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Advanced Tax Strategies in Structuring Private Equity and Real Estate Investment Funds: Balancing Competing Interests

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Advanced Tax Strategies in Structuring Private Equity and Real Estate Investments

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AGENDA

- Certain Tax Considerations
- Fund Entities
- Typical Fund Structures
- Real Estate Fund Structures
- Credit Fund Structures
- Hot Topics

CERTAIN TAX CONSIDERATIONS

ECI

- "Effectively Connected Income" ("ECI") is income that is effectively connected with a trade or business in the United States (a "U.S. trade or business")

- If a non-U.S. person recognizes ECI or is otherwise treated as engaged in a U.S. trade or business, such non-U.S. person is required to:
  - file U.S. federal income tax returns; and
  - pay U.S. federal income tax on such ECI at regular tax rates
    - Non-U.S. corp. may have to pay U.S. 30% "branch profits" tax (possibly reduced or exempt under applicable income tax treaty)

- ECI typically includes operating income from a pass-through entity conducting a U.S. trade or business
  - Partners in such pass-through entity are deemed engaged in a U.S. trade or business
  - Gain on sale of an interest in such pass-through entity can be treated as ECI
  - Tax on ECI may be collected through withholding mechanism

ECI

- Typical ways to address ECI concerns for non-U.S. investors:
  - Holding a pass-through investment through an entity that is treated as a corporation for U.S. federal income tax purposes (a “Blocker”)
  - Imposing contractual obligations or operations guidelines to prevent the fund from being treated as engaged in a U.S. trade or business

892/CAI

- Section 892: Non-U.S. governments (including their controlled entities) can qualify for the exemption from U.S. federal income tax on certain types of income from investments in securities
  - Interest, dividends, annuities, etc., and gains on sale
  - Particularly useful for non-U.S. governments that do not have a tax treaty with the U.S.
- Note that a gain from the sale of stock of a USRPHC is exempt from tax under this section (as long as such USRPHC is not a controlled entity)
  - This may create a dis-alignment of interest from other non-U.S. investors
- Section 892 does not exempt income from the conduct of a commercial activity ("CAI")
  - E.g., owning an unblocked interest in an operating partnerships can cause a non-U.S. governmental investor to be treated as engaged in a commercial activity or otherwise recognize CAI
- If a "controlled entity" of a foreign sovereign is treated as engaged in a commercial activity either in the United States or outside of the United States, such controlled entity can lose its Section 892 exemption

UBTI

- Generally, a tax-exempt organization is exempt from U.S. federal income tax on its passive investment income

- The general exemption from tax does not apply to "unrelated business taxable income" ("UBTI"), which is any gross income derived by a tax-exempt entity from an unrelated trade or business that it regularly carries on, less the deductions directly connected with that trade or business

- UBTI also includes any income derived from property subject to "acquisition indebtedness" ("UDFI")

- Certain common activities of investment funds resulting in UBTI/UDFI:
  - Investments in operating businesses structured as pass-through entities
  - Borrowings by the fund (e.g., subscription lines) or its pass-through subsidiaries to make investments

FIRPTA

- In general, non-U.S. persons generally do not pay U.S. tax on disposals of capital assets
- However, FIRPTA imposes a tax on gains ("FIRPTA Gains") realized from the disposition of a "U.S. real property interest" ("USRPI")
- USRPI includes:
  - Interest in U.S. real estate directly or indirectly through pass-through entities
  - Interests in a "U.S. real property holding corporation" ("USRPHCs")
  - Other direct or indirect rights to share in proceeds, appreciation or profit of U.S. real estate
- FIRPTA Gains are treated as ECI pursuant to Section 897
  - However, FIRPTA Gains do not necessarily cause the person recognizing such gains as being engaged in a U.S. trade or business.
- U.S. Blockers are frequently used to hold interests in U.S. real estate assets, which may generate both ECI and FIRPTA Gains.
- Note, however, that a U.S. Blocker itself may be a "USRPHC" which would trigger FIRPTA Gains if the stock of the U.S. Blocker is sold

QFPF

- "Qualified foreign pension funds" ("QFPFs") are exempt from FIRPTA
  - A QFPF is an entity or arrangement established to provide retirement or pension benefits and satisfying certain other conditions
- However, QFPFs are not otherwise exempt from ECI
- An entity that is exclusively owned by one or more QFPFs is also eligible for the QFPF exemption

