestment.[86] When drafting the fund's agreement it is advisable to address this issue since it can cause phantom income to the investor. If the fund decides to accumulate profits until each investor redeems its interest in the fund, the drafter should consider including a tax distribution provision in the agreement. Moreover, as an additional safety net, the provision could cover any income that is not associated with portfolio investments (e.g., interest on uninvested capital). Without such distribution language, investors will have phantom income and may have difficulties paying their tax bill associated with the investment in the fund. That's never a good thing if it comes as a surprise to the investor.

The language of the distribution should be given some careful thought. The drafter should decide whether to use an annual or cumulative tax distribution and whether to use prior losses offsets when computing the distribution. An annual tax distribution takes into account only the income from the particular taxable year, whereas the cumulative distribution combines the income allocable to the investor in all prior years and offsets it against the cumulative tax distributions paid to the investor. In either case, the drafter may choose to net previous losses against the income allocable to the investor. Among other things, the drafter should also decide when to make the distribution, whether to exclude income under section 704(c) and reverse 704(c), what state tax rates to take into account, how to define available cash for distribution purposes, whether to offset the tax distribution against ordinary distributions, and how to handle distributions to foreign investors who may not be subject to U.S. tax. The same considerations should be taken into account by the fund when it invests in a partnership portfolio company. There, the roles are different; the portfolio company will be the one making the tax distribution and the fund will be the recipient. The following example illustrates the kind of problems that may occur.

The fund invests in a partnership operating company. As often is the case, the fund has some priority interest in the portfolio company, for example a 10 percent cumulative priority to income allocation and the corresponding ordinary cash distributions over any other investor. The agreement provides that tax distributions will be made before ordinary

86. Such an arrangement is more typical for hedge funds, but every once in a while a PE fund or a hybrid fund will have such a provision, particularly in respect of operating income such as interest and dividends.

distributions, if any, and the tax distributions will be viewed as an advance against ordinary distributions. After the 10 percent priority return is paid, all distributions are made 50/50. Let's say the operating company has only two investors, the fund and A. The fund puts in $1,000 in the company and A contributes $500. Let's say the company loses $100 in year one and makes $200 in year two. So, overall, the fund views the investment picture as a profit of $100 and it assumes that it should be entitled to $35 of tax distribution (assume for simplicity that the distribution's effective tax rate is set at 35 percent). Moreover, the fund is under the impression that it is entitled to the remaining $65 since after all it has a priority of 10 percent (it should have earned $100 in year one and $100 of year two).

Let's say, however, that the operating company makes the tax distribution based on annual income computation instead of on a cumulative basis. For tax distribution purposes the fund earned $150 in the current year (10 percent preferred return on $1,000 + 50 percent of the remaining $100 of operating company profit) and A earned $50 (the remainder of the $200 operating company profit.) Thus, under the tax distribution provision the fund is entitled to $52.50 (35 percent of $150) and A is entitled to $17.50 (35 percent of $50). The problem, however, is that there is technically only $100 of actual profit and positive cash flow, which should have been payable and creditable to the fund's capital account. Under the tax distribution language, however, A dipped into the fund's cash by virtue of the tax distribution provision, while under the general allocation scheme and distribution waterfall A should not have been entitled to any allocation and cash. This potential problem is easily avoidable by providing for cumulative tax distribution with a loss offset, or mandatory ordinary distribution (i.e., when an investment is sold, all cash is distributed under the ordinary business deal waterfall). The key point is that the tax distribution language is not merely a convenience but can have an effect on the business deal, and thus, should be carefully scrutinized.

➤ **Useful Reading**

ANDREW W. NEEDHAM, PORTFOLIO 735-1ST: PRIVATE EQUITY FUNDS, at III.B.5 (BNA Tax & Accounting Online).

Terence F. Cuff, *Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements*, 879 PLI/Tax 801 6.c (2009).

ABA Model Real Estate LLC Agreement, 7.3. Tax Distributions (ABA 2008).

Paul H. Asofsky & Andrew W. Needham, *U.S. Private Equity Funds: Common Tax Issues for Investors and Other Participants*, 1.03[4]. 677 PLI/Tax 341 (2005).

## *Deductibility of Fund-Related Expenses*

The deductibility of fund-related expenses was partially covered in the GP/manager section of this chapter. As discussed there, the issue often comes up when the investors struggle to determine whether and how to deduct the 2 percent management fee expense paid to the fund's manager. The issue can be stated in much broader terms, however: whether and to what extent the separately stated expenses of the fund such as interest expense, management compensation expense, and other professional fees such as accounting and legal are deductible by the investors. While this question will often be within the purview of each

individual investor's accountant or tax lawyer, it is useful, at least for PPM disclosure purposes, to lay out certain fundamental issues such as limitation of deductibility of expenses to outside basis, at-risk limitations, 2 percent limitation, and investment interest expense limitations.[87] It is also helpful to make a determination whether the expenses generated at the fund level are section 162 or 212 expenses. This classification could mean the difference between an actual deduction and no deduction at all.[88] To prevent future headaches, it is useful to dispel the investor from day one of certain misconceptions regarding particular expenses before the confusion leads to litigation or animosity. For example, some investors may think that legal expenses associated with the acquisition of portfolio companies should be deductible. As explained in the "Expenses Related to the Deal" section in chapter 2 of this book, these expenses are generally capitalizable or added into basis and would not reduce investor's current income derived from the fund. Furthermore, some investors may think that the 20 percent carried interest paid to the manager is also deductible. That is certainly not the case. While the 20 percent could economically have the same effect as a deduction because it reduces the income inclusion to the investor, it is not deductible within the meaning of sections 162 or 212.

➤ **Useful Reading**

For a thoughtful discussion of the deductibility of fund-related managerial expenses, see Lee Sheppard, *What Can Hedge Fund Managers and Investors Deduct?*, 2008 TNT 136-3.

### *Investor Redemptions*

Redemptions are more prevalent in hedge funds. Private equity funds wind out in stages as investments are liquidated and ultimately culminate with the liquidation of the fund. When redemptions occur, surprisingly, they do not abound with tax issues. Some of the things the practitioner should be watchful for include the stuffing allocation issues (discussed above), the character of the gain (usually capital gain), any withholding if the fund holds U.S. real property interest (USRPI),[89] the ECI rules that may affect the tax outcome to foreign shareholders,[90] any foreign person disclosures issues. In rare circumstances when the fund has one large investor that is being redeemed, the practitioner should also consider the deemed termination rules of section 708 "Exiting the Fund" in this chapter for an additional discussion about tax issues that arise upon exit from the fund (see "exiting the fund").

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87. I.R.C. §§ 67(a), 465, 704(d).

88. Section 162 expenses are above-the-line deductions while the section 212 expenses go on Schedule A and are subject to the 2 percent floor and moreover are not deductible for alternative minimum tax purposes. One could envision an unfortunate investor who thinks that fund-related expenses will be fully deductible but who finds out when his K-1 comes in that the expenses have been classified as production-of-income expenses under section 212. The portion of the expenses that do not exceed the 2 percent AGI floor limitation is lost forever, and the investor may be unable to benefit from the deductions at all. *See generally* I.R.C. §§ 56(b)(1)(A)(i), 68.

89. I.R.C. § 1445.

90. I.R.C. § 1446.

## *Filing Form 1065 and Disclosing Information to the Government*

Often the fund will want to know if it is required to file Form 1065. The typical reasoning of the individual client is that the fund did not sell any investments and did not have any income, or simply that the fund was a foreign entity and therefore should not file. The practitioner should dispel the client of such misconceptions. The issue can be of particular importance to those foreign investors who shy away from unnecessarily disclosing information to the U.S. government. In this respect, the requirements for foreign funds are less stringent than those for domestic funds. Generally, the rules regarding filing partnership returns—Form 1065 and the Schedule K-1s—are set forth in section 6031 of the Internal Revenue Code and the regulations thereunder. Under those rules, domestic partnerships are required to file a tax return even if they had no taxable income during the year.[91] However, if the partnership had no income, deductions, or credits, no return is required.[92] Considering the fact that most funds have at a minimum some operating expenses, they will have to file unless they are dormant for some reason. The requirements for foreign funds are more lax. Generally no return is required unless the fund has ECI or U.S.-source income.[93]

Aside from the question whether the fund is required to file a tax return, a practitioner should keep an eye on the information required to be disclosed on the form. The IRS has expanded, and may in the future continue to expand the scope of that information. For example, for years 2008 and forward, the IRS made significant changes to Form 1065, including but not limited to up-the-chain reporting (i.e., the fund must report direct and indirect investors).[94] Disclosing the identity of the investors to the IRS may not be to the liking of many. Changing the form and related schedules appears to be a recent trend, and one that troubles many practitioners. In early 2010 the IRS announced that it will require entities with over $10 million of assets to disclose their uncertain tax positions.[95] This type of reporting could indirectly affect the fund's investors inasmuch as it would increase their audit and penalty exposure, assuming the uncertain position actually does not hold up in court.

➤ **Useful Reading**

I.R.C. § 6031.

Treas. Reg. § 1.6031(a)-1.

*Reporting Requirements*, *in* Willis & Postlewaite: Partnership Taxation ¶ 21.04[2] (Thomson Reuters/WG&L, 4th ed. 2007 & Supp. Oct. 2010).

91. Treas. Reg. § 1.6031(a)-1(a)(1).

92. Treas. Reg. § 1.6031(a)-1(a)(3)(i).

93. Treas. Reg. § 1.6031(a)-1(b)(1)(i).

94. *See* Form 1065, Schedule B (other information). For a discussion of the changes, see "Form 1065: Preparing for the New Year's Changes" J. Passthrough Entities (Mar.–Apr. 2009).

95. I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408 (February 16, 2010). This announcement was followed by another that finalized the so-called Schedule UTP. *See* I.R.S. Announcement 2010-75. The new schedule introduced some significant changes from the initial draft, such as a phase-in implementation requiring corporations with total assets of $100 million or more to file Schedule UTP for the 2010 tax year with this amount gradually going down to $50 million in tax year 2012 and $10 million in tax year 2014.

Alan S. Lederman & Bobbe Hirsh, *Reporting Obligations for Foreign Partnerships*, 924 PLI/Tax 298-1 (2010).

Sarah Staudenraus & George Spaeth, *Form 1065: Preparing for the New Year's Changes*, J. Passthrough Entities, Mar.–Apr. 2009.

## *VCOC*

To avoid potential issues and limitations under the Employee Retirement Income Security Act of 1974 (ERISA), the fund will usually desire to qualify as a venture capital operating company (VCOC). The reason is that many private equity firms accept capital from U.S. pension and retirement plans. In those instances, the fund manager may be exposed to becoming a fiduciary within the meaning of ERISA, which would expose it to higher standards of care and loyalty and subject the fund to the "prohibited transaction" rules under ERISA. Generally, this translates into a higher liability exposure in tort and more restrictions on what the fund may or may not do. For example, the "carried interest" may violate ERISA anti-self-dealing rules.

The fund can either limit the amount of capital it accepts from U.S. pension and retirement plans or qualify as a VCOC to avoid these issues. Department of Labor Regulations section 2510.3-101 states that a fund will qualify as a VCOC if (1) at least 50 percent of its assets (other than short-term assets) valued at cost are invested in "operating companies" to which the fund has "management rights" and (2) in the ordinary course of its business, the fund actually exercises such management rights. An "operating company" is an entity that is *primarily* engaged, directly or through a *majority*-owned subsidiary, in the production or sale of a product or service (other than the investment of capital) and "management rights" of the kind described in paragraph (d)(3)(ii) of the Department of Labor Regulation (i.e., contractual rights directly between the investor and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company). In other words, active management of the portfolio companies that are "operating companies" could qualify the fund as a VCOC. Unfortunately, however, qualifying as a VCOC does not go hand in hand with avoiding ECI and U.S. trade or business. These two tax concepts often hinge on the fund being a passive investor in the operating company. Often, to prevent any tax issues that may arise from this conflict, practitioners will draft VCOC provisions (sometimes along with an ECI covenant) that would provide something along the lines of "the fund intends to qualify as a VCOC and in so qualifying the fund will enter into certain managerial rights but only to the extent that they will not cause the fund to be treated as engaged in the conduct of a U.S. trade or business." This is an example of an attempt to reach a middle ground. While the utility of such language is somewhat dubious since hardly anyone can pinpoint exactly when and how such U.S. trade or business will arise, arguably the fund is better off with the language than without it.

