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Equity Investments in Pass-Through Entities: Investment Structures, Tax Ramifications

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Today's faculty features:

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EQUITY INVESTMENTS IN PASS-THROUGH ENTITIES: INVESTMENT STRUCTURES AND TAX RAMIFICATIONS

Strafford Webinar

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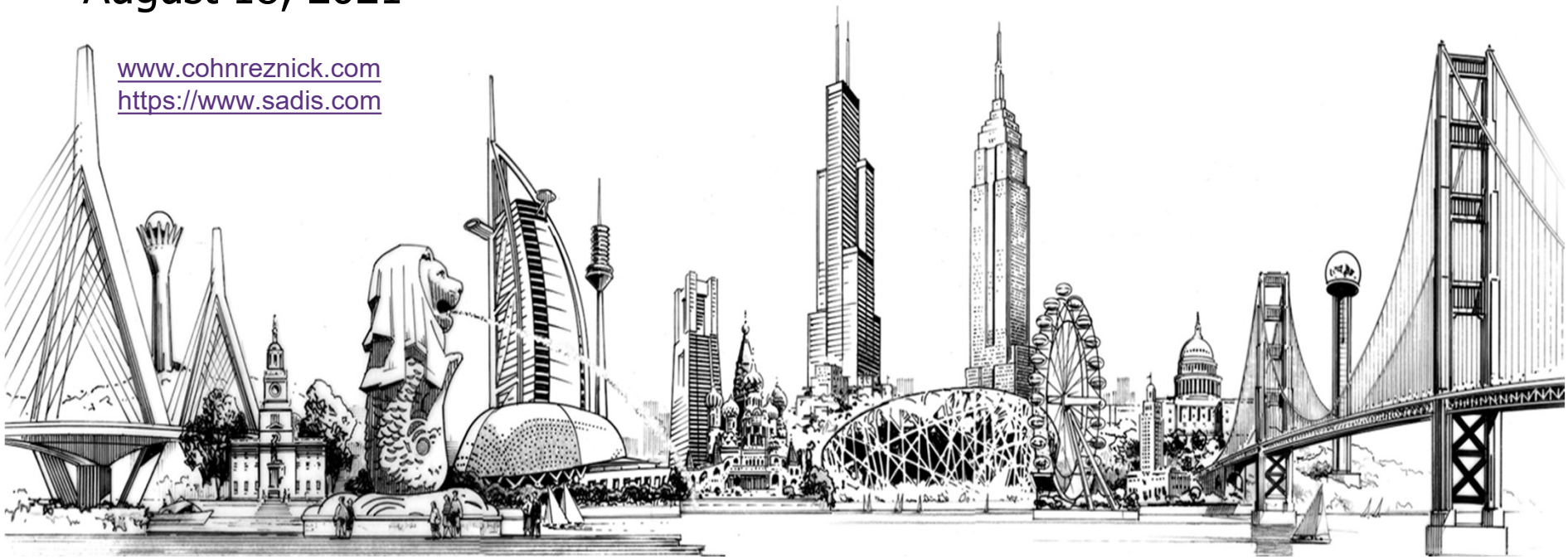


Agenda

- Advantages & Disadvantages of Pass-Through Entities as Portfolio Companies
  - Comparison of Pass-Through Entities to C Corporations
- Special Tax Issues
  - Basis Step-Up
  - Profits Interests
  - Tax Distributions
  - Considerations for Tax-Exempt and Foreign Investors

Advantages of LLCs As Portfolio Companies

- Basis step-up
  - Provides a tax shield for operating income going forward
    - This can either enhance entity cash flows or reduce effective tax on distributions of operating income.
  - Ability to provide a subsequent purchaser with a basis step-up, thus enhancing purchase price.
    - Consider depreciation recapture.
    - Reduction in corporate tax rates from Tax Cuts and Jobs Act ("TCJA") of 2017 reduced value of step-up.
- Tax-Free Distributions
  - Single layer tax
  - Outside basis for entity debt allows for tax-free leveraged recapitalizations.
- Flexibility for structuring management rollovers
- Optimize tax treatment for management incentives
- Ability to waive fiduciary duties and corporate opportunities requirement with respect to minority holders

Disadvantages of LLCs as Portfolio Companies

- Increased tax compliance burden
  - K-1s issued to all investors
  - Fund and investor level state and local tax returns may be required
  - Tracking tax basis
  - Timing and use of estimates
  - SMLLCs might have alternative State and Local tax filing obligations
- Character upon disposition
  - Ordinary income for depreciation recapture, inventory, receivables.
- COD Issues in LLC Workouts
  - Because insolvency and bankruptcy are generally determined at the partner level, investors can be surprised by taxable "cancellation of debt" income associated with the write off or forgiveness of LLC debt.
- Complex structures for funds with UBTI/ECI sensitive investors
- Higher individual tax rates on operating income than corporate income tax rate
  - TCJA reduced US federal corporate income tax rate from 35% to 21%, with a smaller reduction from 39.6% to 37% for individuals.
  - Section 199A can reduce individual effective tax rate to 29.6%
  - Individuals subject to 20% tax on dividends from corporation, versus generally no tax on distributions from LLC.
- Potential for phantom taxable income for owners
- Potential state tax compliance considerations in an asset sale