PFIC

- Passive foreign investment company ("PFIC") is a foreign corporation that has (i) 50% or more passive assets or (ii) 75% or more passive income
  - Look-through rule allows a tested foreign corporation to look through a subsidiary in which such corporation owns at least 25% interest
- A U.S. partner in a fund that owns a PFIC may be subject to certain annual reporting requirements and its share of income with respect to such PFIC may be subject to (i) an interest charge with respect to deferred tax liabilities and (ii) character conversion
- Qualified Electing Fund ("QEF") Election - New Proposed Regulations
  - A U.S. partner, rather than the U.S. partnership, can make a QEF election (and file Form 8621) in respect of PFIC held by the partnership
  - A U.S. partner is required to notify the partnership of its election in order to assist the partnership with information reporting
  - Each partner would include its pro rata share of ordinary earnings and net capital gains attributable to the QEF stock as if such person owned its share of the QEF stock directly

CFC

- Controlled foreign corporation ("CFC") is a foreign corporation where more than 50% of the foreign corporation is owned by "U.S. shareholders"
  - "U.S. shareholder" is a U.S. person that owns directly or indirectly 10% or more vote or value
  - Limited attribution rules for purposes of determining the "U.S. shareholder" status
  - If a foreign corporation is treated as a CFC, its "U.S. shareholders" are required to recognize Subpart F income and "global intangible low-taxed income" or "GILTI" income
  - Also, all or a portion of exit gains on the sale of stock of such CFC will be recharacterized as dividend income under Section 1248

- Structuring options to avoid CFC:
  - Changes to attribution rules pursuant to TCJA made it practically difficult to avoid the CFC status with respect to the fund's foreign portfolio companies
  - However, still a non-U.S. fund entity may be suitable for non-U.S. investments, not to avoid the CFC status, but to avoid Section 1248 re-characterization

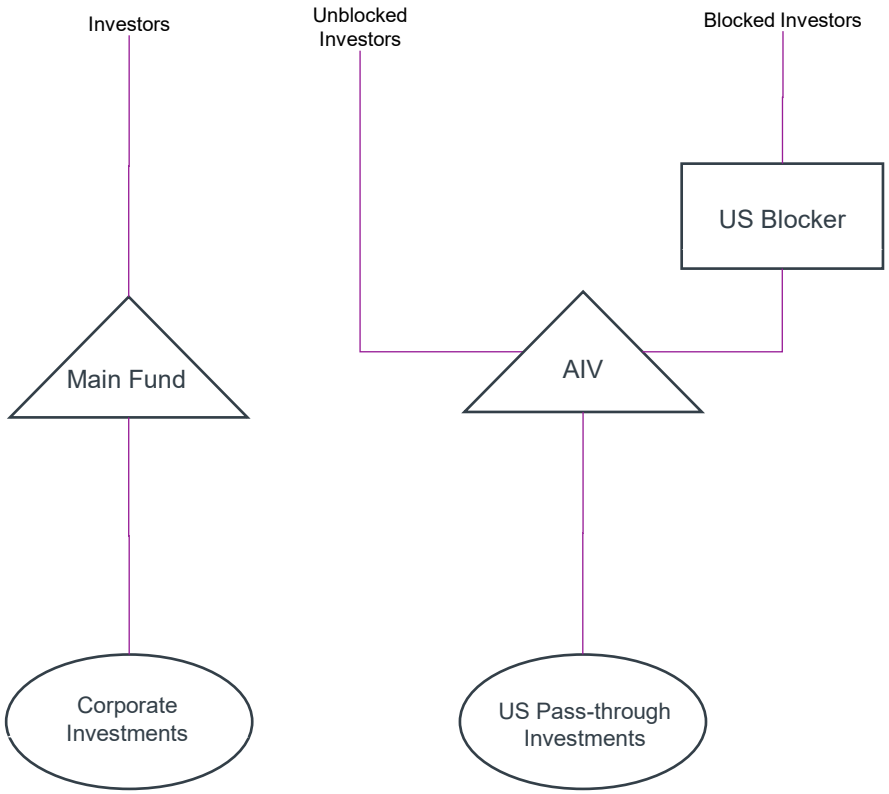
FUND ENTITIES

Fund Entities

- Fund
- Feeder Fund
- Alternative Investment Vehicle
- Parallel Fund
- Blocker
- Carry Vehicle (e.g., Special Limited Partner and GP Vehicles)
- Aggregator