➤ **Useful Reading**

29 C.F.R. § 2510.3-101 (51 FR 41280, Nov. 13, 1986, as amended at 51 FR 47226, Dec. 31, 1986).

Robert A. Rizzi, *Investments by Tax-Exempt Organizations in Pass-Through Entities*, 882 PLI/Tax 891 (2009).

### *Does a Conversion of the Fund Trigger the Two-Year Rule for Profits Interest in Revenue Procedure 93-27?*

While it is unusual, sometimes a fund that was organized as a partnership would convert to a corporation. For example, a fund may anticipate unfavorable legislation that could affect the taxation of carried interest and it may also believe that the issue could be avoided if the fund was organized as a foreign QEF instead. Another example is involuntary conversion by an adverse change in law. For example, a publicly traded fund that currently meets the 90/10 exception falls prey to legislation that eliminates the exception for investment services partnerships. If the conversion happens soon after the formation of the fund, the manager/GP who usually receives a profits interest may be concerned whether the conversion violates the two-year rule in Rev. Proc. 93-27 (this procedure generally provides that the issuance of profits interest for services is not taxable). The two-year rule basically states that Rev. Proc. 93-27 does not apply to partners who receive profits interest but dispose of the interest within two years of the time of receipt. The implication of this rule is that if the interest is disposed within that time, its original issuance would be treated as if the revenue procedure did not apply. This in turn means that the liquidation valuation approach may not apply and the receipt of the interest could be taxable to the manager. While the author is not aware of any law directly on point addressing whether a conversion triggers the rule, practitioners' consensus appears to be that the rule is not triggered. However, practitioners should be extra cautious if the conversion was planned at the time of issuance of the interest or if the fund is converted into a publicly traded corporation.

➤ **Useful Reading**

Jeff Rosenberg, Compensating Employees: Partnerships, Corporations, and Going Public, 528 PLI/TAX 69 (2002).

Deanna Walton et al., Rev. Proc. 2001-43 and Profits Interest: Try, Try Again, 3(6) BUS. ENTITIES 4, 2001 WL 1650939.

## The Fund as a Corporation

While it is not a common occurrence, sometimes a fund will be structured, or treated by operation of law, as a corporation. A separate set of issues arise in that context. A discussion of some of these issues follows.

### *Code Section 351 and Transfers to Investment Company Under 351(e)(1)*

While the most common contribution to a fund is in cash, sometimes an investor may contribute some form of marketable property. If that is the case, the practitioner should make sure that the fund does not fall within the investment company rules of section 351(e)(1). Those rules provide that the nonrecognition provision of section 351 does not apply to transfers of property to an investment company. While the term "investment company" is not defined in the statute, Treas. Reg. § 1.351-1(c)(1) provides that a transfer will be treated as one to an investment company if (1) it results, directly or indirectly, in diversification

of the transferors' interests, and (2) the transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts. While this issue is relatively uncommon, it could present a trap for the unwary, and if the fund anticipates that it will fall within the category of "investment company" as defined above, it should disclose the section 351 issue in its PPM. This issue is the corporate equivalent to the investment partnership issue discussed in " Code Section 721 and Contributions to Investment Partnerships" above.

➤ **Useful Reading**

HOWARD J. ROTHMAN ET AL., *Transfers to Investment Companies—§ 351(e), in* PORTFOLIO 759-2ND: TRANSFERS TO CONTROLLED CORPORATIONS: RELATED PROBLEMS, at V (BNA Tax & Accounting Online).

Gary B. Wilcox & Byron L. Shoji, *Investment Company Limitations for Corporations and Partnerships*, 887 PLI/TAX 547 (2009).

Monte A. Jackel & James B. Sowell, *Transfers to Investment Companies: Complexity in a Conundrum*, PLI/TAX, 887 PLI/TAX 643 (2009).

Barnet Phillips IV, *Exchange Funds: What Is Diversification?*, 887 PLI/TAX 609 (2009).

## *CFC and PFIC*

If a foreign fund is formed in a foreign jurisdiction and is treated as a corporation for U.S. tax purposes, its U.S. investors could be affected adversely by two antideferral regimes, the CFC and PFIC regimes.[96] These issues were briefly mentioned in the "Corporation Versus Pass-Through Entity" section above. The following discussion encompasses some specific issues that arise from the application of these regimes. As the name suggests, both regimes prevent the deferral of income. That is not necessarily the disadvantage, however, that ails U.S. investors. The CFC regime, for example, is generally disadvantageous to U.S. investors because it passes only the income but not the losses of the fund.[97] Also, any income that passes to the U.S. investor in the form of subpart F income under section 951 is generally subject to 35 percent tax.[98] In addition, the sale or redemption of the fund shares will be subject to section 1248 ordinary income treatment up to the extent of earnings and profit (E&P) instead of capital gains treatment.[99] Similar rules apply if the fund is a PFIC. Namely, only income passes through and there is a potential ordinary income exposure at the time of redemption of the shares unless the investor makes a QEF election.[100] The fol-

96. I.R.C. §§ 951–965, 1291–1298.

97. I.R.C. § 951(a)(1)(A).

98. No qualified dividend treatment is available for subpart F inclusions. *See* I.R.S. Notice 2004-70, 2004-2 C.B. 724. On the other hand, however, if the fund is formed in a qualified foreign jurisdiction, distributions of amounts not previously taxed could qualify as a qualified dividend (scheduled to sunset in 2012). *See id.*

99. Those inclusions also could fall within the category of qualifying dividends. *See id.*

100. *See generally* I.R.C.§§ 1291, 1293.

lowing is an outline of some peculiar PFIC and CFC issues that could befall the fund and its investors.[101]

### Determine Whether You Have a CFC

While to a tax-exempt investor the status of the fund as a PFIC or a CFC may be of little relevance (unless the fund generates some insurance income or the investment is debt financed so that the UBTI rules are implicated),[102] to taxable U.S. investors that status would very much be material. Thus, it becomes important whether tax-exempt investors are counted as U.S. shareholders for purposes of the 50 percent ownership CFC test. (A foreign corporation is a CFC if more than 50 percent of its stock is owned by 10 percent U.S. shareholders.[103]) If they are, the chances of the fund being a CFC increase and if they are not, they decrease.[104] The author is not aware of any rule that states that they are not counted in. The rules define a U.S. shareholder as a U.S. person (as defined in section 957(c)). That section cross-references section 7701(a)(30), which in turn covers a great breadth of persons including residents, domestic partnerships, and corporations. Since most tax-exempts are formed under some state's nonprofit corporation laws, they fall within the category of a corporation and thus of a U.S. shareholder. Thus, making the assumption that a U.S. tax-exempt investor should not count in the CFC calculus because it is generally not subject to tax is a misconception that could lead to trouble.

### Determine Whether to File a QEF Election or a Protective Statement

If the fund is set up as a foreign corporation, it is expected that its U.S. investors will file QEF elections (unless the fund is a CFC, in which instance the QEF election will likely be irrelevant because the CFC rules trump the PFIC rules).[105] QEF elections are made pursuant to I.R.C. § 1295(b) and the regulations thereunder. If the investor makes a QEF election, it must report its pro rata share of the fund's earnings and gains each year as required under I.R.C. § 1293. The investor may be able to defer any tax associated with the QEF income if it makes an election under I.R.C. § 1294. Whether this latter election makes sense may depend on whether the QEF can earn a greater return on the funds compared to the interest that accrues on the tax liability associated with the election (if the investor

101. Some additional CFC and PFIC issues are discussed in "To Check or Not to Check; Effect on FTC and Others" in Chapter 4, *infra*.

102. Section 511(a) subjects tax-exempt investors to tax on unrelated business taxable income (UBTI) as determined under section 512. Dividends are excluded from the definition of UBTI. *See* I.R.C. § 512(b)(1). It is the intent of Congress, and the Service appears to concede, that subpart F income should be treated as a dividend for purposes of UBTI. *See* I.R.S. Priv. Ltr. Rul. 2003-15-032, 2003 WL 1861927 (2003). Thus, unless the subpart F income is associated with certain debt-financed property under section 512(b)(4) or insurance income under section 512(b)(17), it should not be UBTI.

103. I.R.C. § 957(a). A U.S. shareholder is a U.S. person who owns, or is considered as owning by attribution, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. I.R.C. § 951(b).

104. Note that this issue generally matters if the fund is a foreign entity treated as a corporation for U.S. purposes. Then for CFC purposes, one will look through the ownership of the fund to its individual U.S. investors.

105. *See* I.R.C. § 1297(d).

makes the payment deferral election under 1294, it must pay the rate of interest imposed on underpayments under I.R.C. § 6601).[106] The obvious advantage of combining a QEF election and a payment deferral election is that the investor preserves capital gain treatment without incurring current tax cost associated with the QEF's income.

Sometimes, however, the investor may not do any of the above. Instead, the investor may opt for filing a protective statement.[107] The protective statement, filed under Treas. Reg. § 1.1295-3, allows the investor to make a retroactive QEF election. While this option appears advantageous, in that the investor does not have to file a form that in essence admits that it has invested in a PFIC and forces it to comply with the QEF filing obligations, the requirements for filing the statement are rather onerous. More importantly, however, an investor filing such a protective statement should know that by filing the protective statement it extends the statute of limitations for all years for which the protective statement is open.[108] In other words, the investor may be extending an otherwise three-year statute of limitations into five, ten, or more years. This significantly reduces the utility of the retroactive election to investors in PFIC funds.

### PFIC Reorganization Issues

As mentioned above, funds sometimes reorganize, migrate, dually register, and so on. In addition to the typical foreign-to-foreign and foreign-to-domestic issues that can arise in reorganizing foreign companies, PFIC funds offer some peculiar issues that the practitioner must heed. Various types of transactions could raise very interesting PFIC reorganization issues. Imagine the following circumstances. An investor in a PFIC fund contributes its interest to another foreign entity. What results? A PFIC fund owns an interest in another PFIC, or a company that owns a PFIC and disposes or distributes that interest. What results? Lastly, an investor has invested in a PFIC indirectly through a foreign corporation that is not a PFIC and now sells or merges that interest. What results? The potential exposure in these circumstances is that if the investor has not made a proper QEF election, the transfer can trigger ordinary income recognition and interest charges, or can otherwise not qualify for nonrecognition under the general reorganization rules. The problem arises under the so-called "nonrecognition override rule" of Prop. Treas. Reg. § 1.1291-6.

➤ **Useful Reading**

An excellent discussion regarding these PFIC issues can be found in KEVIN DOLAN, U.S. TAXATION OF INTERNATIONAL MERGERS, ACQUISITIONS AND JOINT VENTURES, chs. 9.06, 16.07 (Thomson Reuters/WG&L, 1995—2010 & Supp. Nov. 2010).

### Carry-Like Compensation in a Corporate Fund

Funds treated as corporations for U.S. income tax purposes suffer from one significant disadvantage: they cannot issue carry/profits interest to the manager. Therefore, managers

106. *See* I.R.C. § 1294(g).

107. The different PFIC election and filing options are discussed in more detail below in "Fund Is Unpedigreed QEF: Now What?" *infra*.

108. Treas. Reg. § 1.1295-3(c)(1)(ii).

are usually constrained by solutions that can somewhat mirror the economics and tax results of a carry. If the fund is a new entity, for example a newly set-up PFIC for which the manager makes a QEF election, similar result may be achieved by issuing fixed differential stock to the manager. If one successfully takes the position that the stock should be valued based on the liquidation approach, a proposition not free from doubt, one could reason that the stock has a very low dollar value. The fixed differential stock would generally provide that the manager can participate only above the capital contributed by other investors to the fund. The manager gets a 20 percent fixed differential stock that entitles him or her to 20 percent of any increase over the capital contributed to the company by other investors. For example, all investors contribute $1,000. The manager's stock will have a right to a liquidating distribution of (FMV – $1,000) × 20 percent. Thus, at the time of issuance of the interest, the manager will be entitled to $0 on a hypothetical liquidating distribution.

