

U.S. Tax Issues Driving Private Equity Fund Structuring

July 13, 2010

Drivers for Structural Change

- ▶ FIN48 Reserves (ASC 740)
- ▶ Withholding Taxes
- ▶ U.S. Legislation
 - HIRE
 - FATCA Provisions
 - “Closing the Dividend Loophole”
- ▶ Carried Interest Proposals

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FIN 48 [now ASC 740]

- ▶ Accounting for Uncertain Tax Positions
- ▶ Fund managers realized they have tax exposure in various jurisdictions
 - Primarily local country capital gains taxes
- ▶ Many funds had to accrue tax contingencies
 - Investor relations
 - Performance
 - Dangling liabilities
- FIN 48 Insurance
- Investment Manager Indemnity

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A Primer on Treaty Access

- ▶ US has income tax treaties with most developed nations
- ▶ Cayman/Bermuda/BVI do not – “Tax Neutral Jurisdictions”
- ▶ Most treaties:
 - Allow a “look-through” to the beneficial owners of a pass through [i.e., partnership]
 - Do not look-through a corporate entity, ie Cayman Ltd.
 - Regardless of how treated for US tax purposes
 - Major exception may be Spain
- ▶ Some countries regard a US LLC as a corporate entity, i.e., not a pass through
 - However, most treaties have Limitation on Benefits Clause which, for all practical purposes, force a look-through

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Withholding Taxes

- ▶ Now that fund managers are confronted with tax contingencies, a rethink of all taxes is on the horizon
- ▶ Can I better manage withholding taxes on:
 - Interest
 - Dividends
 - Capital gains
- ▶ Benefits to both US and non-US investors
- ▶ Impact on Performance

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Significant Legislative Activity Affecting the HF Industry in 2010

	ENACTED	PROPOSED		
	HIRE/Health Care Reform	Obama	Sen. Levin/ Sen. Baucus/ Rep. Levin	Wyden
Carried Interest		X	X	
UBTI Relief			X	
CTB Reform		X		
WHT on Swaps	X			
Economic Substance	X			
Reporting: Transfers to Offshore Accounts	X			
Withholding & Information Gathering/Penalties	X			
PFIC Reporting	X			
Commodities	X - Dealers			X - Traders
Medicare Tax on Unearned Income	X			

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HIRE Act of 2010

HIRE Act of 2010

- ▶ “FAT CAT” Provisions
 - Driven by Recent IRS Activity
- ▶ Withholding on Swaps
- ▶ PFIC Reporting
- ▶ FBAR Reporting

FAT CAT: Withholding on Non-Compliant Foreign Entities

- ▶ 30% WHT imposed on “Withholdable Payments” to foreign entities that fail to comply with reporting requirements under an Agreement with IRS
- ▶ “Withholdable Payments include:
 - Any US-source FDAP [interest, dividends, etc.]
 - Gross proceeds from sale of any property which can produce US-source interest or dividends
 - Applies even where treaty or PIE relief would normally apply
- Withholding Agent includes any person having control, receipt, custody or payment of any withholdable payment

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FAT CAT: Foreign Financial Institution

- “Foreign Financial Institutions” subject to extensive reporting requirement
 - Includes foreign entities engaged primarily in investing or trading securities, commodities, partnerships, or any interested in such [including a future, forward or option]
 - Thus, applies to offshore HF & PE

FAT CAT: Excluded Recipients

- ▶ Withholding does not apply to extent beneficial owner of a payment is:
 - A foreign government
 - An international organization
 - A foreign central bank of issue
 - Any other class of person identified by Secretary as posing a low risk of US tax evasion

FAT CAT: FFI Agreement

The Foreign Fund Must Agree to:

1. Obtain information to determine which holders are US Accounts
 - “Recalcitrant Account Holders”
2. Comply with verification and due diligence procedures on such accounts as required by Treasury
3. Report annually: US account holder identity, account number, balance [or value], & gross receipts from/payments to holder [other than US tax exempts]
4. Deduct and withhold the 30% tax on payments to recalcitrant account holders and electing FFI's
5. Comply with requests from Treasury for additional information
6. Where foreign law would prevent such reporting, to close the account if a valid waiver of the law cannot be obtained from account holder