Common Uses and Alternatives

- Various forms of legal entity can qualify for US federal income tax treatment as a partnership, and thus a pass-through entity.
  - These include limited partnerships (LPs) or limited liability companies (LLCs) organized under US law.
  - These also include many non-US entities that are by default or a "check-the-box" election permitted to be treated as partnerships for US tax purposes.
- There are other forms of entity that have pass-through features for US tax purposes, but also extra limitations.
  - US corporations can elect S corporation status and generally not be subject to entity-level tax. Unlike a partnership for tax purposes, S corporation ownership is generally limited to US individuals, only one economic class of stock is permitted, and distributions of appreciated property can trigger taxable income, among other disadvantages.
  - Other forms, such as REITs and RICs, have limitations in terms of permitted assets or activities.

Common Uses and Alternatives (continued)

- Pass-through entities are often used in the following scenarios, among others:
  - To permit a purchaser of less than 80% of an S corporation to get a stepped-up tax basis in the S corporation's assets, while permitting the S corporation's owners (through the S corporation) to preserve their pass-through treatment, the S corporation may transfer its assets to an LLC or other pass-through entity, as the operating vehicle going forward.
  - Two parties may wish to form a joint venture, with one or both parties contributing assets, providing services or providing cash, and with various alternatives in terms of sharing of profits, losses and proceeds from operations and on disposition.
  - A private equity fund or other investor in purchasing a corporation may wish to establish an LLC or other pass-through entity as a holding vehicle, permitting flexible economics, a control vehicle, and the ability to grant profits interests as a compensation incentive (discussed below).
- Planning devices can include the following:
  - Partnership freeze structure—a non-pass-through party contributes assets to a pass-through entity and receives in exchange an interest of equal value that largely consists of a preferred but limited interest in capital and future appreciation (so that appreciation that exceeds the rights of the preferred interests goes to the other owners).

Common Uses and Alternatives (continued)

- Leveraged partnership structure—the pass-through entity borrows funds, on a recourse or non-recourse basis with respect to its owners, and distributes the proceeds.
- Mixing bowl partnership—two or more businesses are combined by two or more parties in one pass-through entity, with different parties holding disproportionate interests in each business.
- Up-C structure—as an exit, an IPO corporation becomes an equity owner of the pass-through entity. Other owners can exchange their interests in the pass-through entity for IPO stock, up front or over time. Resulting tax benefits may result in payments to the existing owners.

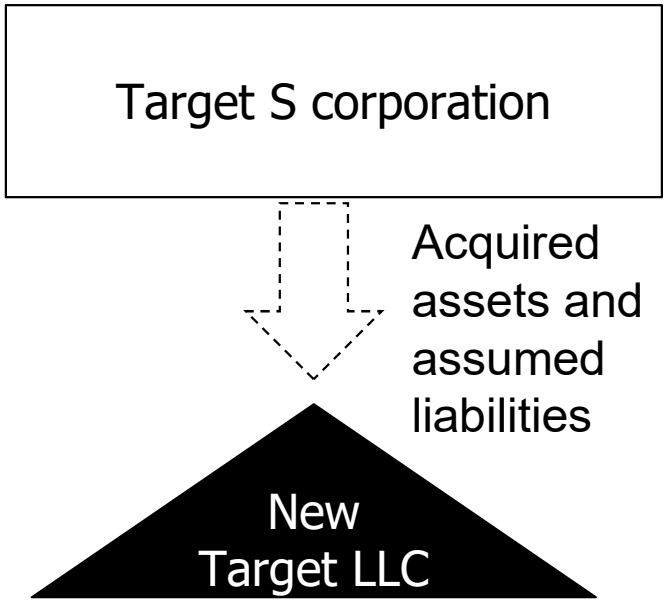
LLC vs. C-Corp

Issue	Pass-Through Structure	C-Corporation
Effective Tax Rate on Distributed Income (including 3.8% Net Investment Income Tax):	33.4% to 40.8% (depending on applicability of "qualified business income" deduction)	39.8%
Effective Tax Rate on Undistributed (i.e. Reinvested) Income	33.4% to 40.8% (depending on applicability of "qualified business income" deduction)	21%
Basis Build-Up	Flow-through income increases tax basis in LLC interests, reducing gain on sale. (Does not apply to the extent blocker corp. stock is sold.)	Cost basis of shares of stock is not adjusted for corporate income.
Basis Step-Up	Subsequent buyer can obtain basis step-up. (Does not apply to the extent blocker corp. stock is sold.)	No basis step-up for subsequent purchaser.
State Taxes	K-1s issued to investors with resulting return obligations in each state where the target does business.	Target files its own state tax returns with no nexus created for investors.
Leveraged Dividend	Can be done on a tax-deferred basis.	Taxable dividend to the extent of earnings and profits.
Tax on Sale	Primarily long-term capital gain, but some ordinary income for depreciation recapture.	All long-term capital gain.
Incentive Equity	Profits interests can be used to provide long-term capital gain on exit.	Options are commonly used—ordinary income on exit. Sometimes restricted stock can be structured to approximate "profits interest" treatment with long-term capital gain on exit.
Add-on acquisitions	Can offer tax-deferred rollover to subsequent sellers.	More difficult to provide tax-deferred rollover in subsequent acquisitions.
IPO	"Up-C" structure can be used to obtain basis step-up for public company (which can be monetized by legacy investors via Tax Receivables Agreement).	"Up-C" structure not available.
Qualified Small Business Stock	No exemption available.	If business is non-service business with gross assets under $50,000,000, gain on sale after 5 years may be exempt from capital gains tax.
Treatment of Tax Payments	Tax distributions are counted towards Fund IRR/carried interest waterfall	Taxes are expenses—do not count towards IRR.