Assume, however, that a manager wants to rearrange an existing service contract compensation arrangement into a stock compensation arrangement in a PFIC fund. Even assuming the above solution works, a proposition that has not been tested by the IRS, the manager is not going to be able to achieve the same economics and tax consequences as in a partnership carry. The reason is that as long as any gain has been accumulated in the fund but it has not been realized prior to rearranging the capital structure, that "built-in" gain should be reflected in the stock's FMV and trigger tax at the time of restructuring the manager's interest.[109] If the manager's stock is valued based on the liquidation approach, the FMV of the stock received by the manager will depend on the built-in gain and in all likelihood would be large, assuming the fund has been profitable. The gist of this fact is that absent some additional planning, a manager cannot bail out its share in the unrealized appreciation in the fund without incurring current tax cost.

➤ **Useful Reading**

Robert P. Rothman, *Translating Corporate Concepts into the Language of LLCs*, 61 TAX LAW. 161 (2007).

BARNET PHILLIPS IV & ROBERT P. ROTHMAN, STRUCTURING CORPORATE ACQUISITIONS—TAX ASPECTS, 884 PLI/Tax 7 (2009).

Lee Sheppard, *Hedge Fund Managers' Year-End Tax Planning*, 2010 TNT 94-2.

## Tracking Stock in a PFIC

In a corporate fund, investors and the manager may sometimes receive tracking stock (i.e., the stock participates in certain investments but it does not in others, or the stock simply has different series that are tied to an underlying portfolio company). When that happens, the taxpayer will want to know whether it can make a QEF election for the tracking stock it received from the fund. The author is not aware of any rule that prohibits such an election.

109. Section 83 of the Internal Revenue Code generally requires the inclusion of FMV over purchase consideration of stock received in exchange for past or future services. The gain may be deferred by imposing a forfeiture restriction or purchasing the stock for FMV with a recourse note payable from future distributions to the manager.

Shareholders of a PFIC can make a QEF election for any stock (even fast-pay stock, which is generally viewed as abusive). Regulations expressly state, for example, that in addition to common stockholders, preferred stockholders can also make QEF elections.[110] Furthermore, the definition of a shareholder and stock for purposes of the QEF rules appear to be broad enough to include tracking stock.[111]

Nevertheless, the Internal Revenue Code grants Treasury authority to promulgate antiabuse regulations under two subsections of the Code. If exercised, this authority could affect the eligibility of tracking stock for QEF election purposes. This authority arises under sections 1298(b)(4) and 1298(f). Neither of these two sections, however, deals expressly with tracking stock, although the 1298(b)(4) may encompass tracking stock. These rules, again, are antiabuse rules. The section 1298(b)(4) rule in essence (if regulations are ever promulgated under this rule) will prevent taxpayers from avoiding the PFIC rules by interposing a non-PFIC entity between the PFIC and the U.S. shareholders and issuing a special class of stock. Even if regulations were issued, these rules should not prevent making QEF election for tracking stock as long as the election is not used to avoid the PFIC rules. Lastly, there is nothing in Form 8621 (the QEF election form) that asks whether the stock is tracking stock, preferred, or anything of the sort. The instructions to the form even suggest that the election could be made for different classes of shares.[112] There is very little in terms of secondary or primary authority dealing with this question. In passing, Lee Sheppard has a brief discussion of the issue in *Hedge Fund Managers' Year-End Tax Planning*.

**Pledge of PFIC Stock**

Working with PFIC funds presents an array of very specific issues that do not come up that often in practice but that could present problems. The practitioner is advised to be particularly cautious when dealing with such funds and their investors. Assuming it is permitted under the fund's agreement (for most it is not, absent approval by the GP), every once in a while an investor in a PFIC fund may want to pledge the stock for whatever reason. The issue is that such pledge will likely be viewed as a disposition of the fund's stock. Section 1298(b)(6) provides that except as provided in regulations, if a taxpayer uses any stock in a passive foreign investment company as security for a loan, the taxpayer shall be treated as having disposed of such stock. One of the key questions here is whether this rule applies to QEFs. After all, it is expected that most investors and managers of a PFIC fund will make the QEF election. While the statute is not patently clear on this issue, proposed regulations clarify that the rule applies to section 1291 funds only.[113]

110. 61 Fed. Reg. 67,752—67,760 (1996).

111. The term "stock" includes any equity interest in a corporation (Treas. Reg. § 1.1295-1(j) cross-referencing Treas. Reg. § 1.1291-9(j)(3) and Regulation Project INTL-656-87).

112. The instructions provide that the shareholder must attach information on "the number of shares in each class of stock owned."

113. Prop. Treas. Reg. § 1.1291-3(d). A section 1291 fund is an unpedigreed QEF or a nonqualified fund. A nonqualified fund is a fund with respect to a shareholder if the shareholder has not elected under section 1295 to treat the PFIC as a QEF. Thus, pedigreed QEF funds should not fall within the purview of the pledge rule.

➤ **Useful Reading**

For a good discussion about whether the pledge can cause taxable income to the investor, see KUNTZ & PERONI, *Passive Foreign Investment Companies*, *in* U.S. INTERNATIONAL TAXATION ¶ B2.08 (Thomson Reuters/WG&L, 2005, with updates through November 2010).

## CFC Trumps PFIC

Another issue that sometimes comes up in the PFIC fund context is whether the CFC rules or the PFIC rules apply when an entity meets both tests. The outcome of this question can have significant consequences to U.S. taxable investors and the fund's U.S. manager. The reason is that often the sale or redemption of a CFC fund would trigger section 1248, which would mean that the investor will have a deemed dividend up to the amount of E&P, generally an unfavorable result to U.S. individual investors who cannot benefit from deemed foreign tax credits[114] and particularly if the dividend is not a qualifying dividend. On the other hand, the redemption of a PFIC fund with a QEF election will generally be treated as the sale or exchange of a capital asset.[115] Fortunately, the answer to this issue is relatively straightforward. As mentioned above, section 1297(d) provides that with respect to a shareholder a corporation shall not be treated as a PFIC during the qualified portion of such shareholder's holding period for stock in such corporation. In pertinent part, the term "qualified portion" means the portion of the shareholder's holding period during which the shareholder is a U.S. shareholder (as defined in section 951(b)) of the corporation and the corporation is a CFC. In other words, the CFC rules trump the PFIC rules. However, as the language of the statute suggests, a CFC can still be a PFIC for U.S. persons holding less than 10 percent interest. Thus, for such investors, the PFIC rules will apply instead of the CFC rules. The answer to this issue might be relatively straightforward, but its outcome could be nonetheless very disadvantageous to U.S. investors. A foreign corporate fund should very closely monitor its capitalization table for CFC issues.

## In-Kind Distribution from a QEF

As mentioned, in the few instances a foreign private equity fund is treated as a corporation for U.S. purposes, its shareholders will usually make a QEF election. The tax treatment of cash distributions from the QEF is relatively straightforward. Thus, in most instances investors should expect some certainty because the usual unwinding of the fund is through selling the portfolio company and distributing the cash. However, sometimes, for various reasons, instead of making a cash distribution, the fund may have to distribute the shares of the portfolio company to the investors. This usually happens when the portfolio company has gone through the initial public offering (IPO) stage and the securities are marketable. In those instances the tax advisor needs to reflect on the application of the QEF rules to such an in-kind distribution. The PFIC rules do not address in-kind distributions expressly. Thus, the key question here is whether the general in-kind subchapter C rules apply to

114. *See* I.R.C. § 902(a).

115. Note, however, that dispositions of unpedigreed QEF would be subject to the excess distribution rules of section 1291. In other words, only pedigreed QEFs could fully benefit of sale or exchange treatment. See generally the 1992 PFIC proposed regulations (IL-656-87 (Apr. 1, 1992)).

the transfers. If those rules apply, section 311(b) should cause a deemed sale at the fund level,[116] and then that gain should be taxable to the investor as capital gain (assuming the property is a capital asset) under the QEF rules.[117] Then, the distribution to the investor should be from previously taxed earnings inasmuch as that distribution is attributable to the investor's share of the section 311(b) gain. Therefore, the distribution should not be taxed under the rules of section 1293(c). Why is this important? It is important because if the subchapter C rules did not operate as described above, the in-kind distribution would create tax treatment inconsistent with the general spirit of the QEF rules. If there was no deemed sale of the distributed in-kind asset, then if the fund has accumulated *previously untaxed* E&P, the distribution would be taxable to the investor as a dividend under the general rules of section 301.[118] Alternatively, if the fund has previously taxed E&P but that E&P was taxed to investors other than the distributee investor, the investor will have to show to the satisfaction of the Commissioner that the distribution is coming up from such previously taxed E&P, which may not be as easy as it sounds.[119]

Both of these awkward complications will be avoided if the principles of subchapter C apply, as expected. Luckily for practitioners, there is authority that supports the position that the deemed sale rules of section 311(b) should apply to QEF in-kind distributions. First, IRS Private Letter Ruling 91-37-047 expressly applies the 311(b) rules to a QEF. The ruling was issued by Chief Counsel (Corporate) and not Chief Counsel (International), which should somewhat decrease its probative value, but still, it is a ruling that is directly on point. Second, and more importantly, the QEF statute itself suggests that section 311(b) applies. Section 1293(e)(3) generally provides that for purposes of computing the E&P of the QEF, the subchapter C E&P rules apply (i.e., section 312). Moreover, section 1293 expressly excludes certain subsections of section 312 *but they do not exclude section 312(b)*, which provides that E&P is increased for distributions of appreciated property. These statutory references make it relatively clear that the E&P of the QEF should be increased by the gain on the in-kind distribution of appreciated property, which in turn makes it clear that the section 1293 rules contemplate that the deemed sale rules of 311(b) apply to QEF in-kind distributions. This increase should flow to the investor under the pro rata share E&P rules of section 1293(a) and the following distribution should be tax free under the rules of section 1293(c).

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116. Section 311(b) provides that if a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation), then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

117. Section 1293(a) requires that every U.S. shareholder of a QEF include in gross income as long-term capital gain such shareholder's pro rata share of the net capital gain of the fund.

118. Remember, the tax-free distribution rules of 1293(c) operate only up to the amount of previously taxed E&P.

119. Remember that before it can take advantage of the tax-free distribution rule of 1293(c), the investor must show to the satisfaction of the Commissioner that the distribution is coming from earnings that were taxed to *any* U.S. shareholder (while the investor could easily show that particular income was taxed to it, by pointing to its tax return, showing that E&P was taxed to someone else is not as easy).

### Information Statements

PFIC Information Statements could be another source of issues for the corporate fund and its investors. According to Treas. Regs. §§ 1.1295-1(f)(1)(iii) and (f)(2), in order to make a QEF election, a U.S. shareholder must obtain a PFIC Information Statement from the fund and reflect the information on Form 8621. Generally this statement must contain either specific information regarding the investor's share of the PFIC's income or sufficient information so that the investor can compute its share.[120] While many times the fund will provide the statement (particularly if faced with a large investor with a lot of bargaining power), sometimes, for various reasons, the fund will not want to do so. For example, it could be particularly burdensome for a foreign fund to compute E&P for U.S. purposes. It is advisable that the investor, if it has the bargaining power, obtain a consent that the fund will provide the statement before the investor invests in the fund. If the investor cannot obtain consent from the fund, it may be at a disadvantage since the onerous section 1291 excess distribution rules would apply, which in turn could be a deal breaker for this particular investor. The NYSBA has observed this particular issue and in 2010 requested that rules be promulgated that would allow investors in PFICs to make QEF elections by relying simply on financial statements provided by the foreign fund.[121] Practitioners are eagerly awaiting the IRS's reaction to the proposal.