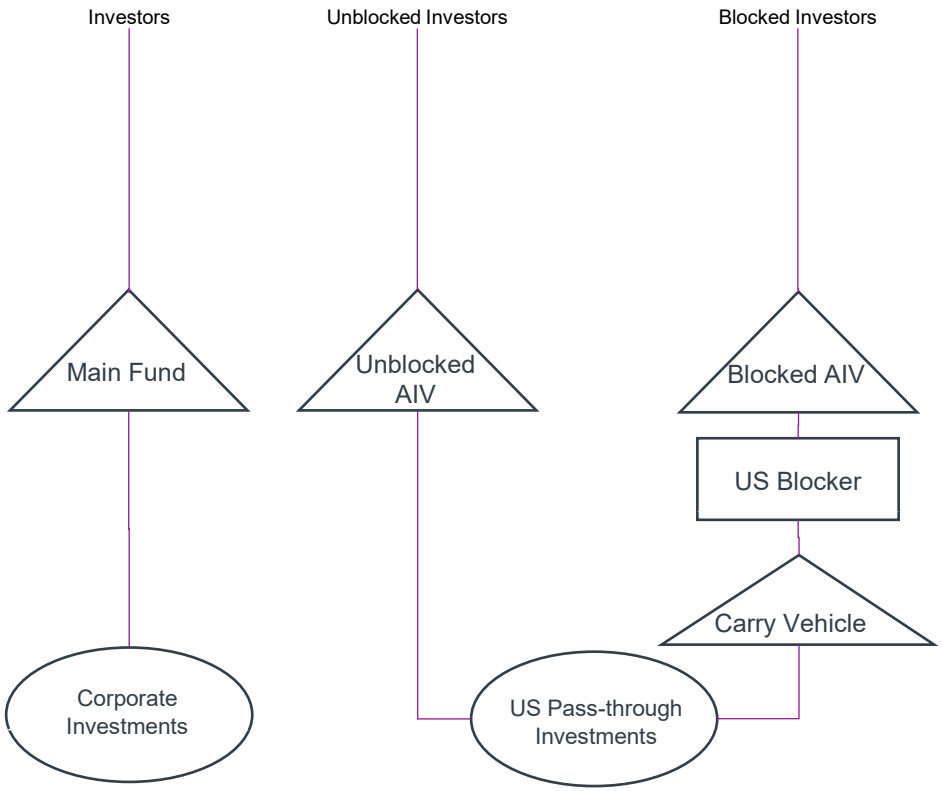
TYPICAL FUND STRUCTURES

Main Fund/AIV Structure – Blocker Above AIV



1. US Pass-through Investments to be made by an AIV in lieu of the Main Fund
2. To address ECI/UBTI/CAI concerns, an asset specific US Blocker will be established to hold an interest in a US Pass-through Investment
3. US Blocker is interposed between the blocked investors and the AIV
4. This AIV structure will allow unblocked investors to avoid the blocker level tax leakage
5. If the Fund plans to exit the investment by way of selling stock of the US Blocker, certain complicated pre-sale restructuring may be required
6. For purposes of carry calculations, the performance of the Main Fund investments and the AIV investments will be aggregated

Main Fund/AIV Structure – Blocker below AIV



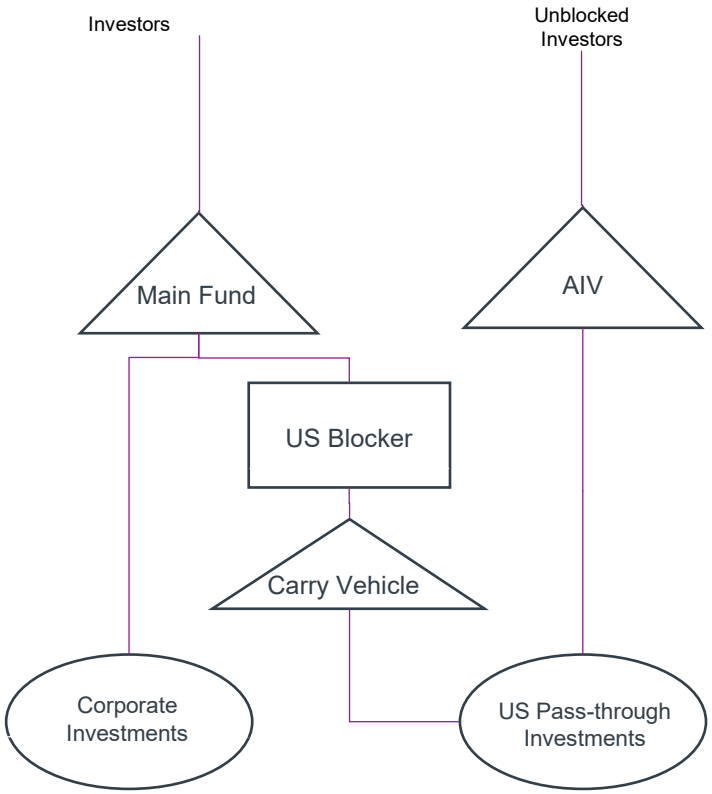
1. US Pass-through Investments to be made by one or more AIVs in lieu of the Main Fund

