A Potpourri of Private Fund Issues

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A Potpourri of Private Fund Issues

- This panel will focus on recent trends and tax issues facing private investment funds.
  - Carried interest taxation and in-kind distributions and waivers;
  - Loan origination surprises;
  - FIRPTA planning and ECI withholding on sales of partnership interests;
  - Unrelated debt financed income and subscription lines
Carried interest taxation and in-kind distributions and waivers
§ 1061 - Generally

**• Basic Rule**
  - Gain with respect to an “applicable partnership interest” (or API) treated as short-term capital gain unless the gain would qualify as long-term capital gain if “3 years” was substituted for “1 year” in § 1222(3) and (4).
  - Focus on relevant holding period (partnership interest vs. underlying assets)

**• “Applicable partnership interest”**
  - Generally means any interest in a partnership that (directly or indirectly) is transferred to (or held by) the taxpayer in connection with the performance of substantial services by the taxpayer (or any related person) in any applicable trade or business.
  - Exception for a partnership directly or indirectly held by a corporation
§ 1061 - Generally

- **Applicable Trade or Business** - means any activity conducted on a regular, continuous and substantial basis which consists (in whole or in part) of:
  - Raising or returning capital, and
  - Investing, disposing, identifying or developing specified assets.

- **Specified assets include:**
  - Stock, PTPs or widely held partnership or trust interests
  - Evidence of indebtedness, notional principal contracts
  - Derivatives or interests in the above or hedges with respect to the above
  - Real estate
  - Partnership interests, to the extent the partnership holds the above.

- **Specified assets apparently do not include:**
  - § 1231 gain
  - § 1256 long-term contracts
  - Partnership interests (unless picked up above)
  - REIT capital gain dividends
Avoiding the Application of 1061

• In-Kind Distributions -
  • 1061 Applies to “gain”
  • Is it practical for Managers and Sponsors
  • Co-investment structures

• Waiver -
  • Timing of waiver - upfront, yearly, deal specific
  • Make-up of waived amount
    • Capital Appreciation
    • Qualified Dividends
    • When does appreciation need to occur
    • Best Practices - What do people look to
Loan origination surprises
Loan Origination

- Trading in stocks or securities for a taxpayer’s own account generally is not a U.S. trade or business – the “Trading Safe Harbor”
  - Not available to a dealer in stocks or securities
  - Also not available if taxpayer has an office or other fixed place of business in the United States through which, or by the direction of which, the transaction in stock or securities is effected
- Secondary market trading in debt falls within the Trading Safe Harbor, but loan origination may be treated as a lending business outside its scope
- Making loans for profit on a considerable, continuous and regular basis in the United States results in a U.S. trade or business

- A non-U.S. person will be subject to U.S. federal net basis income taxation on income that is effectively connected with the conduct of a U.S. trade of business (“ECI”)
  - Dividend equivalent amount of a non-U.S. corporation’s ECI is also subject to 30% branch profits tax
  - State and local tax may additionally apply

- Activities of an agent are attributed to a taxpayer in determining whether a U.S. trade or business exists
Loan Origination (cont’d)

- Under various bilateral U.S. treaties, business profits are not subject to U.S. federal income tax unless attributable to a permanent establishment and activities of an independent agent do not create a permanent establishment.
- Independence is determined based on a facts and circumstances:
  - Courts have generally considered whether agents acting in the ordinary course of its business have legal and economic independence.
- Different approaches have developed for different fund strategies around loan origination activity:
  - Some funds adopt guidelines restricting activity and take the position that they are not engaged in a lending trade or business.
  - The following are several structures that may be used by funds that are engaged in a lending trade or business.
Debt Guidelines

Funds that do not intend to engage in a lending trade or business may adopt guidelines for its debt investments. Common considerations in such guidelines include:

- Timing of entering into loan purchase agreement and closing after original lender’s commitment and funding
- No negotiation of loan terms
- Not an original lender
- Limited percentage ownership of principal
- Existence of secondary market, number of holders
- Ownership limited to a percentage of principal
Debt Guidelines (cont’d)

• No fees for services
• Revolvers and delayed funding loans
• “Bullet” exception during 12 month period
• Loan modifications and restructurings
• Participation in creditors’ committees
• Broker, dealer, bank, insurer or finance company status
• No avoidance transactions, including use of derivatives
• No syndication activity
Debt Guidelines (cont’d)