### Tiered PFICs

Tiered PFICs can bring tears to counsel's eyes. Guidance is not too abundant, and it appears that the issues are not priority for the IRS. The usual setup in which counsel will face tiered PFICs in the private equity context is when a foreign fund invests in a minority interest of foreign portfolio companies through a subsidiary special purpose holding company (holdco for short). For example, a Cayman fund invests in Latin America and Asia and sets up two separate holdcos to hold the investments in each continent. When the special purpose holdcos begin to sell the investments, reporting and other issues can arise. Assuming the U.S. investor has made a QEF election for the fund PFIC and the lower-tier holdco PFIC,[122] the first question is whether the gain generated at the holdco lower tier flows up to the U.S. investor and whether its character is preserved. The second question is regarding

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120. The problem here is that for all practical purposes the investor can make a QEF election only if it receives a statement that provides it with one of the following: (1) the shareholder's pro rata shares of the ordinary earnings and net capital gain, (2) sufficient information to enable the shareholder to calculate its pro rata shares of the PFIC's ordinary earnings and net capital gain, for that taxable year; or (3) a statement that the PFIC has permitted the shareholder to examine the books of account, records, and other documents of the foreign corporation for the shareholder to calculate the amounts of the PFIC's ordinary earnings and the net capital gain according to federal income tax accounting principles and to calculate the shareholder's pro rata shares of the PFIC's ordinary earnings and net capital gain. *See* Treas. Reg. § 1.1295-1(g)(1)(ii).

121. "NYSBA Tax Section Comments on Passive Foreign Investment Company Rules," 2010 TNT 46-18.

122. Unfortunately, the rules are such that an election for an upper-tier PFIC does not apply to lower-tier PFICs. *See* Treas. Reg. § 1.1295-1(d)(3). This could present a trap for the unwary with relatively unpleasant tax consequences.

how to report all of this activity on the PFIC annual information statement. Unfortunately, there is no crystal-clear answer to these issues.

As to the first question, reason and logic dictates that the gain/loss and its character as capital gain or ordinary income should be computed at the lower-tier PFIC. Then, when the cash is distributed up the chain it should not be treated as a dividend because it comes up from previously taxed earnings. Once the U.S. investor has made a QEF election for the fund PFIC and the lower-tier holdco PFIC, the investor will have an interest in two sets of QEFs: (1) a direct interest in the fund as an upper-tier QEF and (2) an indirect interest in the lower-tier PFICs as QEFs.[123] Then the legal mechanics are as follows. When a lower-tier PFIC sells shares or receives dividends, then that income must be reported by each shareholder of the upper-tier PFIC who has made a QEF election for the lower-tier PFIC. Thus, the capital gain and ordinary income of the lower-tier PFIC should be included by the U.S. shareholder in income as long as the shareholder makes QEF elections for the lower-tier PFIC.[124]

The reason is the following. When the U.S. shareholder makes the election in respect of this lower-tier PFIC, then the QEF rules of section 1293 apply directly in respect of that entity. Thus, the U.S. shareholder must include its share of the capital gain and ordinary E&P of the lower-tier entity. Then, that income becomes previously taxed income and increases the shareholder's basis in both the upper-tier fund PFIC shares and the lower-tier PFIC shares held by the fund.[125] When the money comes up the chain from the lower-tier PFIC to the PFIC fund, the distribution is not income to the U.S. shareholder (i.e., is not a dividend) because that income was already taxed. This result seems sensible to the author as any other result would contravene the PFIC rules, which expressly provide that double taxation should be prevented.[126] One of the few rulings that address the tax consequences of tiered PFIC structures is Private Letter Ruling 2008-38-003. In that ruling, the Service enunciated some of the above principles and also ruled that the character of income for E&P purposes is preserved from a lower-tier QEF to an upper-tier QEF. In addition, the Service pointed out that a shareholder of an upper-tier QEF (such as the PFIC fund in the example) does not include in income any distributions of previously taxed earnings of a lower-tier QEF.

The other very pragmatic issue for the fund and its lawyers and accountants is that they need to know how to report all of this for PFIC annual information statement purposes. To continue the above example, logic and reason would dictate that statements must be prepared for the lower-tier PFIC and the upper-tier fund. The lower-tier statements may, or may not, compute the fund shareholder's pro rata share of the lower-tier PFIC's earnings, which in turn creates complications. The rules regarding the statements that must be sent to QEF shareholders are set forth in Treas. Reg. § 1.1295-1(g). More specifically, Treas.

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123. Section 1298(a) generally provides for attribution of PFIC ownership.

124. If the U.S. shareholder does not make an election, things get more complicated and adverse tax consequences may ensue.

125. Notably, this latter proposition is not entirely free from doubt, at least under the Regulations, and the NYSBA recently had a comment to the IRS that the government needs to clarify that this is the correct result, which makes sense, at least to the author. *See* "NYSBA Tax Section Comments on Passive Foreign Investment Company Rules," 2010 TNT 46-18 (Mar. 8, 2010).

126. *See* I.R.C. § 1293(g)(2).

Reg. § 1.1295-1(g)(4) contains the rule that usually applies to tiered PFICs. This regulation expressly permits the issuance of combined statements of the lower and upper PFIC. Combined statements are statements sent out by upper-tier PFICs that include the PFIC information not only about the upper-tier PFIC but also the information received from any lower-tier PFICs. The statement could be either a combined annual information statement or a combined annual intermediary statement as those terms are used in the regulations. In either case there is no special format for the statement as long as the required information and representations are separately stated and identified for each separate corporation. The upper-tier PFIC fund may be able to send an intermediary statement only if the lower-tier PFIC statements report each fund shareholder's pro rata share of the ordinary earnings and net capital gain of the lower-tier PFIC.[127] Intermediary statements are useful because the upper-tier fund can simply attach the lower-tier statement to its own statement.

As mentioned above, there is no abundantly clear guidance regarding tiered PFICs. As to reporting, a relationship with a knowledgeable accountant that does PFIC statements for tiered-PFICs is indispensible. Where guidance is lacking, market procedures set by leading practitioners offer a good guidepost.

### Options in PFICs

An option in a PFIC could present a significant trap for the unwary investor. The issue could arise at the fund level (if the fund is a PFIC) or at the opco level (if the opco is a PFIC). The problem arises from section 1298(a)(4), which provides that if any person has an option to acquire stock, such stock shall be considered as owned by such person. This could have adverse consequences in that the sale of the option could be viewed as the sale of PFIC stock or that stock acquired under the option may be viewed as stock in an unpedigreed QEF. In addition, proposed regulations suggest that convertible debt could be treated as an option as well.[128] One could envision scenarios where both the fund and its investors are surprised by this fact. For example, a U.S. investor owns interest in a flow-through Cayman fund. The fund acquires an option or convertible debt in a foreign company that holds real estate, obtains permits, and then resells the real estate to developers. Assuming the foreign company is a PFIC, the U.S. investor may be in a predicament. The investor would not have an idea that it has to make a QEF election and require PFIC information statements from the fund or the company, because it is of the view that it does not own an interest in a PFIC (i.e., it indirectly owns an interest in an option). Similar issues could arise if the fund is a PFIC and the investor has an option to purchase shares in the fund. It should be noted that, just as the PFIC pledge issue, the principal question of investors and managers is whether this rule applies to QEFs. The answer is that it applies only to unpedigreed QEFs (discussed below).[129]

127. *See* Treas. Reg. § 1.1295-1(g)(3).

128. The only example in Prop. Treas. Reg. § 1.1291-1(h)(3) suggests that convertible debt is treated just as an option. This is not an unusual occurrence in the Internal Revenue Code and the regulations.

129. Prop. Treas. Reg. § 1.1291-1(d).

➤ **Useful Reading**

For more in-depth discussion on this topic, see David R. Tillinghast, *Treatment of Options to Buy PFIC Stock*, 32 TM INT'L J. 481, (2003).

## Unpedigreed QEFs

Unpedigreed QEFs are another trap for the unwary U.S. investor that emanates from the PFIC rules. Many investors and practitioners are not familiar with the hazards of the unpedigreed QEF. The issue could be equally applicable at the fund level (assuming the fund is a PFIC) and at the portfolio company level (assuming that company is a PFIC). Unpedigreed QEFs are QEFs for which the U.S. investors did not make a QEF election on time.[130] The problem can materialize when the investor is oblivious to the existence of a lower-tier PFIC and does not make the election for that PFIC. Then both the QEF rules and the section 1291 "excess distribution" rules apply to the PFIC. The most acute issue here for investors is the nonrecognition override rule of section 1291(f) and the general section 1291(a)(2) disposition rule. What does this mean? This means that in the case of nonrecognition transaction or a taxable disposition of an unpedigreed QEF, the "excess distribution" rules would apply to any FMV in excess of previously taxed income coming out of the QEF. Some of this treatment is predicated on proposed regulations that have not been finalized for close to 20 years.[131]

➤ **Useful Reading**

Thomas A. O'Donnell & Ozzie A. Schindler, *Simultaneous Application of Both Excess Distribution and QEF Rules: The Case of the Unpedigreed QEF,* in PORTFOLIO 923-2nd: PFICs, at IX.B (BNA Tax & Accounting Online).

Christopher Ocasal and Carol Tello, *New PFIC Guidance Provided: But More Remains to Be Done*, 38 TM INT'L J. 675 (2009).

Dolan, Jackman, Tretiak & Dabrowsk, U.S. Taxation of International Mergers, Acquisitions and Joint Ventures P 9.06, Outbound Transfers of Passive Foreign Investment Company Stock. (Thomson Reuters/WG&L, 1995—2010 & Supp. Nov. 2010).

## Fund Is Unpedigreed QEF: Now What?

Some investors, to their dismay, learn after the fact and even many years down the road that they should have made a QEF election for a particular fund. The investor becomes particularly distraught after learning not only that the earnings from the fund will be taxed at ordinary rates but that there will be interest charges, generally at applicable federal rate (AFR) plus 3 percent, on those earnings.[132] Aside from planning on suing the practitioner that failed to advise of the opportunity to make a QEF election, the investor will want to know whether the situation could somehow be salvaged. The unfortunate answer is that

130. Prop. Treas. Reg. § 1.1291-1(b)(2)(iii).

131. *See* Prop. Treas. Reg. § 1.1291-1, -6.

132. Section 1291(a)(1)(B) expressly provides that 1291 inclusions are taxed entirely as ordinary income. For the 3 percent rule, see I.R.C. §§ 1291(c)(3)(A)(ii), 6621(a)(1).

successfully suing the initial advisor for any cost associated with remedying the situation is the only possible happy ending.

What are the investor's options? First and foremost the investor should make sure that it can make a QEF election to begin with (i.e., ask the fund whether the required PFIC information statements would be provided). If it can, the investor might be able to do one of the following: (1) nothing (usually not a good choice); (2) file only a QEF election; (3) file a QEF election in conjunction with a purging election under Treas. Reg. § 1.1291-9 or -10; or (4) try to file for a retroactive election under Treas. Reg. § 1.1295-3. Usually counsel in conjunction with a CPA would create a cost/benefit analysis that models the different options. Many considerations factor in this analysis, the foremost being that the PFIC rules specifically prohibit the use of the remedial provisions of Treasury Regulations section 301.9100 to correct the omission of timely making a QEF election.[133] However, the QEF rules offer two methods for making a retroactive QEF election, known as the protective regime and the consent election, both of which require a lengthy approval process and the satisfaction of specific conditions. The protective regime is usually not an option because the investor must have filed a protective statement for the year it bought the shares, which is rarely the case. The consent regime, however, usually is a viable option. The consent election is very similar to section 9100 relief. While section 9100 relief is expressly prohibited by the regulations, the consent election mitigates that void. Consent elections are specifically intended to provide QEF relief to taxpayers whose failure to make a timely QEF election was not due to their own fault. A consent election, if granted, could extricate the taxpayer from the negative U.S. income tax consequences of the PFIC rules and impose the more benign QEF regime instead. Notably, as discussed below, these elections pose a significant administrative and cost burden. Following are consent election requirements and key points:

1. Procedural requirements:
    a. Before it can file a consent election, the taxpayer must obtain permission from the IRS. This is accomplished by filing a ruling request with the Office of the Associate Chief Counsel (International), attaching all required affidavits,[134] and paying a fee as high as $14,000 (or significantly less depending on the taxpayer's gross income).[135]
    b. The ruling must be requested by the U.S. shareholder of the PFIC (i.e., the same person who has to file the QEF election).