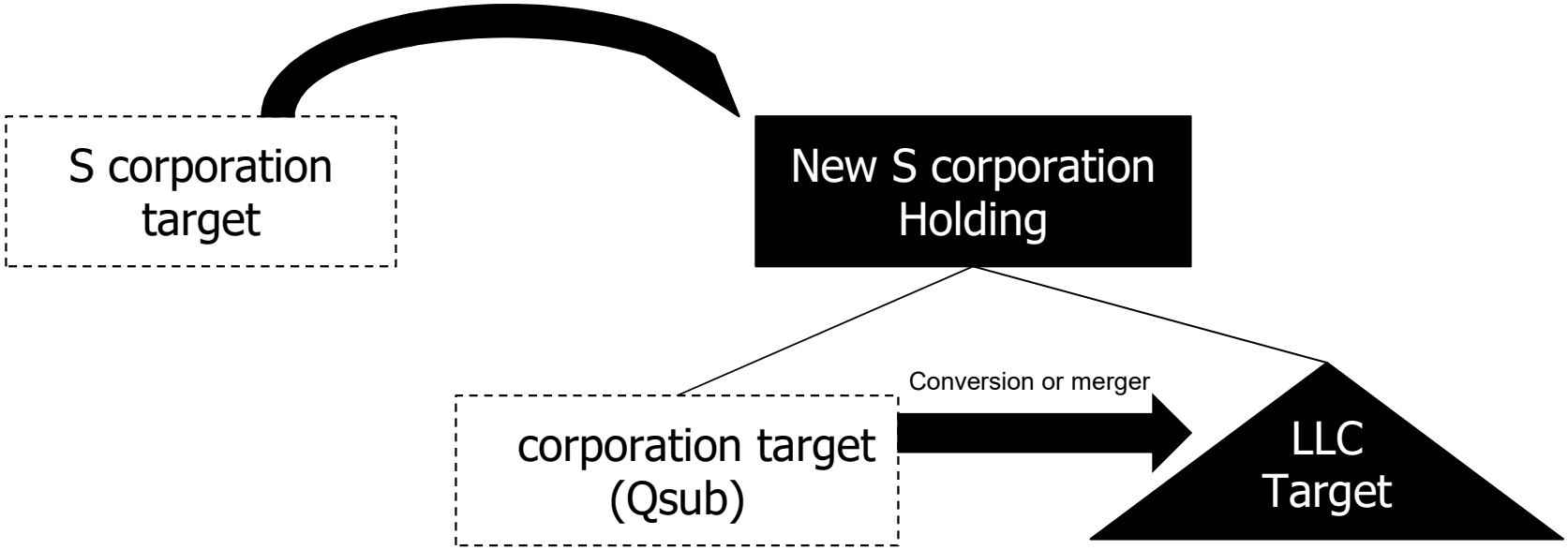
Special Tax Issues: Basis Step-Up

- Is the target LLC a partnership, a corporation, or a disregarded entity?
  - LLCs with two members are partnerships for tax purposes unless an election has been made for the entity to be treated as a corporation.
  - In some cases, an LLC can be used to facilitate the acquisition of an S corporation.
  - Transactions with the same corporate form can have varying tax characterizations.

S Corporation LLC Asset Drop-Down



S Corporation LLC "Conversion"



Purchase of less than 100% of an LLC with a single owner

- Rev. Rul. 99-5: Purchase of assets followed by joint contribution to a new tax partnership.
- Possible disguised sale (if leverage used in transaction).
- Basis step-up is shared.
- 704(c) allocations can be used to remedy pro-rata sharing.
- Beware the Anti-Churning Rules.