For mezzanine funds, guidelines also address considerations such as:

- Percentage of return from equity
- Ownership percentage of borrower equity
- Equity holding period
- Unsecured, subordination of debt
- Term of debt
Horizontal Seasoning - Season and Sell

Onshore Fund Originates Loans

- U.S. Investors

- Originated U.S. Debt

Offers to sell Loans some period after origination and independent board approves the pricing

Onshore Fund

- Offshore Fund

- Seasoned U.S. Debt

Non-U.S. Investors

U.S. Debt

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Vertical Seasoning

U.S. Investors

Onshore Fund

Seasoned Loans

Loan Origination Vehicle

Seasoned U.S. Debt

Originated U.S. Debt

Seasoned U.S. Debt

Non-U.S. Investors

Offshore Fund

Mini Master LP (Cayman)

Debt Equity

U.S. Finco

Originates Loans

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Leveraged Blocker
Insurance Dedicated Fund

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Private Business Development Company

![Diagram of Private Business Development Process]

- **Investors**
- **U.S. Fund**
- **Business Development Company**
- **Originates Loans**
- **Originated U.S. Debt**

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Treaty-Based Structure

- Over 50% U.S. Investors
  - Onshore Feeder
- Less than 50% Non-U.S. Investors
  - Offshore Feeder

Loan Origination Treaty Vehicle

Originated U.S. Debt

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4/26/2019
Reduced Withholding Tax Rates Under Certain Treaties
Treaty-Based Structure - Treaty Eligible Person

Diagram:
- Treaty-Eligible Investor
- Independent GP
- Origination Fund
- Originated loans

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4/26/2019
FIRPTA planning and ECI withholding on sales of partnership interests
FIRPTA ITEMS - QUALIFIED FOREIGN PENSION FUNDS

• The Protecting Americans from Tax Hikes Act (the “PATH Act”) introduced a statutory exemption to FIRPTA for Qualified Foreign Pension Funds (“QFPFs”) as defined in new section 897(l)

• Uncertainty as to the breadth of the exemption as well as the qualification as a QFPF has existed based on the wording of the statute and lack of guidance

• The Consolidations Appropriations Act, 2018, which was enacted into law on March 23, 2018 made some technical corrections to section 897(l)

• As Technical Corrections, they take effect as if included in the provisions of the PATH Act to which they relate
FIRPTA - QUALIFIED FOREIGN PENSION FUNDS

• Rather than specific language exempting a QFPF from the application of section 897, section 897(l) now provides that for purposes of section 897, a QFPF shall not be treated as a non-resident alien individual or foreign corporation.
  • Since 897 only applies to non-resident alien individuals and foreign corporations, the exemption is maintained.
  • Exclusion from treatment as an NRA or foreign corporation is not limited to section 897(a).
• Qualification as “domestically controlled” is determined by reference to the percentage held (less than 50%) by foreign persons.
  • Foreign persons includes a non-resident alien individual, foreign corporation, foreign partnership, foreign trust or foreign estate
• Query: If otherwise treated as a foreign corporation, is QFPF ownership not included when making a determination of “domestically controlled”?
  • Potential benefit to non-QFPF shareholders
• Withholding agent determination
  • Sufficient reliance on QFPF’s certification to treat as DC REIT for other?
FIRPTA - QUALIFIED FOREIGN PENSION FUNDS

• PATH Act language provided exemption to a QFPF or any entity all of the interest of which are held by a QFPF
  • Lack of words “directly or indirectly” lead to uncertainty as to whether ownership through a chain of wholly-owned corporations could qualify

• Technical corrections provide that an entity all the interest of which are held by a QFPF “shall be treated as such a fund”

• Query: What about an entity owned entirely by multiple QFPF’s?
  • Doesn’t seem to be a significant policy reason behind the limitation
  • Pre-technical statute included specific language about USRPI owned through partnerships

• Query: Accept a certification that an entity is entitled to QFPF benefits since owned by multiple QFPF’s?
Certification of QFPF Status

• 1445 withholding
  • 1445 regulations reflect that a QFPF or an entity all the interest of which are held by a QFPF is not a foreign person
  • Allows for the furnishing of a certification of non-foreign status
  • 1.1445-2(b)(2)(i)(B) includes the need for an identifying number
  • Reliance allowed unless actual knowledge or notification that statement is false