133. *See* Treas. Reg. § 1.1295-3(a).

134. Affidavits from both the taxpayer and other persons are required. "Other persons" include the qualified tax professional upon whose advice the shareholder relied, as well as any individual (including an employee of the shareholder) who made a substantial contribution to the return's preparation, and any accountant or attorney, knowledgeable in tax matters, who advised the shareholder with regard to its ownership of the stock of the foreign corporation. The affidavits must include information regarding the events that led to the failure to timely file a QEF election.

135. The fee could be as low as $625 (if the taxpayer has gross income of less than $250,000) or $2,000 (if the taxpayer has gross income between $250,000 and $1,000,000).

c. If the IRS consents to the filing of a retroactive election, the taxpayer must make a retroactive election on Form 8621 for the taxable year in which the consent is granted.
d. The taxpayer will have to file an amended return for each affected taxable year starting from the later of (i) the first year for which the retroactive election is made, or (ii) the earliest open year (usually three years prior to the year in which consent is obtained).

2. Substantive requirements:
   a. In failing to file a QEF election, the taxpayer must have reasonably relied on a qualified tax professional. Usually the taxpayer will have to show that it retained a competent CPA to render advice regarding the preparation of the taxpayer's federal income tax return and associated international issues and that the CPA failed to advise the taxpayer regarding PFIC status and the consequences of a QEF election. The taxpayer might also have to show that the CPA had access to the relevant facts (e.g., that the taxpayer was a shareholder of the particular foreign corporation).
   b. Granting the consent must not prejudice the interest of the IRS. Usually prejudice to the IRS arises as a consequence of the shareholder's inability to file amended returns for closed taxable years. Thus, the IRS's interest is rarely prejudiced if the taxpayer seeks to file a retroactive election for a year for which the statute of limitations is still open and the taxpayer can file an amended return (i.e. three years). If the election goes beyond that time the IRS's interest is often prejudiced. Even if there is prejudice, however, the taxpayer could cure the problem by entering into a closing agreement with the IRS and by paying any amount by which the IRS may be prejudiced.
   c. The taxpayer must request the consent ruling before the IRS has raised the PFIC issue on audit. If an audit commences while the IRS is reviewing the consent request, the taxpayer must notify the Associate Chief Counsel (International).
3. Other key points:
   a. The IRS routinely grants consent.
   b. The process is lengthy. Depending on the IRS's backlog, a ruling can take up to two years from the time the ruling request is filed. Note, however, that in some unusual circumstances rulings could be granted significantly quicker (six or seven months).
   c. The process could be costly. In addition to filing fees, there will be legal and accounting fees for preparing the ruling and affidavits and corresponding with the IRS.
   d. The consent election could be accompanied by a retroactive purging election.[136]
   e. If the taxpayer files for a consent election ruling, it should also file Form 8621 for the current taxable year. This is a protective measure in case the

136. *See infra* note 143.

consent election is not granted. As mentioned above, the ruling process could take up to two years; meanwhile, the taxpayer should be reporting as a QEF. Practitioners may wonder whether filing for a consent election ruling precludes the taxpayer from filing a QEF election for the current year. The answer is that it does not. While there is no official rule on this issue, per unofficial conversation with the Office of Chief Counsel (International), the proper practice is to file Form 8621 and make a notation that the taxpayer has applied for a ruling under Treas. Reg. § 1.1295-3(f).

f. It is recommended that the taxpayer hires a competent accountant to quantify the cost/benefit of the ruling request and compare it to other available options such as a purging election.

As the reader would surmise from the above brief outline, a consent election is a rather steep hill to conquer and this option may not be available for investors that neither have the time nor the money to pursue it. Such investors might consider a QEF election in conjunction with a purging election. The two purging candidates are the dividend purging election under Treas. Reg. § 1.1291-9 and the deemed sale election under Treas. Reg. §1.1291-10. To make a dividend purging election the PFIC must also be a CFC.[137] That would usually be the case if the foreign fund has a significant U.S. shareholder base. On the other hand, a deemed sale election under § 1.1291-10 does not have such a requirement.

The rules for both elections are similar to a certain extent. The taxpayer purges the PFIC taint by a deemed event and then continues PFIC-free going forward (i.e., it is treated as a pedigreed QEF). The purge is triggered at the first day of the year in which the PFIC becomes a QEF.[138] In the case of a deemed dividend election, the investor must take in income the E&P as of the first day of the QEF year and that amount is taxed as an excess distribution under the 1291 rules.[139] Under the deemed sale election, the gain on the deemed sale is taxed as of the first day of the QEF year, again under the excess distribution rules of section 1291.[140] The gain is measured by FMV.[141] In practice, this means that both purging elections apply the same section 1291 excess distribution rules. The difference between the two is that under one election the taxpayer must include in income the E&P while under the other it must include the deem gain. For practical purposes this means that if the investor has a choice between the two elections, generally the investor will prefer the one that leads to a smaller tax liability and make that election respectively.[142] The good news here is that

137. Treas. Reg. § 1.1291-9(a)(1).

138. *See id.*; Treas. Reg. § 1.1291-9(e).

139. *See id.*

140. Treas. Reg. §§ 1.1291-10(a), 1.1291-10(e)(1).

141. *See id.*

142. Note that for 10 percent investors in PFIC/CFCs the deemed dividend election rarely makes sense because, as discussed, the CFC rules trump the PFIC rules and the investor will be subject to the CFC rules. For shareholders of PFIC/CFCs that own less than 10 percent, however, the election still represents a viable alternative.

no ruling is required from the IRS.[143] The investor makes the election on Form 8325 with its annual tax return. The bad news is that in either case the purge causes immediate taxation at ordinary income rates plus an interest charge. In other words, there are no second chances in a belated QEF scenario, because the taxpayer is burdened by a significant cost for professional advice and/or with ordinary income and various charges. Hence, the only truly equitable and happy-ending solution is a successful malpractice suit.

**The Fund Owns a PFIC Subsidiary Indirectly Through a Foreign Opco**

As mentioned earlier, a private equity fund sometimes engages in reorganizations whereby it combines some of its operating companies with other companies. For example, a foreign fund with U.S. investors merges a foreign operating company into another operating company or a special purpose acquisition company (also known as SPAC). Not readily apparent PFIC issues can arise when the foreign operating company held by the fund has a multitiered structure that includes a PFIC. For example, the portfolio company can have special purpose vehicles that hold certain investment properties. Those special purpose vehicles could clearly fall with the category of PFIC. However, the portfolio company itself may not be a PFIC.

Let's take an example of this setup. A foreign pass-through fund with U.S. investors holds a minority interest in a holding company that has wholly owned operating subsidiaries along with several passive holding companies. The top-tier holding company itself is not a PFIC because under the 25 percent attribution rule the assets and income of the opco subsidiaries are attributed to it.[144] Imagine that the fund intends to merge this holdco into an operating company held by a third party. The question here is whether the fund is indirectly disposing of a PFIC and whether the fund investors fall within the purview of the nonrecognition override rule of section 1291(f). The problem is that if the fund's investors are disposing of a PFIC and the PFIC is unpedigreed vis-à-vis some U.S. investors, those U.S. investors could be subject to tax. The answer to this question usually depends on the percentage ownership in the opco (the opco holding company in our example). Prop. Treas. Reg. § 1.1291-1(b)(8)(ii)(A) provides that a person owns an indirect interest in a PFIC through a non-PFIC corporation if the person owns 50 percent or more in the non-PFIC corporation. If this threshold is met, the investor is considered as indirectly owning a proportionate amount (by value) of the PFIC stock held by the non-PFIC. This is a favorable rule for funds and their U.S. investors. Under this rule, a U.S. investor of a foreign fund would rarely be treated as an indirect shareholder in a PFIC owned by an operating company, simply because the U.S. investor would not directly or indirectly own 50 percent or more of the non-PFIC operating company (that is, the holdco that owns all of the operating

143. Note, however, that if the taxpayer is attempting to file for a retroactive purging election, the permission of the IRS is required. Usually the retroactive purge is requested as part of the section 1.1295-3(f) consent ruling. The retroactive purge is very helpful if the IRS does not grant a retroactive QEF election as of the first day of the U.S. shareholder's holding period. In that case even with the retroactive QEF relief the fund will be an unpedigreed QEF. A retroactive purge would eliminate the PFIC taint retroactively, which in a lot of instances would be advantageous. *See* Treas. Reg. § 1.1295-3(g)(4)(i); I.R.S. Priv. Ltr. Rul. 2003-03-024, 2003 WL 134081 (2003).

144. *See* I.R.C. § 1297(c).

company subsidiaries and PFICs). The result of all of this is that usually a PFIC subsidiary somewhere down the chain of a foreign opco (or non-PFIC holdco that owns the opcos and PFICs as in our example) would not run afoul of the nonrecognition override rule if the fund chooses to reorganize its portfolio holdings.

**The Fund Disposes of a Portfolio Company—Year of Sale PFIC Issues**

As mentioned previously, often the fund will own a foreign operating company through a holding company in a tax haven jurisdiction. Usually the holding company will not be a PFIC either because it checks the box or because of the look-through rule in section 1297(c). Let's assume for purposes of this discussion that the holdco is a corporation for U.S. tax purposes. It is not uncommon that the portfolio company is sold in a stock sale by the holding company and thereafter either the holdco is liquidated or the money is distributed up (if the holdco has other investments). The fund will have to determine whether the holdco will be a PFIC in the year of the sale or in any subsequent years (if the holdco remains in existence). The problem is that in the year of sale, the holdco will have a significant amount of cash. Moreover, most of the income of the holdco will be derived from the sale of stock, which is generally passive income. Thus, the fund and its shareholders are exposed to PFIC classification and may have to make a QEF election in respect of the holdco. The other problem in the year of sale is that the change of business exception to the PFIC rules usually does not apply to this scenario.[145] That exception provides that an entity will not be a PFIC if substantially all of the passive income of the corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses, and such corporation will not be a passive foreign investment company for either of the first two taxable years following such taxable year, and such corporation is in fact not a passive foreign investment company for either of such two taxable years.[146]

Since PE funds do not usually reinvest the money from the sale of the portfolio company but pay the money up to the investor, the holding company may not be able to rely on the exception.[147] Thus, the fund must assess the PFIC exposure in this situation. The first question is whether the sale of the stock will be treated as passive income. The answer is that likely it would not be because the proceeds are attributed to the sale of an active business. Notably, the section 1297(b)(2)(C) exception for passive income attributable to an active business owned by the company does not expressly include sale of stock (it includes

145. *See* I.R.C. § 1298(b)(3).

146. I.R.C. § 1298(b)(3)(B).

147. The policy of this exception is stated in the Conference Report to the Tax Reform Act of 1986: "The conference agreement follows the Senate amendment by excluding . . . corporations in a start-up phase of an active business. The agreement expands this . . . exception by excluding from PFIC classification *corporations in transition from one active business to another active business*" (emphasis added). H.R. REP. NO. 99-841, vol. II, at 644 (1986). Note that the actual wording of the statute could encompass situations where there is actually no change of business but there is a distribution of the cash. If a holdco owns several businesses and disposes of one business and instead of reinvesting the money distributes it, it might not be a PFIC in the following two years and may satisfy the literal wording of the exception. However, this interpretation clearly contradicts the "transition" purpose above.

interest, dividends, and royalties).[148] One ruling suggests, however, that the same principles apply to the sale of stock.[149] In Private Letter Ruling 2008-13-036, the Service was asked to rule on the PFIC consequences of the sale of stock in an operating business by a holding company. The Service ruled that the disposition of the stock will be treated as the disposition of the underlying assets of the operating business, and passive income will ensue only up to the passive portion of those assets. While this ruling is very favorable, the Service ultimately ruled in favor of the taxpayer because the taxpayer also qualified for the change of business exception of section 1298. As mentioned above, a PE fund will likely not qualify for this exception because at some time in the future the money will be simply distributed up the chain. Thus, while the fund may avoid the passive income test of the PFIC rules (because the income will be viewed as derived from the sale of active assets per the above ruling), it may nevertheless fail the asset test due to its large cash holding. To avoid any ambiguity and preserve capital gains treatment, it is advisable that U.S.-resident fund investors make QEF elections for the holdco and report their pro rata share of the capital gains earnings derived from the holdco. Also, distributing the money in the year of sale could prevent the holdco from being a PFIC in the following two years, thus meeting the literal requirement of the section 1298(b)(3)(B) change of business exception.[150]

### *457A Issues to Managers*

One less-covered issue sometimes befalls funds and their managers. The Emergency Economic Stabilization Act of 2008 (EESA) added section 457A to the Internal Revenue Code. At first glance, it is not evident from the wording of the section that it is directed at fund managers. After all, the section applies to compensation and most fund managers are paid via partnership carried interest, which is generally not treated as compensation for IRC purposes.[151] However, fund managers were one of the contemplated targets of the legislation and unfamiliarity with it could be a trap for the unwary. The section was drafted primarily to attack hedge fund managers, but non-carried interest-deferred compensation paid

148. The exception provides that the term "passive income" does not include interest, dividends, rents, or royalties that are received or accrued from a related person (within the meaning of section 954(d)(3)) to the extent such amount is properly allocable (under regulations prescribed by the Secretary) to income of such related person that is not passive income.

