

# Schedule K1 and Tax Return Reminders for Private Equity and Venture Capital Fund Managers

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With the 2023 tax year now closed, there are a few key areas Fund Managers should focus on to ensure the tax results of 2023 are as expected, prior to Schedule K1 and tax return preparation time. Here are a few key considerations Fund Managers should be navigating for Schedule K1 issuance, withholding tax payments, and tax return filings. Please note that these reminders are general in nature and each attract their own individual facts and circumstances, therefore please consult your tax advisor.

## ✔ WORTHLESS SECURITIES

There are three very distinct rules surrounding the worthless security deduction of Internal Revenue Code Section 165. If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. In order for a security to qualify as worthless, and be eligible for the worthless security deduction, three criteria must be met:

1. Security must have had value at the beginning of the tax year.
2. There must have been a fixed and identifiable event that happened during the year that created worthlessness.
3. There must be no value at the end of the tax year.

Security defined: a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

**BDO INSIGHTS:** For those investments that are worthless for book (GAAP) purposes, discuss with your tax advisor to understand if the worthless investment qualifies for the worthless stock deduction for US federal income tax purposes. The timing of this deduction, if applicable, must be in the correct tax year.



## ✓ BAD OR WORTHLESS DEBTS ON THE BALANCE SHEET?

Certain tax rules may permit a current tax deduction with respect to worthless debt investments, so Fund Managers should determine whether any existing debt investments became worthless during the year. The tax rules generally apply differently to debt instruments held in a trade or business than those held by investors. Assuming the debt is not held in connection with a fund's trade or business (i.e., the fund is an investor fund), a loss will be permitted for debt investments that became wholly worthless during the taxable year. An identifiable event (such as bankruptcy or cessation of business) is often required to establish worthlessness. The resulting loss will be a capital loss. Whether such loss is a short-term capital loss or long-term capital loss depends on whether the debt instrument is a "security," defined as an instrument issued by a corporation and in "registered form." A worthlessness deduction on a non-security worthless debt will be a short-term capital loss. If the debt is a security, the debt instrument will be deemed sold at the end of the year, and therefore will result in a long-term capital loss if the fund has a long-term holding period.

If the debt is held in connection with the taxpayer's trade or business (that is, it is a "business bad debt"), the related loss will be ordinary under Internal Revenue Code Section 166. If the debt is only partially worthless, an ordinary loss may still be allowed, but the deduction may not exceed the amount "charged off" within the taxable year. Otherwise, a deduction for complete worthlessness is permitted in the taxable year the debt becomes worthless.

**BDO INSIGHTS:** Fund Managers should evaluate their investment portfolio to determine if there are any worthless debts which should be deducted in the 2023 tax year. [Consult with a BDO professional](#) to understand the tax impacts before issuing Schedule K1s and filing of tax returns.

## ✓ MANAGEMENT COMPANY PLANNING

Management Companies and their owners should be looking at year end expenses to see what can be deducted in tax year 2023. See below a few often-overlooked deductions that could benefit Management Companies and their ultimate owners.

### ▶ Management Companies on the accrual basis of accounting:

- Pay compensation/bonuses by March 15, 2024, to get a deduction in the 2023 tax year. Compensation and Bonus accruals paid after March 15, 2024, are deductible in tax year 2024.
- Legal fees: if you have legal services that have been performed in 2023 but not yet billed, request an invoice from your legal service provider(s) so that you can accrue the legal fees in tax year 2023 and receive a 2023 tax deduction.

**BDO INSIGHTS:** Good tax planning for Management Companies ensure owners achieve the maximum deductions where possible for their Management Companies. [Connect with a BDO professional](#) to learn more.



## ✓ QUALIFIED SMALL BUSINESS STOCK

Internal Revenue Code Section 1202 may offer a generous tax benefit for private equity and venture capital funds. Section 1202 permits a taxpayer, other than a corporation, to exclude up to 100% of the gain from the sale or exchange of qualified small business stock (QSBS) held for more than five years. Originally enacted in 1993 to encourage investment in small companies, Section 1202 initially granted a 50% exclusion of gain, which was later increased to 75% for QSBS stock acquired after February 17, 2009 and then to 100% for QSBS stock acquired after September 27, 2010. The percentage of excludable gain under Section 1202 depends on the year in which the stock was acquired, and the holding period of QSBS begins on the day after the date the stock was issued, regardless of whether the QSBS is received in a taxable or non-taxable transaction. While the tax savings under Section 1202 are not without limits, the limitations that have been provided are generous. In all cases, the amount of gain that can be excluded is limited (per taxpayer and per issuer) to the greater of: \$10 million (\$5 million in the case of married individuals filing separately); or ten times the taxpayer's aggregate adjusted basis in the QSBS sold during the taxable year. The exclusion of the gain can provide PE and VC funds a valuable tax savings opportunity upon their exit from an investment in a qualifying small business.

**BDO INSIGHTS:** Fund Managers should review their realizations for the year to ensure that any gains of domestic C corporation stock that are eligible for QSBS are reported to investors properly on their Schedule K1s so that they can claim the eligible QSBS benefits if they qualify. Further, investments held at year end, or being purchased in 2024, should be reviewed for initial QSBS qualification and if possible structured into SEC 1202 eligibility. For those investments that initially qualify, careful consideration should be taken throughout the holding period to ensure that otherwise avoidable actions don't disqualify the intended QSBS benefit (such as poorly structured redemptions). Note that QSBS qualification is initially done by the C corp/portfolio company. [Consult with a BDO professional](#) to learn more.



## ✓ SHORT TERM INVESTMENTS: BANK INTEREST AND MONEY MARKET DIVIDENDS/INTEREST

Many Fund Managers are taking advantage of the favorable returns on short term deposits while awaiting deployment of capital to investments. These short-term deposits generally generate the type of income that may be subject to federal tax withholding for non-US investors, generally at a 30% rate absent any treaty applications. The documentation and reporting requirements surrounding this particular type of income is quite complex and does carry non filing penalties for failure to file or remit withholding taxes timely.

**BDO INSIGHT:** If your Fund has generated bank interest or money market dividends, and there are foreign investors in the Fund, the Fund may have a Form 1042 withholding obligation and filing requirement. [Speak with a BDO professional](#) to learn more.

In conclusion, Fund Managers should review their 2023 transactions and discuss with their tax advisors to ensure there are no misunderstandings before Schedule K1s are issued to investors. Good communication with tax advisors/preparers, should ensure a smooth Schedule K1 and tax return season.

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