FAT CAT: FFI Agreement

- ▶ Alternative – In lieu of annual reporting and withholding on recalcitrant account holders, FFI can elect to provide full 1099 reporting for each US account
 - As if US holder were a natural person & US citizen
 - Eliminates need to report account balance or value, and gross receipts/payments

FFI Election Out of Withholding

- FFI may choose not to act as a withholding agent
- FFI may elect to have a U.S. withholding agent or a lower tier FFI that entered into an agreement with the U.S. Treasury withhold on payments made to the electing FFI
- If the election is made, withholding will apply to any payment made to the electing FFI for:
 - Payments allocable to accounts held by FFIs not entering into an FFI agreement, or
 - Payments to recalcitrant account holders
- Electing FFI waives any right under a treaty with respect to an amount deducted and withheld pursuant to the election

FAT CAT: US Accounts

- ▶ The term “US Account” means any “Financial Account” which is held by one or more Specified US persons or US owned foreign entities
 - Excludes accounts held by natural persons of < \$50k
 - “Specified US Person” excludes: Public Companies, Tax Exempts, IRAs, US, State & Local, Banks, RICS, REITS, Common Trust Funds, Certain Trusts
- ▶ “Financial Account” of an FFI includes:
 - Any depository or custodial account with such FFI
 - Any equity or debt interest in such FFI, unless regularly traded on established securities market

FAT CAT: Open Questions

- ▶ What will be exact form of certification of non-US status?
- ▶ How will FFI Agreement be Administered?
- ▶ How will the due diligence and verification requirements be met?

“Closing the Dividend Loophole”

- ▶ Coordination of rules for “dividend equivalents” and “substitute dividend payments”
- ▶ Payments with regard to one or more US stocks sourced to US
 - Basket swaps
- ▶ Payments characterized as dividends including for treaty purposes

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“Closing the Dividend Loophole “ Effective Dates

- ▶ For payments made after 3/18/2012, applies to all NPCs
- ▶ For Payments made between 9/14/2010 and 3/18/2012, applies only to “Specified NPCs” – a contract which has one of the following:
 - “Long Party” sold to “Short Party”
 - “Short Party” sold to “Long Party”
 - Underlying not readily tradable
 - “Short Party” posts security as collateral with “Long Party” or
 - Any other NPC identified by Treasury

UBTI Relief Proposal

- ▶ Tax exempts subject to UBTI
- ▶ Relief for debt-financed securities transactions
 - No relief proposed for trade or business income
- ▶ Re-proposed by Rep. Levin in March, 2010