149. I.R.S. Priv. Ltr. Rul. 2008-13-036, 2008 WL 825637.

150. Again, whether this is helpful is quite arguable considering that the TRA conference report speaks in terms of transitions from one active business to another. Clearly in distributions to the investors there is not such transition.

151. This treatment will likely change if the Levin carried interest legislation is enacted.

to managers of a private equity funds may be also captured by this section.[152] The section provides that "any compensation which is deferred under a nonqualified deferred compensation plan of a nonqualified entity shall be includible in gross income when there is no substantial risk of forfeiture."[153] The definition of "nonqualified entity" is broad enough to capture most deferred compensation arrangements of foreign funds. Why was this section enacted? Congress was not satisfied by enacting section 409A, which generally applies to deferrals but does not prohibit them, and decided to enact this section to completely curtail deferrals of compensation income to managers. Congress was particularly unhappy that foreign funds, which do not pay U.S. tax and thus are not concerned with deductions, were indifferent as to whether the compensation to the managers was deductible or deferred. Notice 2009-8 and the secondary sources listed below could be helpful to a private equity fund manager in evaluating whether it has a section 457A problem. If there is such a problem, the potential detriment is that the deferred compensation will be currently includable in income.[154]

➤ **Useful Reading**

James N. Calvin, *Recent Changes Affect Deferred Compensation of Offshore Fund Managers*, 243 DTR J-1 (Daily Tax Report 2008).

Tax Analysts, *NYSBA Makes Recommendations for Carried Interest Legislation*, 2008 TNT 187-42.

Andrew W. Needham, Portfolio 736-1st: Hedge Funds, at VI.B (BNA Tax & Accounting Online).

## Redomiciling the Fund

Re-domiciling a fund can require some significant thought. While this is not something that happens all the time, under certain circumstances the benefits of redomiciling significantly outweigh the cost. A fund may consider redomiciling when, for instance, there is an adverse change in the local jurisdiction law of the fund, or the law of the jurisdiction of the fund's investors and managers in respect of the tax treatment of the fund. For example, enacting a legislation that provides that a Cayman entity that has checked the box will be

152. Compared to private equity managers, hedge fund managers are more prone to structuring their 20 percent carry interest as a deferred compensation management fee instead of partnership profits interest. The reason is that most hedge funds derive short-term capital gains that are taxed at 35 percent, and thus, a hedge fund manager cannot avail itself of the capital gain benefit usually associated with a profits interest. On the other hand, if the 20 percent carry is structured as a fee and the manager is on the cash basis of accounting, the fee would not be includable in income until paid to the manager. Usually this inclusion is counterbalanced by the fact that the investors would want to incur the expense for the fee as early as possible because such fee is deductible by the investor. However, many investors such as foreigners and tax exempts are impervious to this deduction and thus would not insist on timely payment and inclusion of the 20 percent carry. Therefore, hedge fund managers have fertile ground for deferring their compensation even after the underlying investment is sold.

153. I.R.S. Notice 2009-8, 2009-4 I.R.B. 347 (January 26, 2009) provides interim guidance on the application of new section 457A.

154. I.R.C. 457A(a).

treated as a U.S. corporation for tax purposes would likely cause the fund to move to a jurisdiction that does not have this burden.[155]

The first step for the practitioner is to determine whether and how the redomestication can be done under local law. For example, until 2006 Cyprus did not have legislation enabling companies to transfer their statutory seat into and out of Cyprus. Assuming that redomiciling can be done under local law, then the tax practitioner needs to worry about the tax consequences of the transfer. For tax purposes, many of the redomiciling transfers would likely be viewed under the usual form triad asset-up, interest-up, or asset-over, if the fund is a partnership, or under the tax-free reorganization rules if the fund is a corporation. The analysis the tax practitioner will engage in generally revolves around the foreign-to-foreign rules of section 367 or the transfers to foreign partnerships rules.[156] The typical tax concern here is to avoid triggering a taxable event at the time the fund redomesticates. While the author is not aware of any specialized discussion regarding these issues, in addition to the section 367 discussion in this book, there are many other useful sources that address the applicable section that come into play in redomiciling.

➤ **Useful Reading**

BRUCE N. DAVIS, *Outbound and Foreign-To-Foreign Exchanges Under § 367(b),* PORTFOLIO 920-2ND: OTHER TRANSFERS UNDER SECTION 367, at II.C (BNA Tax & Accounting Online).

PHILIP A. STOFFREGEN, KENNETH L. HARRIS, FRANCIS J. WIRTZ, *Acquiring an Interest in a Foreign Partnership Through Contribution, Purchase, or Conversion of an Existing Corporation*, in PORTFOLIO 910-2ND: PARTNERS AND PARTNERSHIPS—INTERNATIONAL TAX ASPECTS, at V.A (BNA Tax & Accounting Online).

## Exiting the Fund

### *Liquidating Distributions of Marketable Securities*

Most private equity fund investors are paid in cash. Usually winding down the fund is a lengthy process since investments are sold over time and cash is distributed as investments are closed. Ultimately the fund closes its doors and makes one final cash liquidation payment to its investors. It is possible, however, that the investor receives property other than cash at time of liquidation. In such instances, the type of property received may affect the investor's tax exposure. The most likely scenario is that the investor receives marketable or unmarketable securities instead of cash (marketable securities are a likely scenario assuming the fund is successful and takes its investments to fruition, that is, an IPO). Let's take as an example the tax consequences of the distribution of marketable securities. Under most circumstances the marketable securities will be treated just as cash. However, for partnership funds and their investors, the general rule is swallowed by its many exceptions.

Section 731(c) provides the general rule for the treatment of the fair market value of marketable securities distributed to a partner as "money." This rule is adverse to taxpayers

155. In similar fashion the Stop Tax Haven Abuse Act (section 103 of the Act) proposed to tax foreign corporations managed and controlled in the United States as domestic corporations.

156. Section 367 is discussed in more depth in "Foreign Reorganization Issues" in Chapter 4, *infra* and in Appendix D.

because any cash receipt in excess of basis is taxable to the investor.[157] Luckily for investors, many exceptions to this rule follow. Section 731(c) is inapplicable to a distribution of a security if that security was contributed to the partnership by the distributee-partner.[158] This first rule rarely comes into play for private equity funds. Also, when certain conditions are met, section 731(c) is inapplicable if the security was not a marketable security on the date acquired by the partnership.[159] One can envision a typical scenario here of the fund acquiring an interest in an operating company early on, seeing the investment through the IPO phase when the stock becomes marketable, then distributing the stock to the investor. Under these circumstances, the investor should be able to avoid a tax bill at the time of distribution.

In addition, the investor should be very familiar with the limitations on gain imposed by IRC § 731(c)(3)(B). Section 731(c) is inapplicable to the extent the distributee-investor receives its share of the partnership's net appreciation inherent in its marketable securities. Lastly, and most importantly for funds and their investors, is the IRC § 731(c)(3)(A)(iii) exception for investment partnerships. The rule provides that the marketable securities would not be treated as cash if the distribution was from an investment partnership to an eligible partner.[160] For these purposes, a partnership is an investment partnership if it has never been engaged in a trade or business, and substantially all its assets (by value) have always consisted of money, stock, notes, bonds, debentures, or other evidences of indebtedness.[161] A partnership would not be treated as engaged in a trade or business by reason of being an investor, trader, or dealer of the above-enumerated securities.[162] An eligible partner is a partner that did not contribute to the partnership any property other than the above-enumerated property.[163] Moreover, a partner is not disqualified as a partner solely because the partner contributed services to the partnership.[164] Thus, for private equity fund investors that receive distributions of recently IPO'ed marketable stock, the cash equivalent rule of section 731 should, in all likelihood, not present a problem.

➤ **Useful Reading**

McKEE, NELSON & WHITMIRE, *Distributions of Marketable Securities*, *in* FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS ¶ 19.09 (Thomson Reuters/WG&L, 4th ed. 2007 & Supp. Oct. 2010).

Phillip Gall and David R. Franklin, *Partnership Distributions of Marketable Securities*, TNT Doc. No. 2007-23551.

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157. Conversely, the receipt of in-kind distribution of a nonmarketable securities property from a partnership is not taxable. I.R.C. § 731(a)(1).

158. I.R.C. § 731(c)(3)(A)(i).

159. I.R.C. § 731(c)(3)(A)(ii); Treas. Reg. § 1.731-2(d)(1)(iii).

160. Treas. Reg. § 1.731-2(e)(1).

161. I.R.C. § 731(c)(3)(C)(i).

162. Treas. Reg. § 1.731-2(e)(3).

163. I.R.C. § 731(c)(3)(C)(iii)(I).

164. *See* Treas. Reg. § 1.731-2(e)(2)(i).

### *Worthless Interest and Abandonment (Exits in Downturn)*

When things are going well, nobody is worrying about worthlessness or abandonment, but when the investment landscape turns dismal, investors explore their options of abandoning the interest in the fund or otherwise claiming a loss for worthless securities. The issue here generally revolves around whether the investor can take the loss, and if so, whether the loss deduction will be ordinary or capital.[165] First and foremost, the investor has to prove that the interest in the fund is worthless or that the investor abandoned it. Many times, unless the investor completely severs its relationship with the fund, it would be impossible to prove such worthlessness or abandonment. To take as an example an interest in a foreign PFIC fund, absent a sale or liquidation of the interest, the major hurdle for the investor is that the regulations expressly provide that a mere decline in stock value is not sufficient for a deduction.[166] This regulation makes it plainly clear that no loss is allowed unless a loss is recognized under Treas. Reg. § 1.1002-1 or under the worthless securities deduction rules of Treas. Reg. § 1.165-5. To prove worthlessness, the investor usually has to show balance sheet insolvency and complete lack of future potential value.[167] The lack of future potential is usually proven by some identifiable event such as a winding-down phase or sale of all of the fund's portfolio companies at distressed prices.[168]

As to the character of the loss, assuming such loss could be claimed by the investor in the first place, it has been the case for a long time that capital losses for U.S. individuals are limited to the extent of capital gains plus $3,000.[169] This puts an investor with significant capital losses at a predicament because first, the investor is incurring a loss, and second, it is facing a deferral of the loss until better times bring in capital gains in the future. Claiming an ordinary deduction, if possible, is a better tax position since even if the investor does not have enough income in the year of the loss, it can carry the loss back and offset income in previous years.

The outcome of this "character" issue may very well depend on whether the fund is treated as a partnership or as a corporation for U.S. purposes. If the fund is a partnership, there is a long-settled law that supports a position for ordinary loss in some cases. In Rev. Rul. 93-80, the IRS ruled that "a loss incurred on the abandonment or worthlessness of a partnership interest is an ordinary loss if sale or exchange treatment does not apply. If there is an actual or deemed distribution to the partner, or if the transaction is otherwise in substance a sale or exchange, the partner's loss is capital (except as provided in section 751(b))."[170] In other words, the general rule is that if the investor does not get any cash or relief from a liability in exchange for the partnership interest, it can claim an ordinary loss. If the fund is treated as a corporation, however, section 165(g) expressly provides that any worthlessness will be treated as a sale or exchange of a capital asset. The gist of this taxpayer adverse rule is that it applies only to worthlessness of securities such as stock.