2. To address ECI/UBTI/CAI concerns, an asset specific US Blocker will be established below one of the AIV (a "Blocked AIV")

3. US Blocker will hold an interest in a US Pass-through Investment through a carry partnership (a "Carry Vehicle") that is structured as a partnership for U.S. federal income tax purposes. This Carry Vehicle is intended to allow the carry recipients to receive carry on an unblocked basis.

4. This structure allows the Fund to sell the US Blocker stock without complicated pre-sale restructuring

Main Fund/AIV Structure – Other Variation

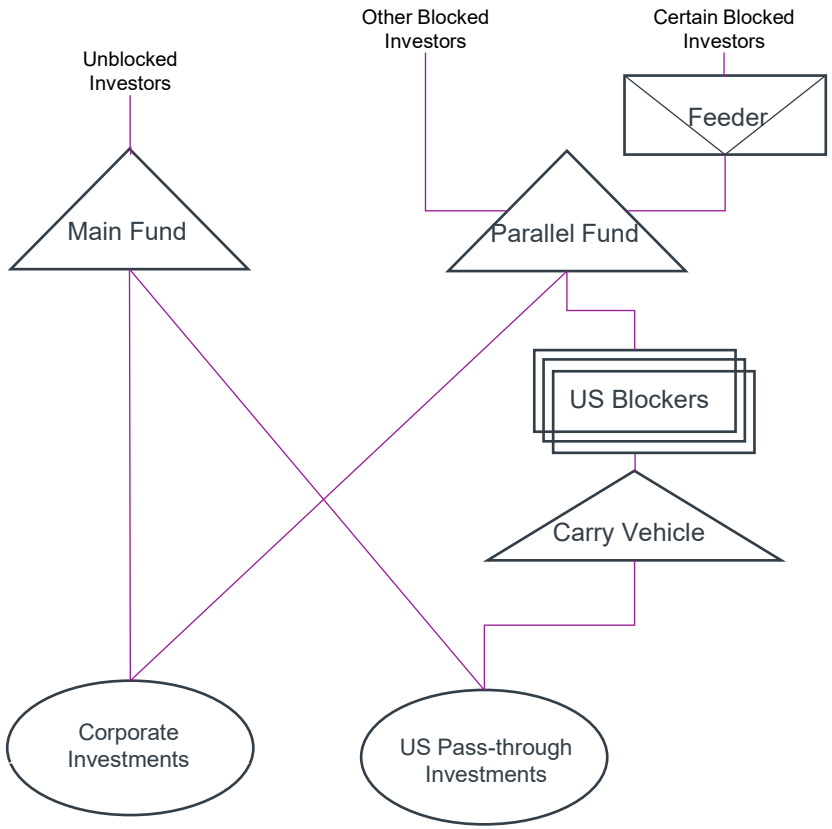


1. US Pass-through Investments to be made in part by the Main Fund through one or more US Blockers, and in part by an AIV on an unblocked basis

2. This structure allows the Fund to sell the US Blocker stock without complicated pre-sale restructuring

3. One less entity as compared to the prior variation, but this structure would require a tracking arrangement to be implemented in the Main Fund documents

Parallel Fund



1. The Main Fund will be for unblocked investors and will make both corporate and US Pass-through Investments on an unblocked basis