• 1446 withholding
  • Not yet reflective of QFPF status
  • Practical application seems to be “white paper” certification
    • More than just affirmative statement of QFPF status
  • Reliance?
Section 864(c)(8) and 1446(f)

- TJCA added Section 864(c)(8) to codify position outlined in Rev. Rul. 91-32 regarding treatment of gain on disposition of partnership interest when partnership is engaged in any trade or business within the US.
- Grant of regulatory authority regarding non-recognition transactions created some questions.
  - Proposed regulations clarify that 864(c)(8) does not override non-recognition, although requested comments on 731 distributions.
- Treatment of tiered partnerships was also unclear.
  - Proposed regulations clarify that disposition of lower-tier partnership by upper-tier partnership with foreign partners are covered.
- Proposed regulations modified coordination with 897(g) when partnership engaged in trade or business hold USRPI.
- Proposed regulation provides that a lower-tier partnership that holds USRPI is treated as engaged in a trade or business within the United States.
  - Impact to QFPF that holds USRPI through tiers of partnerships that are otherwise not engaged in a trade or business?
Section 864(c)(8) and 1446(f)

- TJCA added Section 1446(f) as a corollary withholding tax provision to 864(c)(8).
- Notice 2018-08 suspended withholding requirement on dispositions of certain interests in publicly traded partnerships.
- Notice 2018-29 provided interim guidance pending the issuance of regulations and generally adopts the forms and procedures relating to FIRPTA withholding under §1445 and the regulations thereunder.

  - Provides exceptions to withholding under these circumstances:
    - Transferor certifies non-foreign status
    - No realized gain on the disposition
    - Transferor certifies ECI portion of allocable income was less than 25% of total allocable income in 3 prior taxable years
    - Partnership certifies it would have less than 25% ECI on hypothetical sale of assets
    - Disposition is treated as non-recognition transaction
Unrelated debt financed income and subscription lines
UBTI

• If a tax-exempt entity engages in a business that is unrelated to its primary (charitable) purpose, the general rule is that income will be considered unrelated business taxable income and any net income will be subject to the unrelated business income tax (UBIT).

• Investment by a tax-exempt entity in a partnership or tiers of partnerships that are treated as engaging in a business unrelated to the tax-exempt entities primary purpose is considered participating directly for this purpose

• The tax law contains a number of exclusions:
  • dividends,
  • interest
  • rents from real property.

• When debt is incurred by an exempt organization to acquire an income-producing asset, UBIT is applicable to that portion of the income or gain that is debt-financed (with some exceptions).
UDFI

- Section 514 of the Internal Revenue Code provides that income generated by debt-financed property is subject to UBIT.
  - Debt-financed property is any property held to produce income with respect to which there is acquisition indebtedness
  - Income is defined broadly and includes periodic payments, as well as gain upon disposition of the property
- Proportionate
  - Income generated by the property will be treated as UDFI based on the ratio of average acquisition indebtedness to the adjusted basis of the property during the year.
- 1 Year Look Back
  - If debt-financed property is sold or disposed of, the gain must be computed using highest acquisition indebtedness in preceding 12 months and average-adjusted basis.
- Partners in a partnership are generally treated as if they had conducted the partnership’s activity themselves, including incurring debt.
Acquisition Indebtedness

- Any indebtedness incurred in connection with the acquisition or improvement of property:
  - Whether before, during or after acquisition
  - Encompasses mortgages as well as liens and other indebtedness
  - Look to whether the indebtedness would not have been incurred but for the acquisition or improvement of the property.
- But For Test: For post-acquisition/improvement indebtedness, look to whether the need to incur such indebtedness was reasonably foreseeable at the time of the acquisition or improvement. Examples in section 1.514(c)-1(a)(2) of the regulations:
  - Example 1: An exempt organization pledges securities in exchange for a loan and uses the proceeds to purchase a rental property. The outstanding indebtedness constitutes acquisition indebtedness with respect to the rental property.
  - Example 2: An exempt organization mortgages exempt-use property to replace working capital used in remodeling a rental property. The outstanding indebtedness constitutes acquisition indebtedness with respect to the rental property because the need for indebtedness was reasonably foreseeable when the organization reduced its working capital below the amount necessary for current operations.
- IRS guidance from 1986 notes that the sooner the debt is incurred after acquisition of the property, the more likely that it was reasonably foreseeable that debt would be incurred.
Bridging Capital Calls