165. *See generally* I.R.C. § 165(g).
166. Treas. Reg. § 1.165-4.
167. *See, e.g.*, Morton v. Comm'r, 38 B.T.A. 1270 (1938); Greenberg v. Comm'r, T.C.M. 1971-220 (1971).
168. An identifiable event is required by the regulations. *See* Treas. Reg. § 1.165-1(b).
169. Treas. Reg. § 1.1211-1(b)(2)(ii).
170. *See also* IRS E-Mail Chief Counsel Advice 200851054.

Partnership interest is not enumerated as a security for the purposes of this section. In other words, while investors in pass-through funds who can prove worthlessness or abandonment have a window of opportunity to claim an ordinary loss, those in corporate funds do not because they are expressly pulled within the purview of section 165(g). Whether such dichotomy makes sense is a separate issue left to the reader to ponder.

➤ **Useful Reading**

*Citron v. Comm'r*, 97 T.C. 200 (1991).

Rev. Rul. 93-80, 1993-2 C.B. 239.

Rev. Rul. 2004-58, 2004-1 C.B. 1043.

IRS E-Mail Chief Counsel Advice 200851054 (2008).

WILLIAM MCKEE, WILLIAM NELSON & ROBERT WHITMIRE, *Abandonments, Forfeitures, and Worthlessness of Partnership Interests*, *in* FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS ¶ 16.06 (Thomson Reuters/WG&L, 4th ed. 2007 & Supp. Oct. 2010).

Thomas C. Lenz & Joseph J. Bergthold, *When Private Equity Fund Debt Goes Bad*, J. PASSTHROUGH ENTITIES, Jan. 1, 2010.

### *Secondaries*

Sometimes a private equity investor will not wait for the fund to be unwound to exit the investment. Luckily for such investors, there is a vibrant secondary market for private equity interest. Firms such as AXA Private Equity and Alpinvest Partners are major players in this market and have significant capital dedicated to purchasing such investments.[171] This market, also called "secondaries" or "secondary market," offers an opportunity for investors to sell not only their interest in the fund but also their uncalled preexisting commitments to contribute capital to the fund. Investors often try to tap this secondary market when they are pressed for cash. For example, pension and college endowments that have incurred losses may find it difficult to meet payout deadlines, and one way to raise cash quickly is to dispose of private equity investments in this secondary market. As of the writing of this book, the secondary market is booming with more than 100 deals in 2010 worth $25 billion.[172]

Tax issues in secondaries are not too prevalent or convoluted. Private equity interest is generally a capital asset, and its sale would usually trigger capital gain or loss unless there is some limitation such as section 751 "hot asset" rules.[173] There is one interesting issue, however, that is worth exploring. The secondary may involve some contractual assignment or novation of the unfunded capital commitment from the selling private equity investor to the purchaser. The question is whether the assumption or novation of this unfunded

171. *See, e.g.*, AXA Private Equity, AXA Private Equity Closes Its Fourth Generation of Secondary Fund at US$ 2.9 Billion (June 7, 2007), http://www.axaprivateequity.com/en/press/Pages/fourthgenerationofSecondaryFund.aspx.

172. *See* Frances Denmark, "Private Equity 'Secondary' Deals Are Booming," INSTITUTIONAL INVESTOR, Nov. 12, 2010, http://www.institutionalinvestor.com/asset_management/Articles/2710796/Private-Equity-Secondary-Deals-Are-Booming.html.

173. *See* I.R.C. § 741.

commitment would trigger cancellation of debt income (CODI) or otherwise cause some recharacterization of the income/loss from capital to ordinary. The author is not aware of any authority directly on point in the private equity context, but under general CODI principles, the assignment should not result in any such gain.

The cancellation of unfunded capital call commitment does not create an accession to wealth to the obligor. It merely prevents wealth from being decreased. The situation is akin to a guarantee. There is established law that provides that the extinguishment of a guarantee does not cause CODI particularly due to the lack of accession to wealth. The closest tax case that the author is aware of with an issue similar to the secondaries issue that can befall the fund is *Hunt v. Commissioner*.[174] The case involved Lamar Hunt, a founder of the American Football League and the son of the billionaire oilman H. L. Hunt. The facts of the case are rather involved but in pertinent part they are as follows: The Hunt brothers were speculators in gold and silver futures. Early on they made a lot of money but then had a liquidity crisis when the price of silver started to fall (they had to meet high COMEX margin requirements). As a solution to their monetary needs they entered into a partnership, agreement with Placid Oil Company, an entity owned by six Hunt trusts. Placid had the capacity to borrow around $800 million. Placid was supposed to be a GP of the partnership and the brothers were to contribute silver assets and indebtedness. Then Placid was going to borrow and contribute the money to the partnership. Under the partnership agreement the brothers were obligated to make periodic contribution amounts (PCAs) to the partnership. These amounts were to be used to repay capital contributed by Placid. The obligation to make a PCA would not arise unless the income of the partnership fell below a certain level (in essence, it was contingent). Subsequently, as result of certain restructurings the PCAs were eliminated. The Service reasoned that the release of PCAs resulted in $174 million of CODI. The Tax Court disagreed and said that the PCAs were not indebtedness within the meaning of the CODI rules. Here is what the court said:

> Gross income includes all income from whatever source derived, including income from the cancellation of indebtedness. Sec. 61(a)( 12). However, not all discharges of indebtedness must be included in gross income. Sec. 1.162-12(a), Income Tax Regs.; *Zarin v. Commissioner*, 92 T.C. 1984, 1989 (1989). Specifically, this Court has held that the release of a contingent liability does not result in cancellation of indebtedness income. In *Landreth v. Commissioner*, 50 T.C. 803 (1968), we addressed this issue and concluded as follows:
>
> "If the respondent intends to suggest that any person who guarantees the payment of a loan realizes income when the principal debtor discharges the loan, we reject the proposition. The respondent cites, and we have found, no authority for the proposition that a guarantor constructively receives income when the debtor makes payments to the creditor on his obligation, and we think that it has no foundation in the principles of tax law. The situation of a guarantor is not like that of a debtor who as a result of the original loan obtains a nontaxable increase in assets. The guarantor obtains nothing except perhaps a taxable consideration for his promise. Where a debtor is relieved of his obligation to repay the loan, his

174. T.C.M. 1990-248, 1990 WL 66551 (U.S. Tax Ct.).

> net worth is increased over what it would have been if the original transaction had never occurred. This real increase in wealth may be properly taxable. *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).
>
> "However, where the guarantor is relieved of his contingent liability, either because of payment by the debtor to the creditor or because of a release given him by the creditor, no previously untaxed accretion in assets thereby results in an increase in net worth. *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (C.A. 2, 1932); *Fashion Park, Inc.*, 21 T.C. 600 (1954). Payment by the principal debtor does not increase the guarantor's net worth; it merely prevents it, pro tanto, from being decreased. The guarantor no more realizes income from the transaction than he would if a tornado, bearing down on his home and threatening a loss, changes course and leaves the house intact. * * * [Landreth v. Commissioner, 50 T.C. at 812–813.]"

Based on these principles the Tax Court ultimately held that the release from the PCAs did not cause CODI. How does this reasoning apply to secondaries? The release of the commitment does not summon a previously untaxed accretion in assets but merely prevents the selling investor's wealth from being decreased. Caveat: The case clearly concerns contingent contributions. Thus, it has an application inasmuch as the commitment is not already called. If the commitment has not been called, it is still in the domain of the contingent because it would be due only when the GP calls it because there is a new portfolio investment, follow-up investment, or payment of certain expenses for which capital is required. In other words, it could be reasoned that the selling investor's obligation is contingent inasmuch as it must be paid when the fund actually makes investments or incurs expenses. What if the commitment obligation is not contingent, that is, it has already been called or it is mandatory to begin with? There appears to be no law on point that addresses this situation directly. It is logical that the same principles should apply as in the case of contingent obligation. After all, the key is that the obligation is not indebtedness within the meaning of the CODI rules. There must be some accession to wealth for there to be income. As the court pointed out above, a mere prevention from wealth being decreased does not constitute income. The Tax Court in *Zarin* also succinctly reasoned that "[w]e have no doubt that an increase in wealth from the cancellation of indebtedness is taxable *where the taxpayer received something of value in exchange for the indebtedness*."[175] It is difficult to envision what kind of value the investor is receiving by making a commitment to contribute money in the future. The investor will receive such value when it makes the contribution and receives a capital account and a commensurate share in the profits of the fund. Until then the capital commitment is a naked obligation sitting in the balance.

175. Zarin v. Comm'r, 92 T.C. 1984 (T.C. 1989) (emphasis added).

## Fund Reporting Issues

Compliance is discussed in several sections of this book. In this section we will take a look at certain compliance issues that arise at the fund level.[176] Compliance is often on the back burner for many funds and their investors. It shouldn't be. It can have an array of unpleasant consequences, and thus, it is advisable to think about it beforehand. For one, compliance often means that the confidentiality of a lot of investors may be blown. While to many investors confidentiality is not an issue, to others it is, and divulging their identity to the IRS could be a deal breaker for these investors. Moreover, not complying with U.S. reporting requirements could have adverse tax consequences. Aside from civil penalties (and in some cases criminal penalties for willful failure to file), failure to file a timely return could cause a denial of deductions.[177] Thus, it is recommended that the fund and its investors consider these issues early on. Preferably, the risks of compliance should be disclosed in the PPM. While not all conceivable filing requirements need be included in the PPM, those that could cause severe consequences if not complied with should be included in the PPM (e.g., reportable transaction disclosure discussions). A sample of some reporting issues that practitioners should heed follows.[178]

### *Form 1065—U.S. Reporting Requirements for Foreign Funds*

Often funds will be set up offshore. One of the reasons for this is the less stringent filing requirements. If the fund is a partnership, the general rule in Treas. Reg. § 1.6031(a)–1(b)(1)(i) is that a foreign partnership is not required to file a partnership return if the foreign partnership does not have gross income that is (or is treated as) effectively connected with the conduct of a trade or business within the United States (a.k.a. ECI) and does not have gross income (including gains) derived from sources within the United States (a.k.a. U.S.-source income). In other words, funds that invest outside the U.S. do not need to file Form 1065.[179] By contrast, domestic funds must generally file Form 1065 unless they have no income, deductions, or credits. If the fund is a corporation, Treas. Reg. § 1.6012-2(g)(1)(i) generally provides that

> every foreign corporation which is engaged in trade or business in the United States at any time during the taxable year or which has income which is subject to taxation under Subtitle A of the Code (relating to income taxes) shall make a return on Form 1120-F. Thus, for example, a foreign corporation which is engaged in trade or business in the United States at any time during the taxable year is required to file a return on Form 1120-F even though (a) it has no income which is

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176. Some foreign-related compliance and withholding issues are discussed in "Foreign Country Withholding" and "Filing Obligations for U.S. Investors" in Chapter 4, *infra*.

177. Treas. Reg. § 1.882-4(a)(3). While the section 882 rule applies to foreign corporations, a similar rule applies to foreign partnerships. If a foreign partnership is required to file a U.S. partnership tax return but fails to do so, the U.S. partners may claim no deductions, losses, or credits. *See* I.R.C. 6231(f).

178. See also the discussion of reporting in the outbound context in Filing Obligations for U.S. Investors" in Chapter 4, *infra*.

179. See also the discussion in "Filing Form 1065 and Disclosing Information to the Government" in Chapter 1, *supra*.

effectively connected with the conduct of a trade or business in the United States, (b) it has no income from sources within the United States, or (c) its income is exempt from income tax by reason of an income tax convention or any section of the Code.

The common theme of this reporting obligation is that funds that intend to have little exposure to U.S. compliance are better off setting up shop outside the United States. This could have the added benefit of relying on the rule that if a tax obligation is fully satisfied via withholding no return is required.[180] If these funds set up in the United States, they could unnecessarily run into reporting obligations and expose their investors to revealing their identity.