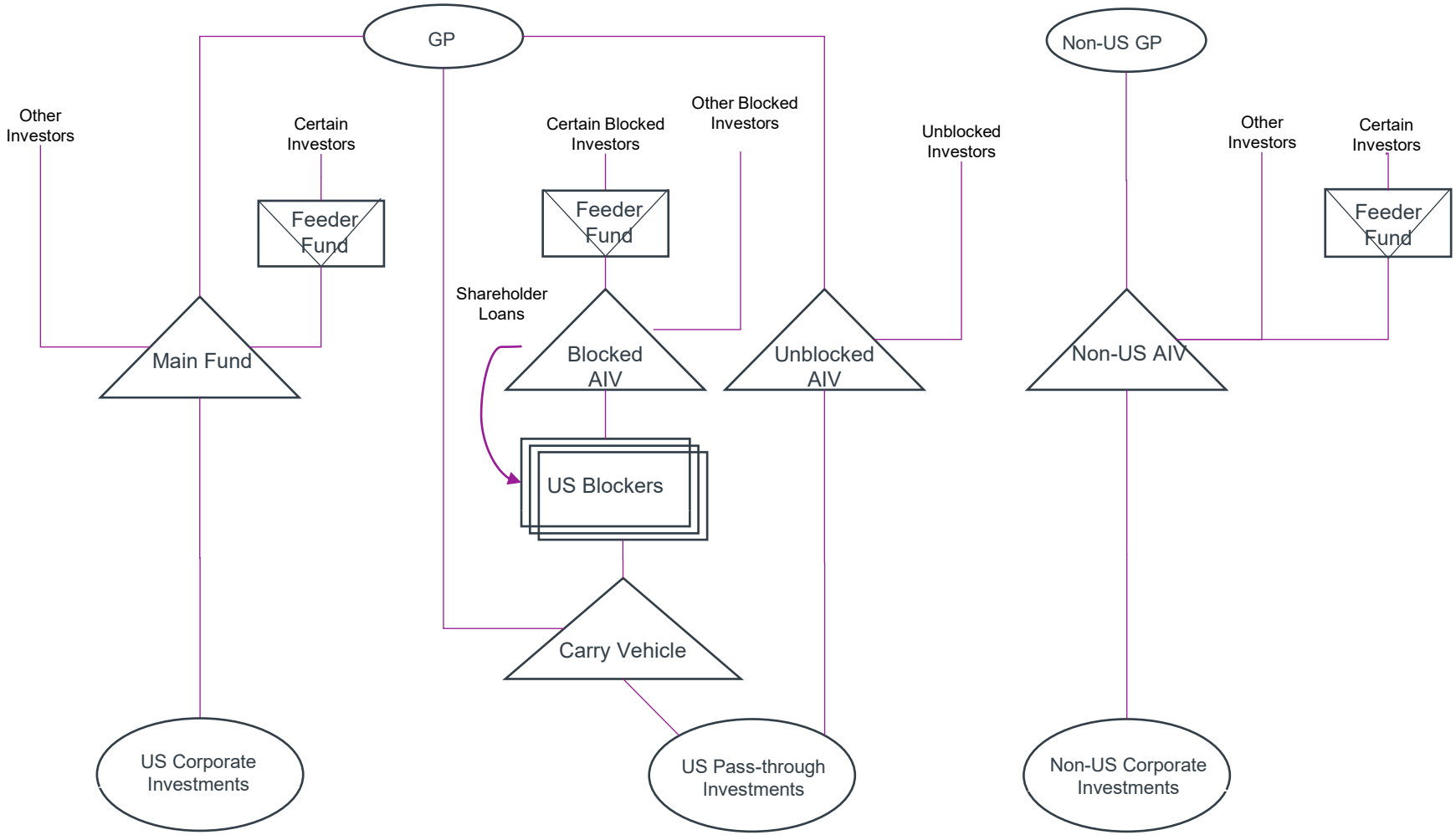
2. A parallel fund (the "Parallel Fund") is offered to ECI/UBTI/CAI-sensitive investors

3. To address ECI/UBTI/CAI concerns, the Parallel Fund will make US pass-through investments through one or more asset specific US Blockers

4. To address UDFI concerns (if the Fund plans to borrow to make certain investments) or to provide additional protection against ECI/CAI, a feeder ("Feeder") may be established