Example—Purchase of 80% of Single Member LLC

- Target ABC LLC has a single owner ("A") and its sole asset is intangible goodwill with basis of $0 and value of $20 million.
- PE Fund DEF purchases 80% of ABC from A for $16 million.
- Treated as formation of a new tax partnership to which:
  - DEF contributes goodwill with basis and fair market value of $16 million.
  - A contributes goodwill basis of $0 and fair market value of $4 million.
- $16 million tax basis and book value of the "DEF contributed goodwill" will be amortized for 15 years for tax purposes and book purposes on a straight line method. Deductions will be allocated 80% to DEF ($12,800,000) and 20% to A ($3,200,000).
- $4 million of book value of the "A contributed goodwill" will be amortized for 15 years for book purposes. Book deductions will be allocated 80% to DEF ($3,200,000) and 20% to A ($800,000). No tax amortization available on A contributed goodwill (because $0 basis).
- "Remedial allocation" method allows A to receive taxable income of $3,200,000 with respect to A contributed goodwill, and offsetting tax deductions of $3,200,000 to DEF in respect of A contributed goodwill.
- Net result—DEF gets benefit of a $16,000,000 basis step-up. No basis step-up benefit to A.

Purchase of less than 100% of an LLC with multiple owners

- Purchase from the selling members (an "across-the-top") purchase, a §754 election will allow the purchaser's share of asset basis to be stepped up pursuant to Code §743(b).
- Depreciation/amortization of the step-up inures solely to the purchaser.
- Allocation of the step-up among the assets of the target may be negotiated as it can impact the tax treatment of the sellers.
- In a leveraged buy-out, leverage used to finance the acquisition will generally not result in a 743(b) adjustment. Instead, gain recognized by the sellers will generally get a basis step-up under the "disguised sale" rules or via a Code §734(b) adjustment, both of which will increase the entity basis instead of buyer basis.
  - Buyer gets benefit of basis step-up for its share of the debt.

Example—Purchase of 80% of Multi-Member LLC

- Target ABC has two owners, A and B and its sole asset is intangible goodwill with basis of $0 and value of $20 million.
- PE Fund DEF purchases 80% of ABC from A and B for $16 million.
  - Treated as a purchase of a partnership interest.
  - If ABC makes an election under Code §754, DEF will obtain a basis step-up in the goodwill of $16 million, which will be amortizable by DEF over a 15 year period. No basis step-up benefit to A or B.
  - If ABC incurs leverage to pay any portion of the purchase price (and a §754 election is in place), then ABC will obtain a shared basis step-up equal to the amount of gain recognized by A and B in connection with the distribution of debt proceeds.
    - If ABC has become a multi-member LLC within two years prior to the transaction, this step-up may come via a "disguised sale". The primary difference is in the treatment of this common basis step-up for purposes of the "anti-churning" rules of Code §197(f)(9).

Special Tax Issues: 704(c) Basis Step-up for Growth Equity Investments

- Reverse §704(c) allocations for benefit of basis step-up
  - Traditional Method with Curative Allocations.
  - Remedial Allocation Method.
- Consider tax distributions for phantom income on remedial allocations.

Example—Growth Equity Investment

- Target ABC has two owners, A and B and its sole asset is intangible goodwill with basis of $0 and value of $20 million.
- PE Fund DEF invests $5 million in ABC to fund working capital and receives a 20% interest in ABC.
- In connection with DEF investment, value of ABC goodwill is written up to $20 million for book purposes.
- If ABC elects to apply "remedial allocations," then DEF will receive $4 million in amortization deductions, and A and B will receive $4 million in remedial income allocations (essentially placing the parties in the timing (if not character) position they would have been in had DEF purchased 20% of ABC from A and B for a 15 year installment obligation equal to A and B's 80% share of the $5 million in cash invested). Thus, DEF receives the benefit of a basis step-up, but at A and B's expense.
- A and B can be made neutral (as to the timing effect of the allocations) if tax distributions are made to protect them against the timing detriment of the additional income. There may still be a character detriment (as ordinary remedial allocations may reduce what would otherwise have been long-term capital gain).

Traps for the Unwary

- Disguised sales and 707(b)(1)(B).
- The Anti-Churning Rules.
- Creating a Partnership—Economic Substance and Adherence to Form.
  - Sufficient time for partnership to experience income or loss;
  - Proper tax return filing.

Special Tax Issues: Profits Interests

- A service provider can be granted a profits interest in an entity treated as a partnership for US federal income tax purposes.
- In general terms, a profits interest is an interest in a partnership that, as of the date of grant, would not entitle the recipient to share in the liquidating proceeds of the partnership, were the partnership to sell all its assets (including goodwill and going concern value) at then-fair market value and liquidate.
  - A profits interest reflects an interest only in the future appreciation and income of a partnership.
- A service provider does not recognize taxable income on grant of a profit interest or, if the profit interest is subject to vesting and forfeiture, upon vesting.
- A service provider that holds a profits interest is treated as a partner, and as holding a profits interest as a capital asset. As a result, a profits interest holder may recognize long-term capital gains on a sale of his or her interest in the partnership.