### *Foreign Fund Has a Large Cash Account in a U.S. Bank*

Sometimes the tax practitioner will come across a partnership fund in a foreign jurisdiction that has a large cash account in the United States. The fund may have no business in the United States at all. In abundance of caution, however, the fund may ask whether it will have some reporting obligations due to this cash position. While the author is not aware of a rule that states that a foreign partnership must file a U.S. tax return if it holds large cash assets in the United States, such reporting may be required indirectly. The IRC § 6031 reporting rules are tied to the existence of U.S. income and not assets. A large U.S. bank account naturally will generate interest income. If the U.S. bank accounts generate such interest income, that income will usually be U.S. source.[181] Then in play comes Treas. Reg. §1.6031(a)-1(b)(3)(iii), which specifies that a partnership that has U.S.-source income and at least one U.S. partner must file partnership returns unless it qualifies under the de minimis exception of subparagraph (b)(2). The de minimis exception provides that "[a] foreign partnership (other than a withholding foreign partnership, as defined in Section 1.1441-5(c)(2)(i)) that has $20,000 or less of U.S.-source income and has no ECI during its taxable year is not required to file a partnership return if, at no time during the partnership taxable year, one percent or more of any item of partnership income, gain, loss, deduction,

180. Treas. Reg. §§ 1.6012-2(g)(2)(i)(a); 1.6012-1(b)(2)(i); 1.6031(a)-1(b)(3)(i)(C). These rules would usually work out as follows. For example, in the case of a foreign master-feeder fund with a U.S. feeder and a foreign blocked feeder the fund will derive some U.S.-source income subject to withholding. The master fund will take the position that it is not engaged in a U.S. trade or business under the trading exception. The foreign master fund will give the U.S. withholding agent form W-8IMY with a W-8BEN for the foreign feeder blocker and W-9 or W-8IMY for the U.S. feeder. Because the foreign master fund has U.S.-source income and U.S. partners, but its tax obligations will be paid via withholding, the foreign master fund has to file a partnership return with K-1s only for the U.S. partners. No such K-1s are required for the foreign blocker feeder. Treas. Reg. § 1.6031(a)-1(b)(3)(iii). At the same time, the U.S. withholding agent issues Forms 1042-S to the foreign blocker and U.S. feeder. Assuming the foreign blocker does not have ECI, the blocker would not have a K-1 and would not have to file a U.S. tax return because its share of tax liability was fully satisfied through withholding.

181. *See* I.R.C. § 861(a)(1).

or credit is allocable in the aggregate to direct United States partners."[182] In other words, this is a tough threshold to meet. If the foreign fund generates more than $20,000 on its U.S. deposits or more than 1 percent is allocated to direct U.S. partners, then it is out of the de minimis exception and it must report. Funds with such cash accounts should carefully monitor their interest exposure if they want to fall outside the U.S. tax return reporting requirements. Even better, foreign funds with large cash balances should keep their money outside the United States.

### *Reporting Requirements Associated with Name Changes*

It is not uncommon for a fund to change its name or to convert from one legal form to another. Usually a compliance issue comes up regarding where, how, and when to report such changes. Unfortunately, there is nothing concrete regarding this issue. The IRS has the following blurb on its website:

> Business owners and other authorized individuals can submit a name change for their business. The specific action required may vary depending on the type of business. . . . Partnership: If you are filing a current year Form 1065, mark the appropriate name change box on the form: Page 1, Line G, Box 3. If you have already filed your return for the current year, write to us at the address where you filed your return to inform us of the name change. In addition: The notification must be signed by a partner of the business.

Thus if the change took place prior to filing the tax return for the current taxable year, then the IRS should be alerted on that tax return. If the name change took place subsequently to that tax return, then the fund should write a letter to the IRS advising it of the change. The issue can be somewhat confusing to practitioners if the change took place, for example, in January 2009 and the fund is filing its 2008 tax return on April 15. One could reason that the fund should be allowed to report the name change and file with the new name on its 2009 return (i.e., April 2010) instead of on its 2008 return. However, that course of action appears inappropriate. The function of checking the change-of-name box is not so much to give the exact new name or the time the name changed as to alert the IRS that the name has changed (a fact that, one could surmise, the IRS would want to know about as soon as possible). The issue appears sufficiently trivial and innocuous, but to keep a clean slate with the IRS, funds should report any changes as soon as possible.

182. A withholding foreign partnership (WFP) is a foreign partnership that has entered into a withholding agreement with the IRS. Foreign funds would enter in such agreements because there are various withholding-related benefits such as eliminating the risk of over- or under-withholding by a domestic agent and later filing for refunds and balance dues (the fund itself becomes the withholding agent; WFPs are discussed in "Withholding" in Chapter 3, *infra*. Note that funds that are WFPs should be alerted that they would not qualify for this de minimis exception. To most WFPs, this fact may be irrelevant because they have to provide information to the IRS under the agreement they are required to sign, but nonetheless, the exception should be mentioned in the limited circumstances in which it might be material.

### *Reporting Requirements for Fund Investors*

In addition to the compliance requirements imposed on the fund, tax practitioners must consider all the reporting requirements that may be imposed on the fund's investors.[183] Those should be disclosed clearly in the PPM. While to most investors a reporting obligation would not be a deal breaker, to some it might, and to protect the fund from future litigation, the lawyer should touch on this issue in the PPM. Some of the most noticeable requirements include:

Form 5471, applicable to U.S. owners of foreign corporations

Form 926, applicable to outbound transfers by U.S. persons

Form 8621, applicable to investors in a PFIC/QEF

Form 8833, applicable to investors claiming treaty benefits

Form 8865, applicable to transfers to foreign partnerships

Form FBAR, applicable to U.S. persons holding financial accounts in foreign institutions.[184]

Form 8939, applicable to investors holding an interest in a fund subject to FATCA.

As a general observation, it is highly advisable that the investor finds a competent CPA or other tax compliance professional. Preferably, such professional should have access to corroborating groups and committees such as the ABA sections and subsections on international taxation and private equity/hedge funds. The reason is that some of these forms and the related instructions are not the most clear-cut documents to work with and the expertise of various people and collective knowledge could be required to come to the correct compliance result. Coming to the right result is essential considering that inaccurate compliance can have monetary impact on the fund's investor. Noncompliance or improper compliance can lead to penalties and possibly result in a longer statute of limitations (e.g., when the investor did not properly apprise the IRS of substantial omissions of income, the statute of limitations could be extended to six years under section 6501(e)(1)).[185]

➤ **Useful Reading**

A very useful source of compliance-related discussion can be found in Portfolio 947-1st: Reporting Requirements Under the Code for International Transactions (BNA Tax & Accounting Online).

183. Some of these requirements are discussed in more detail in "Filing Obligations for U.S. Investors" in Chapter 4, *infra*.

184. When practitioners refer to FBAR ("Report of Foreign Bank and Financial Accounts") they typically mean Form TD F 90-22.1. Each U.S. taxpayer who has a financial interest in, or signature authority over, a financial account in a foreign country with an aggregate value of more than $10,000 at any time during a particular calendar year is required to file with the IRS this FBAR form.

185. Note that FATCA introduced a six-year statute of limitations for an omission of gross income in excess of $5,000 when the omitted gross income is attributable to a foreign financial asset. FATCA § 203; I.R.C. §§ 6229, 6501. Investors in foreign private equity funds could flatly fall within this new extended statute of limitations.

### *Certificates Related to Withholding Obligations*

Tax withholding rules can come into play under various circumstances during the fund's lifetime.[186] The fund may have to withhold from payments it makes to its investors. In order to determine whether it must withhold, the fund will usually require various certificates from its investors. Let's take as an example backup withholding for U.S. investors. The fund may require a backup withholding certificate from its investors before it decides whether to withhold tax from any distributions made to the investors. The certification is usually made by the investor on a duly executed Form W-9. The fund is required to withhold if any of the following conditions exist:

1. The payee fails to furnish its tax identification number to the payor in the manner required;
2. The IRS notifies the payor that the tax identification number furnished by the payee is incorrect;
3. The IRS notifies the payor that backup withholding is required because the payee failed to properly report interest, dividends, or patronage dividends in prior taxable years; or
4. The payee fails to certify, under penalties of perjury, that the payee is not subject to backup withholding when such certification is required.[187]

Since usually criteria (1)–(3) are not a problem, the withholding hinges on the Form W-9 certification. Many fund investors would be exempt from backup withholding and should accordingly certify so to the fund. For example, exempted payees include foreigners subject to section 1441 withholding, financial institutions, tax-exempt organizations, governmental entities, and international organizations.[188] If the investor fails to furnish a certificate, then the fund must withhold. If the fund is required to withhold, but does not withhold, it can ultimately be subject to penalties and responsible for the tax. There are other certificates and forms that could have similar consequences (such as FIRPTA certificates and section 1441 forms and certificates).[189] The point is that a failure to deal with these certificates could have significant tax consequences.

➤ **Useful Reading**

Great reading on general withholding issues can be found in CAROL P. TELLO, PORTFOLIO 915-2ND: U.S. WITHHOLDING AND REPORTING REQUIREMENTS FOR PAYMENTS OF U.S. SOURCE INCOME TO FOREIGN PERSONS (BNA Tax & Accounting Online).

### Asking for a Ruling

While it is not a common practice among funds, sometimes the fund will decide to ask the Service for a ruling on particular issue. Also, investors may have to ask for a ruling either

186. Some of the more pertinent withholding rules are outlined in "Withholding" in Chapter 3, *infra*.
187. *See* I.R.C. 3406(a).
188. *See, e.g.*, Treas. Reg. § 31.3406(g)-1.
189. These are more fully described in "Withholding" and "Sections 1441 Versus 1445 Versus 1446" in Chapter 3, *infra*.

under the rules for section 9100 relief or, for example, retroactive QEF consent election under Treas. Reg. § 1.1295-3. It is advisable that the practitioner handing the ruling be familiar with some general guidelines, and preferably familiar with the below-enumerated sources. First and foremost, the practitioner should know whether the issue is a ruling or no ruling area. For certain rulings such as a consent retroactive QEF elections there is hardly a question because the regulations require the rulings as a prerequisite to the retroactive QEF election.[190] For some other areas for which the availability of a ruling is not that easy to discern, the IRS issues specific ruling procedures and updates them annually. If it is not entirely evident from the procedure whether the issue is a ruling issue, the practitioner should call the designated Chief Counsel Office and ask whether the Office is inclined to rule on the issue. It is important to know whether the issue is a ruling issue because if it is not, the IRS will not issue a ruling but will be in possession of the taxpayer's information, namely the fact pattern at issue, and will be free to transfer that information to the appropriate IRS compliance and enforcement department.

Along the same lines, the fund or investor should assess the likelihood of obtaining a favorable ruling before submitting the request. Preliminary conference with the IRS could be helpful to test the waters.[191] Lastly, the practitioner should be intimately familiar with the ruling procedure and should follow it closely. For example, with the request, the practitioner should include a statement of deletions and put brackets around all information that identifies the taxpayer. The IRS has some very particular guidelines of operation, and not adhering to these guidelines could lead to delays. The instructions could be as specific and meticulous as to require that the deletion statement and checklist the taxpayer fills out as part of the request be placed on top of the request.

➤ **Useful Reading**

Rev. Proc. 2010-1, 2010-1 I.R.B. 1.

Rev. Proc. 2010-2, 2010-1 I.R.B. 90.

Rev. Proc. 2010-3, 2010-1 I.R.B. 110.

Rev. Proc. 2009-7, 2009-1 I.R.B. 226.

LISA MARIE STARCZEWSKI, PORTFOLIO 621-2ND: IRS NATIONAL OFFICE PROCEDURES—RULINGS, CLOSING AGREEMENTS (BNA Tax & Accounting Online).

190. Treas. Reg. § 1.1295-3(f)(4)(i).

191. If the practitioner cannot discern exactly whom to talk to regarding a ruling, a good starting point is "5425: IRS Code and Subject Matter Directory," which is published and updated by the Office of Chief Counsel Telephone Directory of the IRS.