5. The Feeder is typically structured as a reverse hybrid entity to preserve any available treaty benefits

Example of a Fund Complex

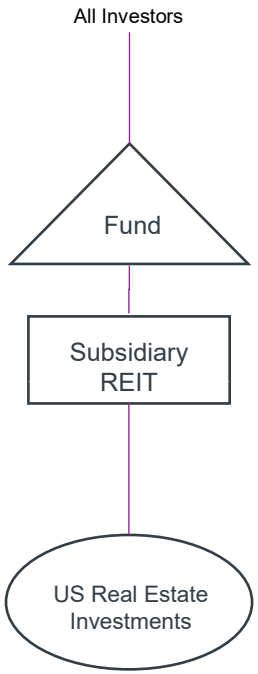


REAL ESTATE FUND STRUCTURES

Real Estate Funds Considerations

- What is a REIT?
  - A preferential tax vehicle that can be used to invest in U.S. real estate provided certain ownership, distribution and operational requirements are met
  - Restricted to holding and operating REIT qualifying assets (e.g., office, residential buildings, cold storage, hotels, senior housing, etc.; not condo).
- Benefits of using a REIT in a Real Estate Fund
  - A "blocker" without an entity level tax
  - Can be used to convert ECI/UBTI rental income into dividend income
  - REIT ordinary dividends (<50% ownership) qualifies for 892 benefits
  - Sale of shares in a "domestically controlled" REIT is not subject to FIRPTA withholding
- Disadvantages of using a REIT in a Real Estate Fund
  - Increased formation and operational complexity (e.g., use of taxable REIT subsidiaries) and compliance cost
  - Unlike a partnership structure, losses do not flow up from a REIT to its stockholders
  - It is not a perfect blocker

Simple Subsidiary REIT Structure



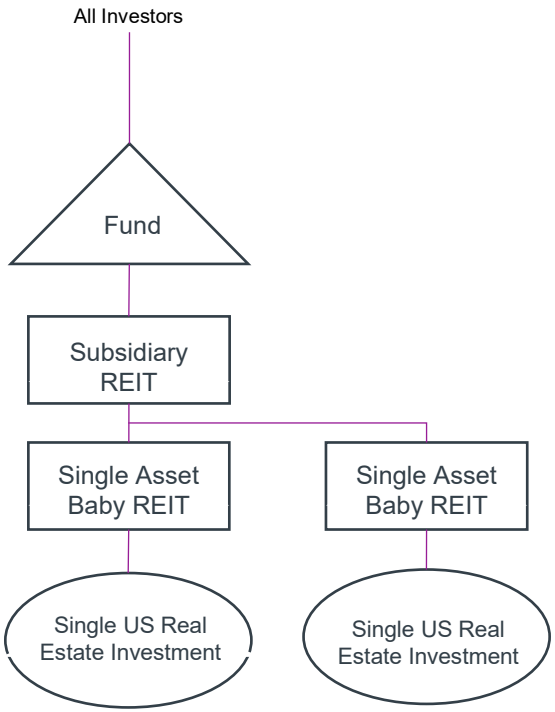
1. Simple structure suitable for forever hold real estate assets

2. The Fund is typically set up as a partnership for U.S. federal income tax purposes

3. To address ECI/UBTI/CAI concerns for certain investors, all U.S. real estate investments will be made through a Subsidiary REIT. The Subsidiary REIT has no tax leakage. The Subsidiary REIT serves as a UBTI/ECI/CAI blocker.

4. However, the Subsidiary REIT is only effective in blocking ECI/CAI until there are sales of US real property that result in capital gain dividends to the non-US investor

More Complex Subsidiary REIT Structure



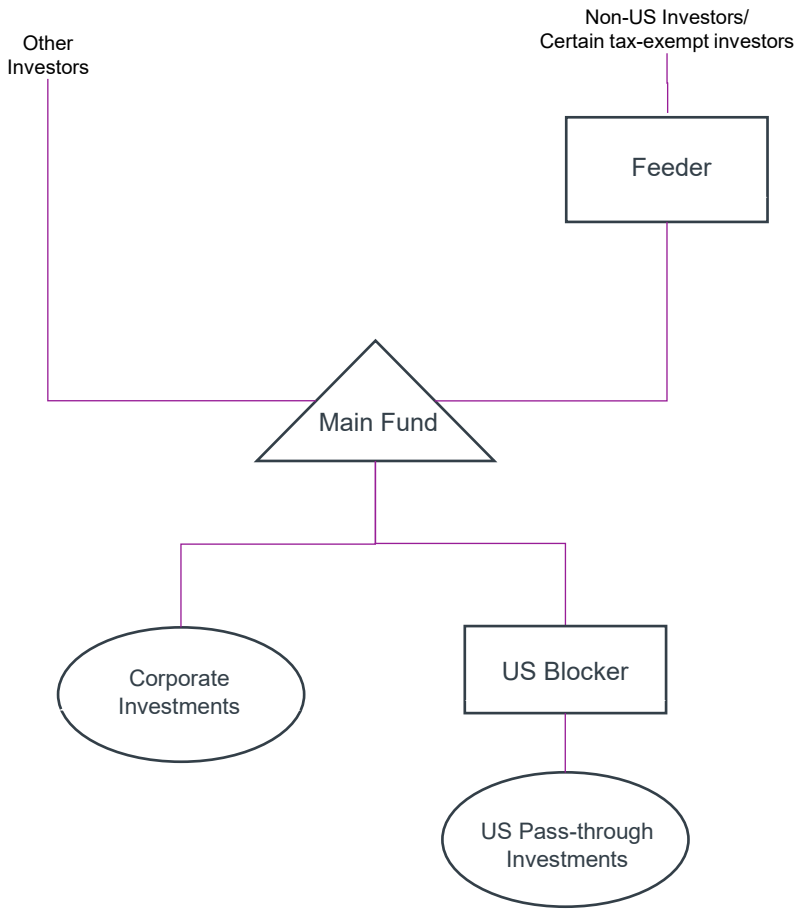
1. A more complex structure to facilitate real estate sales
2. The Fund is typically set up as a partnership for U.S. federal income tax purposes
3. To address ECI/UBTI/CAI concerns for certain investors, all U.S. real estate investments will be made through a Subsidiary REIT. The Subsidiary REIT has no tax leakage. The Subsidiary REIT serves as an ECI/CAI/UBTI blocker.
4. Each US real estate investment is held in its own baby REIT to facilitate ease of exit as a baby REIT stock sale instead of as a fee simple sale
5. If less than 50% of the REIT is owned by non-US persons (i.e., a "domestically-controlled REIT"), the sale of the baby REIT stock is exempt from taxation for non-US investors