Special Tax Issues: Profits Interests (continued)

- Profits interests can be issued with a wide variety of economic terms.
  - Vesting and forfeiture.
  - Catch-up provisions, so that the recipient gets a larger share of profits on an exit event until his or her share of overall proceeds is the same as if the recipient had shared in proceeds from dollar one.
  - Formulas and hurdles varying the amount received in different circumstances.
- In economic terms, a profits interest closely resembles a compensatory option with a fair market value strike price.
  - The tax treatment of a compensatory option for an interest in a partnership is less favorable than a profits interest, however—ordinary compensation income, subject to higher tax rates for an individual, on exercise, reflecting the spread between the exercise price paid and the then-fair market value of the interest received.
- Profit interests also resemble restricted stock grants.
  - Unlike a restricted stock grant, which reflects current value of stock (or a similar grant of a partnership interest that reflects current liquidation value, referred to as a capital interest), the recipient of a profits interest does not have taxable compensation income on grant or vesting.

Special Tax Issues: Profits Interests (continued)

- Under current law, and unlike the requirements for a restricted stock or partnership capital interest grant, a Section 83(b) election is not required to be made for a profits interest that is subject to vesting and forfeiture to be treated as outstanding as of the date of grant.
  - Proposed regulations would require a Section 83(b) election.
  - Section 83(b) elections are often made, on a protective basis.
- For income and employment tax purposes, including payment of withholding and employment taxes, a holder of a profits interest that is also paid for services by the same partnership is treated as self-employed.
  - Alternative structures, including investment by profit interest holders in an employment partnership through a management LLC or establishment of a subsidiary corporation to own a small percentage (often 0.5%) of an employing LLC, can be used to preserve status as both an employee and a partner.
  - Keeping profits interest holders as W-2 Employees can be important for maximizing the deduction for "qualified business income" under Section 199A.
  - The tax treatment of a service provider as a partner can have significant state and local tax implications as well, such as with respect to the New York City unincorporated business tax (no deductions for compensatory payments to partners).

Special Tax Issues: Profits Interests (continued)

- Profit interests can also be introduced in a pass-through entity that is not itself an operating entity, but instead holds an interest (typically controlling) in an underlying operating corporation.
  - This approach provides the potential tax advantages of a profits interest, versus a compensatory option or restricted stock, noted above.
- If the exit from a pass-through entity involves conversion to a corporation for US federal income tax purposes, e.g., on an IPO, profit interests can be converted tax-free into stock.
  - Additional planning, e.g., issuance of options or bonus plans, is required to preserve the option upside of a profit interest following such a conversion.
- Code Section 1061 imposes a 3 year holding period requirement for long-term capital gains on certain profits interests held in connection with "applicable trade or business" (generally financial services).
  - The requirement does not apply to Code Section 1231 gains treated as long-term capital gains or long-term capital gains recognized with respect to Section 1256 Contracts.

Special Tax Issues: Negotiating Tax Distributions

- Issues to Consider
  - Tax rates (federal & state, income type)
  - Timing (annual or quarterly)
  - Calculation Period (cumulative or annual)
  - 704(c)
  - Basis Step-Up (754 election and/or 707(a)/704(c))
  - Preferred Equity Issues

Tax Rate for Tax Distributions

- Uniform rate for all members, or separate based on residence?
- If a fixed rate, is the federal deduction for state taxes taken into account?
- To what extent is the net investment income tax for members who do not materially participate factored in?
- Is 199A deduction taken into account?
- Is character of income (ordinary vs. capital) being considered?
- Are adjustments being made for lack of deductibility of section 212 expenses?

Timing of Tax Distributions

- Annual is simpler, but quarterly may be needed for meeting estimated tax deposit obligations.
  - This is often of more import for individuals and PE funds funding investment through blocker corporations with no other source of cash to make tax deposits.
- If quarterly distributions are made, may need to "true up" in final quarter to avoid over/under distribution.

Calculation Period of Tax Distributions: Cumulative or Annual?

- Cumulative treats the LLC like a corporation (offsetting income with prior year net operating loss.
  - This preserves more cash in the business.
  - May be required by lenders.
- Individuals often prefer that distributions be based solely on annual income. If a loss was used in a prior year, an individual may not have cash in hand to pay tax currently.

Are Tax Distributions Made on 704(c) Allocations?

- Most often relates to rollover sellers (or earlier round investors) receiving remedial allocations.
- In a growth equity investment, remedial allocations will give rise to phantom income without tax distributions.
  - If tax distributions are made on 704(c) allocations, must be advances on other distributions to be sure that economics are borne by correct parties.
- If disproportionate tax distributions to sellers are problematic as a business matter, consider making pro-rata distributions to investors.

Do Tax Distributions Take Step-Up into Account?

- As noted above, acquisitions are often structured to ensure that the buyer obtains full benefit of the basis step-up.
- If tax distributions take that step-up into account, this often means that buyer gets less cash as tax distributions, reducing the IRR of the investment.
- Ignoring step-up in tax distributions allows buyer to currently monetize the step-up.
- Lenders often push back on allowing excess tax distributions. This should be a pure pricing issue.
- If borrower projections on which underwriting decision is based ignore step-up, lenders should allow the excess tax distributions.
- Compromise position: Only allow excess tax distributions if no event of default.
  - In some cases, additional financial covenants may be imposed for excess distributions.

