

Contents

Introduction.....	xi
<i>Chapter 1</i>	
Issues at the Fund Level.....	1
Formation Issues.....	1
Corporation Versus Pass-Through Entity.....	2
Series LLC—Do or Not Do?.....	4
Forced Corporation Treatment: The PTP Rules.....	5
Domestic Versus Foreign.....	7
Operating, Exit, and Withholding Taxes of the Jurisdiction of Organization.....	7
Primary Jurisdiction of the Investee Operating Companies of the Fund.....	7
PFIC Exposure.....	8
CFC Exposure to U.S. Investors.....	8
Reporting Obligations.....	9
Possible Changes in U.S. or Foreign Law.....	9
Nontax Considerations in Choosing Jurisdiction.....	10
Fund of Funds; Funds Investing in Other Funds.....	10
General Partner/Manager Issues—Interest for Services.....	11
Compensatory Options.....	13
The Inadvertent Partner.....	18
Type and Structure of the Fund: Blockers and Other Issues.....	18
Contributions Contingent on Approving the Investment.....	20
Phantom Income Issues.....	21
Employment Tax Issues.....	22
Is the Cash Method of Accounting Available to the Fund?.....	23
Book-Tax Conformity at the Fund Level.....	24
Is Mark-to-Market Available to the Fund and, If So, Should the Fund Use It?.....	24
The Private Placement Memorandum.....	25
Tax Opinions.....	26
The Fund as a Partnership.....	27
Code Section 721 and Contributions to Investment Partnerships.....	27
Special Methods for 704(c) and “Reverse” 704(c) Allocations.....	27
Validity of Stuffing Allocations.....	29
Possible Tax Issues for Investors that Do Not Meet Capital Requirements or Meet Requirements Late.....	29
Retroactive Allocations When Partners Admitted Late.....	31

Tax Distributions 32

Deductibility of Fund-Related Expenses 33

Investor Redemptions 34

Filing Form 1065 and Disclosing Information to the Government 35

VCOOC 36

Does a Conversion of the Fund Trigger the Two-Year Rule
for Profits Interest in Revenue Procedure 93-27? 37