CREDIT FUND STRUCTURES

Credit Fund Tax Considerations

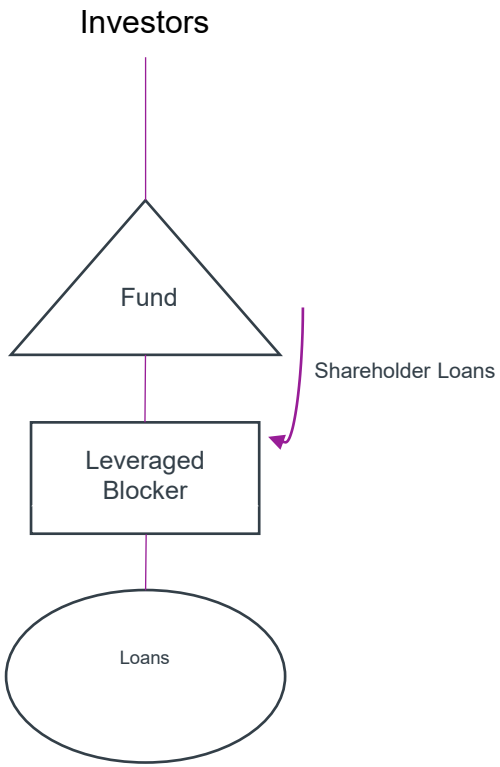
- U.S. tax considerations – ECI
- Securities trading safe harbor
- De minimis origination
- Common structures

Master-Feeder Structure



1. Simple structure typically adopted for hedge funds
2. The Main Fund is typically set up as a partnership for U.S. federal income tax purposes
3. To address ECI/UBTI/CAI concerns for certain investors, U.S. pass-through investments ("US Pass-through Investments") will be made through a U.S. entity that is treated as a corporation for U.S. federal income tax purposes (a "US Blocker). The blocker level tax leakage will be borne by all investors.
4. Certain ECI/CAI sensitive investors may request the fund to set up a non-U.S. feeder (the "Feeder") that will elect to be treated as a corporation for U.S. federal income tax purposes to provide additional protection against ECI/CAI
5. If the Main Fund plans to borrow to make investments, certain tax-exempt investors may also wish to invest through the Feeder to address UDFI concerns
6. The blocker level tax leakage will be borne by all investors