- PE funds typically maintain limited cash reserves despite the need for significant cash requirements on short notice to close an acquisition.
- Maintaining large cash reserves in low-yield accounts would clearly hurt the fund's internal rate of return and the results for the investors and sponsors.
- Most fund documents provide for a 10-day notice period to limited partners for capital calls.
  - This affects the investor's return on its assets because it must maintain this cash in a highly liquid account.
  - To alleviate this burden for the investor, many funds routinely borrow the amount needed to close an acquisition and then make a capital call.
  - Since the debt is incurred to acquire the investment, this course of action raises the specter that the fund has now incurred acquisition indebtedness under the first prong of the section 514 definition because the debt was incurred to acquire the investment.
Rulings on Acquisition Indebtedness

• Rev. Rul. 77-72: Indebtedness owed to a parent by its subsidiary is merely a matter of accounting and not acquisition indebtedness.

• Rev. Rul. 76-95: A tax-exempt organization acquired an interest in rental property subject to mortgage and prepaid a proportionate share of indebtedness. Though property was still encumbered by mortgage, the organization liquidated its proportionate share and secured releases of financial obligations, therefore it has no acquisition indebtedness with respect this property.

• Rev. Rul. 78-88: Income from securities lending is not acquisition indebtedness because the indebtedness was not for the purpose of making additional investments.

• PLR 200320027: A tax-exempt organization held shares in a common trust fund, with proportionate attribution of activity and borrowing. Another participant redeemed its shares and the fund covered shortfalls by drawing on a line of credit, with amounts to be repaid within 30 days. This was not acquisition indebtedness because the proceeds were not used to acquire or improve investment property and there was no close connection between the debt and any such property.

• Many rulings with similar conclusions (e.g., PLRs 200235042, 200233032, 200010061, 9644063)
Exceptions to Acquisition Indebtedness

- Exception most applicable to private funds is contained in section 514(c)(9).
- Certain debt incurred by educational institutions and their supporting organizations, qualified 401 and 403(b) plans or multi-parent title holding companies (qualified organizations) to acquire real property is not treated as acquisition indebtedness.
  - Restrictions apply, including:
    - The price for acquiring the property must be fixed at the date of acquisition.
    - The amount of the debt or other amount payable or its timing must not be dependent on revenue, income or profits of the property.
    - The property must not be leased back to the seller or a related party.
    - The property cannot be acquired from certain disqualified persons.
    - The seller, related parties or disqualified persons cannot be the providers of the financing.
- The qualified organizations exception does not apply to property acquired through a partnership unless the partnership complies with various restrictions on the property and debt imposed on qualified organizations, and one of the following applies:
  - All partners are qualified organizations.
  - Each allocation to a partner must be a qualified allocation under 168(h)(6).
  - The fractions rule applies
    - allocations must have economic effect and the partners’ share of overall partnership income for any year cannot exceed the partner’s percentage share of overall partnership loss for the taxable year for which the partners’ percentage share of overall partnership loss would be the smallest.
Shareholders of the business decided to sell one segment of the business in order to develop a different business line; the facts are as follows:

- Sole owner of company formed Plantation Patterns (New), which purchased all stock of Plantation Patterns (Old).
- Plantation Patterns (Old) sold remaining assets to former shareholders.
- Plantation Patterns (New) funded purchase with cash and several notes issued to shareholders of Plantation Patterns (Old).
- Sole owner of company guaranteed the notes, which arguably would not have been issued without him doing this. The court re-characterized the guaranteed debt as equity because the company was inadequately capitalized. T
- The debt was found to be equity regardless of the fact that it had a maturity date; substance over form was emphasized. The decision was affirmed upon appeal.
UDFI Issues for Investment Funds

- Old rules do not contemplate modern forms of investing.
- Tracing indebtedness to assets is a challenge.
- Imperfect analogy of any of the rulings to bridging capital calls in an investment fund.
- Uncertain treatment of pledges and guarantees.
  - But see Rev. Rul. 70-132 and PLRs 8008171 and 8807082
  - Non pass-through entities are often used to block UDFI, but may create other issues.