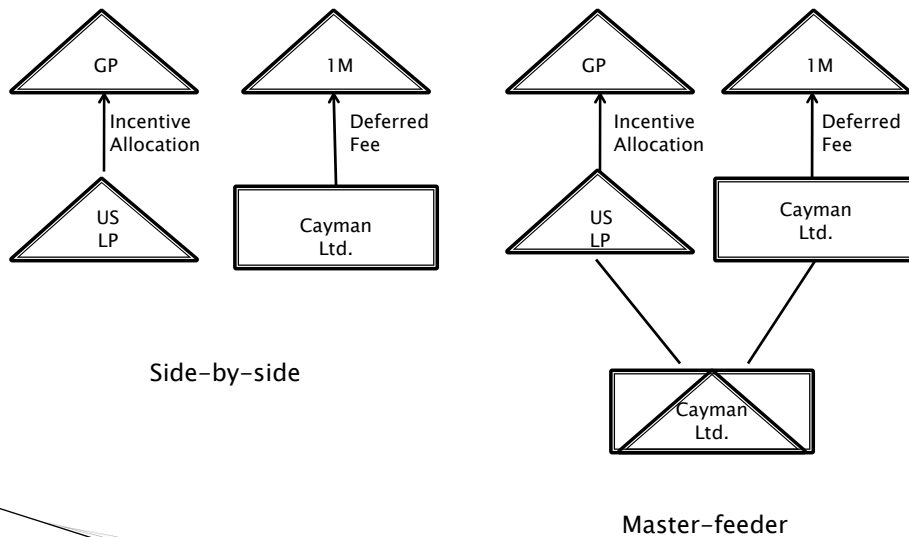
Carried Interest Proposal – HR 4213

- ▶ Recharacterization of “Carry”
 - At Fund Level
 - At Individual Level – 50% Until 2013, 75% Thereafter
 - Distributions of Securities – Taxable; Treated as Money
 - Dispositions of Partnership Interests
 - Losses Limited to Prior Inclusions, Carryforward
 - Subject to Self-Employment Taxes Regardless of Entity
- ▶ “Investment Services Partnership Interest”
- ▶ “Qualified Capital Interest” = Contributions + Previously Taxed Capital
 - Loans from Partnership or Nonservice Partners not QCI
- ▶ Senate considering similar provision
 - Possible VC Exception

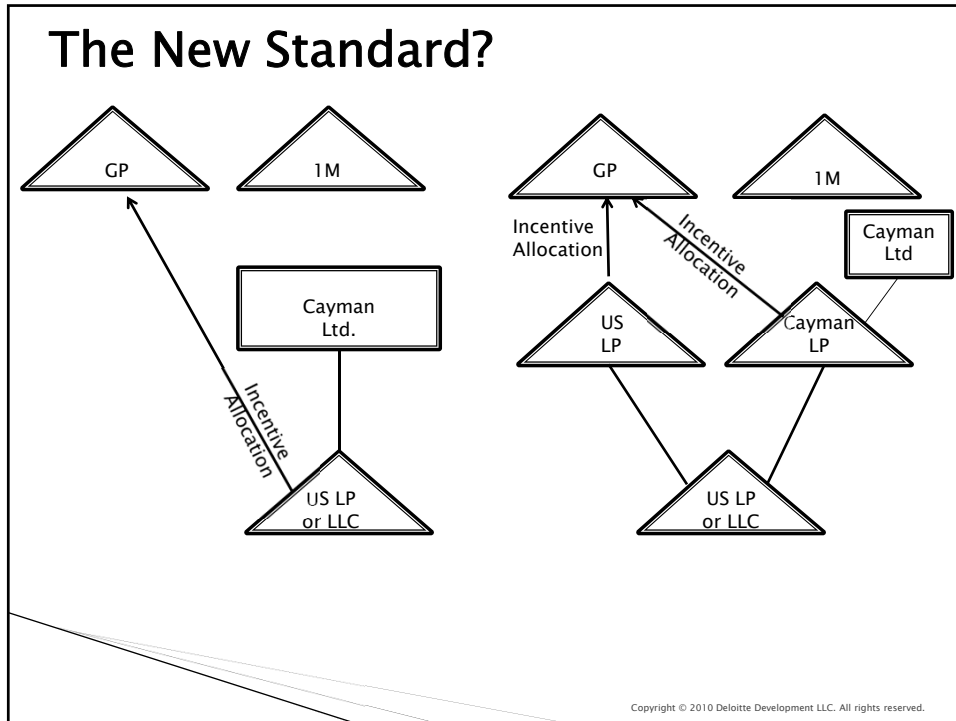
Carried Interest – Potential Planning Ideas

- ▶ Pre-Effective Date
 - Accelerate Gains
 - Fiduciary Issues for GP
 - Sale of GP Interest
 - Distribution of Securities
- ▶ Post-Effective Date
 - Seeders
 - Third Party Loan Secured by Partnership Interest?
 - Manage PFIC
- ▶ Penalty Regime – 40%

The Old Standard



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Impact of Changes

- ▶ Operations
- ▶ Administration
- ▶ Regulation
- ▶ Reporting
- ▶ What does all of this mean for the private equity & hedge fund industries?
 - Cayman, Bermuda, BVI
 - Ireland, Luxembourg

Contact Information

Sarah Davidoff, Partner
sadvidoff@stroock.com
212.806.5578 Office
646.400.1103 Mobile

Caroline Williams, Co-Head of Private Equity Group,
Walkers
Carolinewilliams@walkersglobal.com
345.914.6432 Office
345.925.7186 Mobile

Ted Dougherty, National Hedge Fund Tax Leader, Deloitte
edwdougherty@deloitte.com
212.436.2165 Office
908.553.8903 Mobile