Are Tax Distributions with Respect to Preferred Equity Advances on Other Distributions?

- Generally an economic point as to whether a coupon on preferred equity is a "pre-tax" or "post-tax" amount.
- Of particular importance where a blocker corporation is utilized, as funds rarely expect corporate income tax imposed on the blocker to reduce preferred coupon.
- Many PE investors take the view that like in a C corporation, an LLC should "pay its taxes" above the line, such that tax distributions to pay taxes on preferred coupon should not reduce the coupon.

Guaranteed Payments

- Preferred coupons may be treated as "guaranteed payments" if structured so that the coupon is payable in all cases without regard to income of the partnership.
- In that case, if tax distributions are desired with respect to the income included, must be specifically reflected in the drafting.
- Guaranteed payments for accrual LLCs are included on the accrual method.
- If tax distributions on guaranteed payments are not advances, they are likely additional guaranteed payments (such that the tax distributions themselves are taxable).
- Under current regulations, guaranteed payments for capital can be treated as "interest" subject to 30% of "adjusted taxable income" limitation on deductibility.

Special Tax Issues: Considerations for Non-US Investors

- Treated for US federal income tax purposes as engaged in a US trade or business if the pass-through entity is so engaged, reflecting taxable income that is effectively connected with the US business, referred to as ECI.
- Obligated to file US federal income tax returns reflecting allocable share of income and loss from pass-through entity's US trade or business.
  - Filing obligation applies even if pass-through entity is operating at a loss.
  - Complicated rules can apply to determine the portion of a non-US investor's other items of income and loss, unrelated to the pass-through entity, that may need to be disclosed and taken into account for US federal income tax purposes.
- Obligated to pay US federal income tax on resulting income, at rates of up to 21% for non-US corporate investors and up to 37% (with eligibility for lower tax rate up to 20% on long-term capital gains and an effective tax rate reduced to 29.6% on certain operating income) for non-US individual investors.
  - Non-US investors generally can use deductions attributable to a US business to offset other US business income, subject to restrictions similar to those that apply to US investors.

Special Tax Issues: Considerations for Non-US Investors (continued)

- Tax treaties generally do not exempt a non-US investors from US tax, or reduce the rate of applicable tax, if as is generally the case the pass-through entity is engaged in business in the US through a "permanent establishment."

- Non-US corporate investors are also subject to US federal branch profits tax at a 30% rate (reflecting, in general terms, deemed dividend amounts), subject to reduction or exemption under applicable tax treaties.
- The pass-through entity is obligated to collect and pay US federal withholding tax on US business income allocated to non-US investors (including quarterly estimated payments).
  - Withholding applies to the US business income at the rate that would apply to the non-US investor if it were a US investor (21% for non-US corporate investors, 37% for non-US individual investors), even if the income level (or other deductions of the investor) would result in a lower ultimate US federal income tax liability.
  - The non-US investor applies the withheld taxes against amounts otherwise due on its US federal income tax return, and can seek a refund.
  - Penalties can be significant.

Special Tax Issues: Considerations for Non-US Investors (continued)

- The non-US investor also will receive a Schedule K-1 from the pass-through entity, as a partnership engaged in a US business, with a copy of the Schedule K-1 included in the partnership tax return filed by the pass-through entity with the IRS.
- US federal withholding tax also will apply, at a 30% rate (imposed on a gross basis), to various US source income that is not effectively connected with the pass-through entity's US business (i.e. FDAP income).
  - A US domestic tax law exemption for "portfolio interest" may apply to interest earned on US source interest income.

Special Tax Issues: Considerations for Non-US Investors (continued)

- Applicable tax treaties may also reduce or eliminate withholding tax on US source income not attributable to the US business.
  - The particular form of pass-through entity used may prevent claiming tax treaty benefits, in general where the non-US investor's home tax jurisdiction does not treat the pass-through entity as tax transparent.
  - Thus, for example, a US limited liability company, or LLC, may be treated as a company, and not tax-transparent, for purposes of a non-US investor's home tax jurisdiction, and as a result the non-US investor may be prevented from relying on a tax treaty to reduce or eliminate US withholding tax on US source dividends earned by the pass-through entity.

Special Tax Issues: Considerations for Non-US Investors (continued)

- The pass-through entity will be required to obtain tax forms from a non-US investor confirming its US tax status.
  - In general, a non-US individual investor would provide an IRS Form W-8BEN, a non-US corporate investor would provide an IRS Form W-8BEN-E (reflecting the Foreign Account Tax Compliance Act, or FATCA, rules) and a non-US investor that itself is treated as a pass-through for US tax purposes would provide an IRS Form W-8IMY (together with forms for its investors).
  - If the provided forms do not reflect compliance with FATCA, the pass-through entity may be obligated to impose 30% withholding on certain items under the FATCA rules.
- Non-US investors also can be subject to US federal income and withholding tax filing and payment obligations, under the Foreign Investment in Real Property Tax Act, or FIRPTA, provisions, with respect to equity investments through pass-through entities in US real property.
  - FIRPTA also applies to investments , including through pass-through entities, in the stock of United States real property holding corporations, or USRPHCs, which in general terms are US corporations the majority of the value of which consists of US real property.