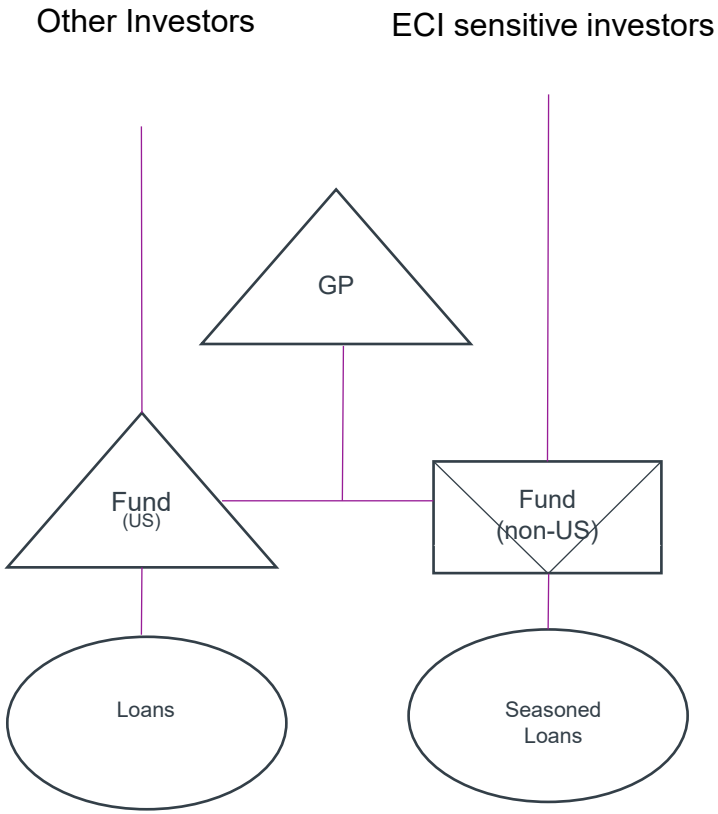
Leveraged Blocker Structure



1. Blocker is a corporation

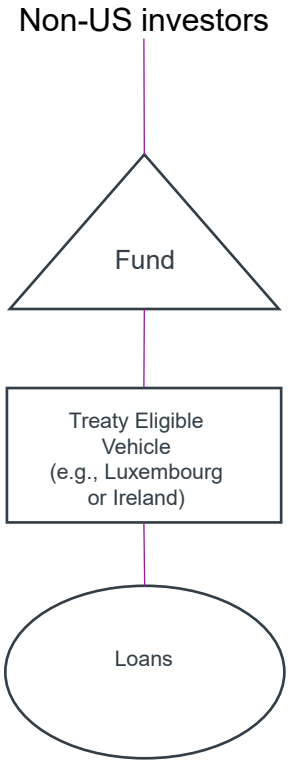
2. Interest and dividends subject to 30% WHT. Interest may qualify for portfolio interest. Dividends WHT may be reduced by treaty.

Season and Sell Structure



1. Loan origination by US fund and held for seasoning period
2. Non-US fund may purchase loan at FMV

Treaty Structure



1. US manager originates loans on behalf of Treaty Eligible Vehicle
2. US manager should be an independent agent of the Fund
3. Treaty Eligible Vehicle is a resident of treaty jurisdiction and further satisfies a LOB provision

HOT TOPICS

Subsequent Closings

- Funds typically adopt a mechanism to true up investors investing on day one and investors investing through subsequent closings

- Subsequent closing is typically structured and reported as a disguised sale of an interest in a fund from existing partners to the incoming partners.

- Notional interest amount charged to incoming partners reported as part of the amount realized

- No need to adjust/re-allocate fund income among partners in connection with a subsequent closing. Incoming partners will simply inherit the existing partners' capital accounts and other notional accounts (e.g., contribution accounts)

- In certain cases, special arrangement or structuring may be necessary to avoid withholding obligations under Sections 1445/1446(f)

- To avoid such withholding issues with respect to the disguised sale of a fund interest, certain funds retain the capital contributions from income partners. However, notional interest amount will typically be paid back to the existing partners.

- Subsequent closing will be then reported as capital contributions of incoming partners and distributions or other payments to existing partners

SEC Proposal

- SEC issued proposed rules on February 9, 2022

- Market practice today limits claw back from the GP to the actual aggregate carry distributions reduced by taxes paid or deemed paid by the carry recipients

- SEC proposal would eliminate this after-tax claw back limitations, which may result in the carry recipients bearing the tax liabilities for income that would be clawed back

Carried Interest

- Typically structured as a profits interest received by the general partner
- To preserve preferential tax rates applicable to capital gains, carry waiver mechanics may be implemented (Section 1061)
- Investment professionals will typically receive a “profits interest” granted by the general partner (rather than by the Fund) based on carried interests received by the general partner from the fund
- Such profits interest is typically subject to vesting conditions, and may be subject to a hurdle amount that is set up to ensure that such interest is treated as a “profits interest” within the meaning of Rev. Proc. 93-27
- Separating out the tax persons that hold the carried interest and the capital interest

Tax Reform

- Tax reform is currently uncertain and therefore it is difficult to evaluate what tax provisions will ultimately be enacted and their impact on fund structuring
- Same rate for ordinary income and capital gains?
- Increase in corporate tax rate?
- Increase in top marginal individual income tax rate?
- Wyden's Subchapter K reform, if enacted, would severely limit the flexibilities of Subchapter K under current law and could have a material impact on fund structuring