The Fund as a Corporation 37

Code Section 351 and Transfers to Investment Company Under 351(e)(1) 37

CFC and PFIC 38

 Determine Whether You Have a CFC 39

 Determine Whether to File a QEF Election or a Protective Statement 39

 PFIC Reorganization Issues 40

 Carry-Like Compensation in a Corporate Fund 40

 Tracking Stock in a PFIC 41

 Pledge of PFIC Stock 42

 CFC Trumps PFIC 43

 In-Kind Distribution from a QEF 43

 Information Statements 45

 Tiered PFICs 45

 Options in PFICs 47

 Unpedigreed QEFs 48

 Fund Is Unpedigreed QEF: Now What? 48

 The Fund Owns a PFIC Subsidiary Indirectly Through a Foreign Opco . . . 52

 The Fund Disposes of a Portfolio Company—Year of Sale PFIC Issues . . . 53

457A Issues to Managers 54

Redomiciling the Fund 55

Exiting the Fund 56

 Liquidating Distributions of Marketable Securities 56

 Worthless Interest and Abandonment (Exits in Downturn) 58

 Secondaries 59

Fund Reporting Issues 62

 Form 1065—U.S. Reporting Requirements for Foreign Funds 62

 Foreign Fund Has a Large Cash Account in a U.S. Bank 63

 Reporting Requirements Associated with Name Changes 64

 Reporting Requirements for Fund Investors 65

 Certificates Related to Withholding Obligations 66

Asking for a Ruling 66

Chapter 2

Issues at the Operating Company 69

 General Issues 69

 Tax Due Diligence 69

 Scrutinizing the Deal Documents 70

 Classification of Portfolio Company 71

Type of Investment	72
Stock Versus Note	72
Other Instruments	76
Investing in a Note	77
OID Issues.	81
Form of Exit	81
Purchase Price Adjustments and Earnouts	82
Earnout Paid in Full Under the Installment Method	86
Earnout Not Paid in Full Under the Installment Method	87
Electing out of the Installment Method.	88
Additional Considerations.	89
Incentives or Similar Arrangements	92
Protecting the Fund with Indemnities.	93
Obtaining Certain Tax Certificates When Acquiring a Portfolio Company	94
Limitation on Deductibility of Losses on Transactions	
Between Related Parties	95
AHYDO Issues	96
Expenses Related to the Deal	98
Ability to Amortize the Intangibles of Acquired Company—	
Section 197(F)(9) Churning Issues	100
Conversions of the Operating Company.	100
Operating Company Bankrupt, Insolvent, or Distressed	103
The Fund Invests in a Troubled Company.	103
The Fund Remains in the Troubled Company.	107
The Fund Exits the Troubled Company	112
Exiting the Operating Company—General Issues	115
What Kind of Exit?	115
Exit-Related Tax Issues.	115
Rescinding the Transaction.	129
Issues Typical to Investing in Partnership Portfolio Companies	131
Fund Holds Noncompensatory Options in the Operating Company—	
Partner or Not?.	131
Warrant Reasonably Certain to Be Exercised—Disguised Sale Problem.	132
Partner for Tax Law Purposes but Not for State Law Purposes	133
Liquidating in Accordance with Capital Accounts Versus Waterfall	133
Partner Note and Unfunded Contribution Commitment.	135
To Claw Back or Not	136
Guaranteed Payments Versus Distributive Share	136
704(c) and Reverse 704(c)	137
754 Elections and Securing 743 Adjustments.	139
Issues Related to Leveraged Buy-Outs.	140
Modifications and Recapitalizations of Partnership Interest	143
Capital Shifts at the Operating Company Due to Exercise of Options.	144
Exchanges of Partnership Interest.	146
Partner Modifies Note—Does Section 721 Apply?	146

Potential Ordinary Income at Time of Exit—Section 751	148
Deemed Terminations Under Section 708	148
Reporting Requirements for Sale or Exchange of Partnership Interest—Section 6050K	149
Issues Typical to Investing in Corporate Portfolio Companies	150
Classifying the Interest in the Operating Company—Debt or Equity	150
Convertible Preferred Versus Convertible Debt Investments Versus Warrants	151
Better Treatment at Time of Conversion	151
Preferential Tacking	152
No OID	152
Some Peculiarities of Private Equity Investments of Choice	152
Contingent Warrants/Options	152
Conversion Discount Notes	153
“Eat ’Em Up” Preferred	154
Allocating Purchase Price of Investment Units	156
Deep-in-the-Money Warrants	158
Section 305 and Preferred Stock Issues	159
Convertible Debentures Treated as Preferred Stock for Section 305(C) Purposes	159
“As Converted” Versus “Greater of” Versus “Capped” Participation	160
Cumulative Dividends—Declared Versus Not Declared Dividends	162
Changes in Conversion Ratios	164
Conversion Ratio Fixed in the Future	164
Stock Redeemable After Majority Vote	165
Purchase Price Adjustment Exception	166
Is the Dividend Received Deduction Available for a Section 305(c) Dividend?	167
Section 306 Problems	168
Founder Tax Issues	168
351 Generally	169
Waterman Steamship	172
Qualified Small Business Stock (QSBS)	173
LIFO Recapture after an S Election	176
Rearrangement of the Capital Structure: Recaps, Exchanges of Instruments	177
Is the Fund Exchanging Securities? Section 354 Problem	178
Material Modification Issues and Computing Any Gain on the Modification; Application of E Reorganization Rules	178
Structural Subordination	182
Is There a Section 1001 Sale or Exchange?	182
Is There CODI?	183
Applicability of Nonrecognition Provisions	185
Swapping Old Note for an Investment Unit	185
Conversions of Preferred Stock	186
Modification of Warrants or Options	187