Special Tax Issues: Considerations for Non-US Investors (continued)

- FIRPTA withholding is generally 15% of the proceeds (not the gain) on a sale of FIRPTA assets.
- A non-US investor is also obligated to file a US federal income tax return reflecting gain on a FIRPTA asset, and pay any remaining tax (or receive a refund) after taking into account withheld amounts.
- Special exemptions can apply to qualified non-US pension funds and sovereign wealth investors.

- A non-US investor may be eligible for foreign tax credits, in its home tax jurisdiction, for US taxes paid.
  - The availability of foreign tax credits depends on particular non-US tax rules, and the particular structure of an investment (e.g., through LLCs) may be an issue.
- Additional special exemptions and considerations can apply to a non-US investor that is a foreign government or government instrumentality.
  - In general, foreign governments are exempt from US federal income and withholding tax except from income attributable to US commercial activities. Such commercial activities income, or CAI, overlaps with, but is not identical to, ECI.

Special Tax Issues: Considerations for Non-US Investors (continued)

- State and local tax filing, payment and withholding obligations may also apply.
- Blocker structures (discussed below) may be used to shield non-US investors from US tax filing and payment obligations.
- TCJA imposed tax on non-US persons on the sale or other disposition of an interest in a partnership that is engaged in a trade or business within the United States (an "ECI partnership") and this tax is enforced via a 10% withholding tax.
- Withholding responsibility generally is imposed on "transferee," which in case of a redemption of a partnership interest could be the partnership itself.

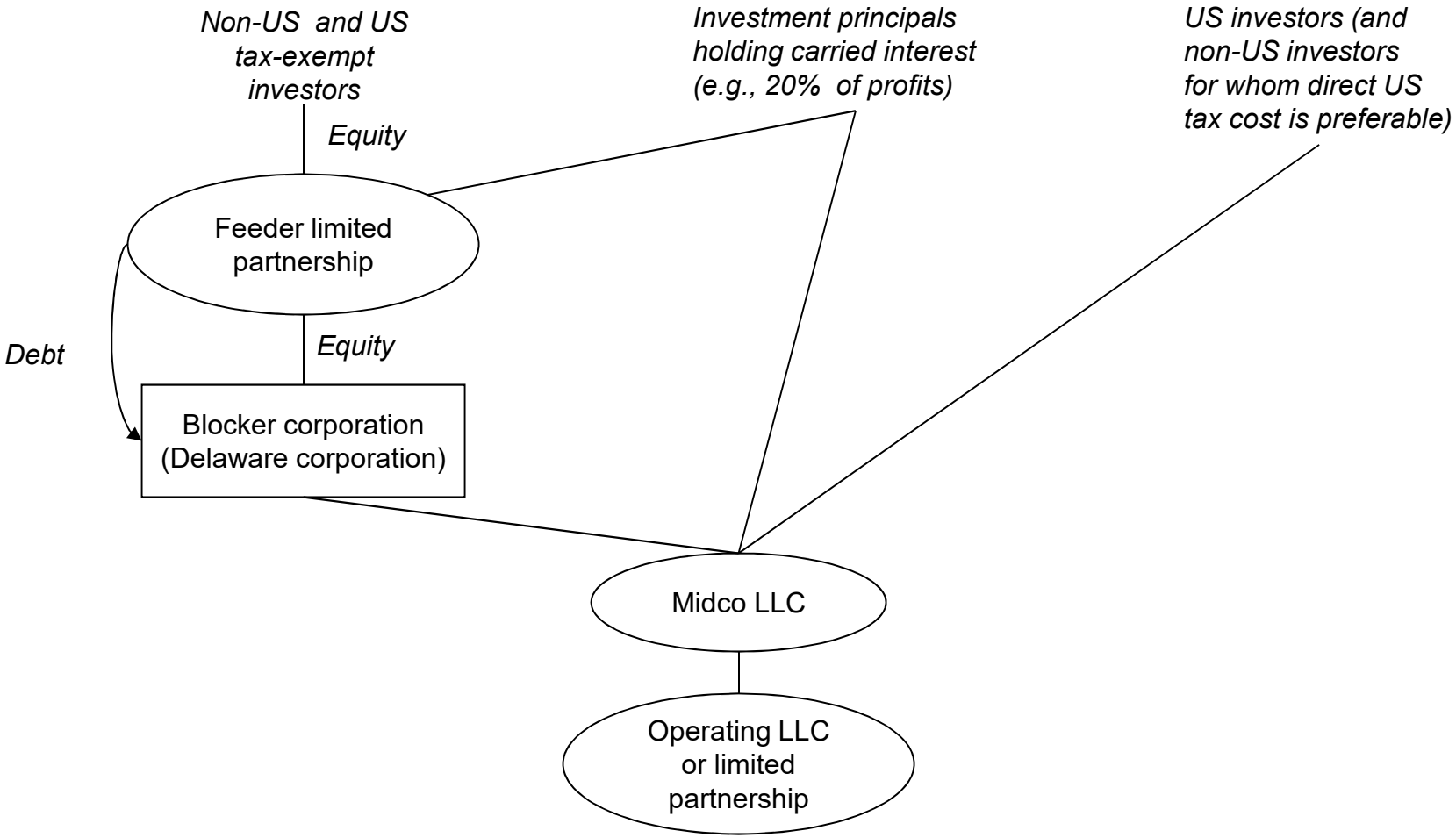
Special Tax Issues: Considerations for US Tax-Exempt Investors

- Subject to US federal income tax filing and payment obligations with respect to unrelated business taxable income, or UBTI, allocated from a pass-through entity.
  - UBTI arises generally from business operations.
  - Debt-financed income, such as borrowing by a pass-through entity to purchase underlying assets or stock of subsidiaries, can result in UBTI, referred to as UDFI.
  - Income from interest, dividends, rents and royalties generally is not UBTI as long as it is not debt-financed.
  - Thus some income can be ECI and not UBTI, or UBTI and not ECI, and thus a concern for non-US, or US tax-exempt, investors, but not both.
- UBTI is generally reflects on a US tax-exempt investor's annual IRS Form 990, with tax paid at corporate income tax rates of up to 21%.
  - Deductions or credits from other investments that could generate UBTI can be applied to offset a tax-exempt investor's UBTI, generally subject to restrictions applicable to corporate taxpayers.
- TCJA limits ability of US tax-exempt investors to tax losses from one unrelated business against UBTI from another and requires additional reporting of NAICS code from Fund as part of required disclosures.

Special Tax Issues: Considerations for US Tax-Exempt Investors (continued)

- Certain US tax-exempt investors, notably state and local government pension plans and other instrumentalities, generally take the view that they are not subject to US federal income tax filing or payment obligations with respect to UBTI.
- State and local tax filing, payment and withholding obligations may also apply.
- Blocker structures (discussed below) may be used to shield US tax-exempt investors from US tax filing and payment obligations.

Special Tax Issues: Blocker Structures for Non-US and Tax-Exempt Investors



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Special Tax Issues: Blocker Structures for Non-US and Tax-Exempt Investors (continued)

- Blocker Corporation: In general, a non-US investor will be shielded from tax filing obligations with respect to an investment in a pass-through entity engaged in business in the US, and a US tax-exempt investor will be shielded from ECI generated by a pass-through investment, if the investment is made through a US corporation (C Corporation).
- The blocker corporation itself will be subject to 21% US federal income tax filing and payment obligations, as well as applicable state and local taxes.
  - As a result, the use of a blocker will not, in general, reduce the economic burden of taxes, and its effect on the rate of return of a non-US or US tax-exempt investor.
- 30% US withholding tax, subject to reduction under applicable tax treaties, will be imposed on dividends paid by a blocker corporation to non-US investors.
- Withholding tax does not apply to liquidating distributions from a blocker corporation (with certain exceptions under FIRPTA).
  - As a result, a private equity fund, in structuring multiple pass-through entity transactions, may choose to establish a separate blocker corporation for non-US investors in each transaction.

Special Tax Issues: Blocker Structures for Non-US and Tax-Exempt Investors (continued)

- A blocker corporation can be capitalized with debt, as well as equity.
  - Subject to various possible limitations, interest on debt may result in current tax deductions for the blocker corporation, offsetting taxable income (and resulting tax liabilities) attributable to taxable income allocated to the blocker corporation by the pass-through entity.
  - Payments of principal to a non-US investor on blocker corporation debt generally will not be subject to US withholding tax.
  - Payments of interest to a non-US investor on blocker corporation debt that does not qualify as "portfolio interest" will be subject to 30% US withholding tax subject to reduction or exemption under applicable tax treaty.
  - Interest payments to a non-US investor from the blocker corporation may also be exempt as portfolio interest if, among other requirements, the non-US investor, directly or through a pass-through, does not own 10% or more of the blocker corporation.

Special Tax Issues: Blocker Structures for Non-US and Tax-Exempt Investors (continued)

- The net after-tax return to non-US and US tax-exempt investors may be better if, on an exit, the blocker corporation is sold, rather than a sale by the blocker corporation of its interest in the pass-through entity.
  - In general, and assuming the FIRPTA rules do not apply, no US federal income tax should apply to a sale of the blocker corporation.
  - By contrast, as noted above, the blocker corporation would be subject to US federal income tax on gain from a sale of its interest in an underlying pass-through entity.
  - A buyer may discount the purchase price paid for blocker corporation stock, because the buyer does not get a stepped up tax basis, and resulting tax benefits, from a purchase of the blocker corporation.
- Different alternatives are available for sharing proceeds between non-US and tax-exempt investors in a blocker corporation and direct investors in a pass-through entity.
  - Private equity funds should consider whether any carried interest is calculated before or after the tax and other costs of a blocker corporation.

Thank You

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