Chapter 3

Inbound Issues	189
U.S. Trade or Business Rules	190
Is the Activity a Trade or Business?	192
Application of the Trading Safe Harbor	194
When Does the Trade or Business Begin?	195
Is the Fund Engaged in a U.S. Lending Business?	196
The Issue of Origination	199
Type of Obligation the Fund Is Originating	200
Does Amending or Modifying Debt Cause Trade or Business?	201
Does the Use of an Accounting or a Law Firm in the United States Create a Trade or Business Issue?	202
Purging Fee Income; Avoiding ECI and UBTI	204
Attribution of U.S. Trade or Business	205
Agency Attribution	205
Subsidiary Attribution	208
Section 875	210
Attribution of Permanent Establishment	211
Blocker or No Blocker	216
Branch Profits Tax Issues	219
Portfolio Interest Exception Issues	220
Does the Payment Received by the Fund Qualify for the Exception?	220
Is the Obligation a Short-Term Obligation or Obligation Bearing Contingent Interest?	221
The 10 Percent Rule, Look-Through, and Convertible Debt Implications	222
Capital Gains—Partnerships Versus Corporations	224
Sale of Partnership Interest	226
Avoiding Dividend Treatment by Equity Swaps and Stock Lending	227
When the Operating Company Is an S Corporation	228
Issues Related to Investment in U.S. Real Estate	229
Sections 1441 Versus 1445 Versus 1446	229
Does the Net Election Affect the Ability to Rely on the “Type of Income” Withholding Rule Under 1446?	230
Selectivity of the Net Election	231
Can the Election Cause the Fund or Its Partners to Be Engaged in a U.S. Trade or Business?	232
Investing in Options and SAMs	232
Withholding	234
When Is a U.S. Partnership Required to Withhold?	234
No Withholding on Certain Short-Term Obligations	236
Withholding on OID	237
Withholding on 305(c) Preferred	238
The Gross-Up	239
Certification of Status Issues	239

Effect of Treaties on Withholding	241
Treaty Overrides and Saving Clauses	245

Chapter 4

Outbound Issues	247
Setting Up the Acquisition Structure	247
Key Planning Points for Acquisition Structure	249
General Considerations	251
Determine the Right Jurisdiction to Form an Acquisition Company	251
Consider Outbound Transfer of Asset and Stock Rules and Reporting Obligations	252
U.S. Tax Considerations	252
Transparent Versus Nontransparent	252
Minimize Ordinary Income at Time of Exit	254
Secure FTCs If Possible	256
Preserve Qualified Dividend Treatment on Operating and Exit Distributions If Available	256
Local Tax Considerations	257
Setting up a Holdco Considerations	257
Miscellaneous Considerations	257
Maximize Versatility on Exit	257
Utilize Hybrids and Reverse Hybrids If Needed	258
Scenarios	258
Do You Have to Check the Box?	261
To Check or Not to Check; Effect on FTC and Others	261
Converting a Corporation to a Pass-Through Entity	265
Practitioner Forgot to File the Election: Now What?	266
Revenue Procedure 2009-41	267
Regulations Section 301.9100-3	267
Availability of Protective Check-the-Box Election	269
Whether to Use a Hybrid Entity	270
How Does the Manager's 20 Percent Carry in the Fund Affect the CFC Status of Portfolio Companies?	271
The EU Participation Exemption	272
Debt-Financed Acquisition Issues	273
The Application of the Antideferral Provisions	273
E&P of a Foreign Opco Determined Under U.S. Rules	276
The Effect of Foreign Treaties	278
Is the Entity a Resident?	278
Effect of Limitation on Benefits Provisions	279
Obtaining Residency and Exemption Certificates	280
Drafting to Protect Against Adverse Changes in the Treaty	280
Permanent Establishment in the Opco Country	281
Monitoring the Status of Treaties	281
Income Access Shares	282
Dividends Received Deduction Generally Unavailable	282

Foreign Currency Gains Under Section 988	283
Foreign Reorganization Issues	284
Contributions to Capital Treated as Exchanges	284
GRA	285
GRA Errors Trigger Gain	285
Fund Is a Domestic PTP—Satisfying the 90/10 Test	285
Exiting the Investment	286
Local Tax Law	287
U.S. Tax Law	287
VAT Issues	289
Effect of Local Taxes—Avoiding Surprises	289
Foreign Country Withholding	290
Filing Obligations for U.S. Investors	290
Conflict of Laws—Associated Reporting Issues	292
 <i>Chapter 5</i>	
Non-Federal Income Tax Issues	295
Criminal Law	295
Ethics Issues	295
State and Local Tax	296
Estate and Gift Tax	296
Tort and Malpractice	296
Fiduciary Suits Against the Fund	297
Conclusion	297
 <i>Appendix A</i>	
Choice of Entity Considerations	299
 <i>Appendix B</i>	
Section 305	303
 <i>Appendix C</i>	
Inbound Sale of Stock Checklist	309
 <i>Appendix D</i>	
Section 367 Outline	311
 <i>Appendix E</i>	
Some Common Tax Provisions in the Private Equity Context	319
 <i>Appendix F</i>	
Sample Onshore Fund Limited Partnership Agreement	337
Bibliography	367
Table of Cases	379
Index	383