ECONOMY, ELECTION AND YEAR-END PLANNING:
THE PERFECT STORM FOR PRIVATE EQUITY

November 9, 2020
Discussion Topics

Current Climate

Domestic Considerations
- Debt Workouts
- Carried Interest
- Section 163(j)

International Tax Considerations

Wrap Up
Current Climate
Introduction

▶ As the end of the year approaches, PE Funds and portfolio companies are experiencing a variety of economic and legislative changes both domestically and internationally. We will cover several areas such as debt workouts and international tax considerations that could impact planning for this year and possibly next year.

▶ Year-end planning for 2020 continues to take place against the backdrop of new tax laws that make major changes to the rules for individuals and businesses, as well as the presidential election.

▶ As we head towards year-end, the election may effect how past tax laws, current tax laws and future tax laws will impact PE Funds and their investments.

▶ Today, we will discuss year-end planning considerations and how potential tax law changes might impact these decisions.
Domestic Considerations
Domestic Considerations
DEBT WORKOUTS

- Transfers of property in satisfaction of debt
- Contribution of debt in exchange for a partnership interest
- Partnership allocations of cancellation of indebtedness income (CODI)
- Abandonment or worthlessness of a partnership interest
- Incorporation of a partnership prior to debt workout

THE PERFECT STORM FOR PRIVATE EQUITY
Domestic Considerations

DEBT WORKOUTS

TRANSFERS OF PROPERTY IN SATISFACTION OF DEBT

▶ Assume AB LLC has $100 of outstanding indebtedness
▶ Capital assets valued at $60 having a tax basis $10
▶ AB LLC transfers its assets to the lender in full satisfaction of the outstanding liability

Recourse Debt

- The transfer of property in satisfaction of a recourse liability is treated as if the debtor sold the property for consideration equal to the fair market value (FMV) of the property.

- To the extent debt in excess of the FMV of the property is cancelled, the debtor recognizes cancellation of indebtedness income (CODI).

- AB LLC will recognize $50 of capital gain on a deemed sale of the assets ($60 FMV - $10 tax basis) and $40 of CODI ($100 recourse liability relief - $60 FMV).

Nonrecourse Debt

- If property is transferred in satisfaction of a nonrecourse liability, the entire balance of the relieved liability is treated as proceeds on the sale of the property.

- AB LLC will recognize $90 of capital gain on a deemed sale of assets ($100 nonrecourse liability relief - $10 tax basis).
Domestic Considerations
DEBT WORKOUTS

CONTRIBUTION OF DEBT IN EXCHANGE FOR A PARTNERSHIP INTEREST

A common planning strategy involves the lender exchanging the outstanding liability for an equity interest in the partnership.

Potentially significant consequences can result to the creditor, partnership and partners.

Treatment to the Creditor: Generally no deduction to the creditor. Instead, the creditor substitutes basis in the loan for basis in the partnership interest (regardless of value in the partnership interest).

Treatment to the Partnership: The partnership is treated as satisfying the outstanding loan with the partnership interest exchanged. CODI is recognized to the extent the outstanding loan balance exceeds the FMV of the partnership interest transferred.

Treatment to the Partners: Any recognized CODI must be allocated to the partners. Allocations of CODI can be complicated and should take into account (1) general substantial economic effect rules under Section 704(b)(2) allocations made in accordance with the partner’s interest in the partnership, and (3) minimum gain chargeback provisions.
PARTNERSHIP ALLOCATIONS OF CODI

- COD income generally will be allocated consistent with the terms of the partnership agreement, including minimum gain chargeback provisions.

- The result may vary, however, where a partner has a negative capital account and no deficit restoration obligation (Rev. Rul. 92-97).

- Elimination of partnership debt will give rise to a deemed distribution under Section 752 which can trigger recognition of negative tax capital.

- This deemed distribution will be considered an “advance” against the COD income and occurs as of year-end after the COD income has been allocated and increased a partner’s basis in its interest (Rev. Rul. 92-97; Rev. Rul. 94-4).

- Rev. Rul. 99-43 provides that a special allocation of COD income to an insolvent partner will not be respected where the partnership agreement is amended after the COD income has been realized.
Domestic Considerations
DEBT WORKOUTS

ABANDONMENT OR WORTHLESSNESS OF A PARTNERSHIP INTEREST

- A partner may seek to abandon a partnership interest due to worthlessness or to avoid recognition of CODI.
- The IRS has provided guidance regarding the consequences to a partner upon the abandonment of a partnership interest (Rev. Rul. 93-80).
  - The determination of capital loss versus ordinary deduction turns on whether the abandoning partner is to be allocated partnership liabilities prior to abandonment.
    - If the abandoning partner is allocated partnership liabilities immediately before the abandonment, capital loss results.
    - If the abandoning partner is not partnership allocated liabilities immediately before the abandonment, ordinary loss results.
Domestic Considerations

DEBT WORKOUTS

INCORPORATION OF A PARTNERSHIP PRIOR TO DEBT WORKOUT

- Partnership incorporation may be tax-free and insulate future COD events
- Necessary to navigate incorporation issues including gain under Section 357(c) as well as legal issues associated with bank rights
- Various methods of incorporation may produce different results
- Important issues to consider
  - Whether there was an actual transfer of liabilities for income tax purposes
  - Whether an incorporation requires solvency to be respected
  - Whether the transaction needs a business purpose other than avoidance of income tax

THE PERFECT STORM FOR PRIVATE EQUITY
Domestic Considerations
CARRIED INTEREST RULES

KEY QUESTIONS

- Are all capital gains subject to Section 1061 recharacterization?
- What are the available exceptions to Section 1061?
- Can we structure carry waivers under the proposed regulations?
- Do non-taxable transfers trigger gain recognition under Section 1061?
- Are there special rules related to holding period determinations?
- When is a partnership interest a “specified asset”?
Domestic Considerations
CARRIED INTEREST RULES

ARE ALL CAPITAL GAINS SUBJECT TO SECTION 1061 RECHARACTERIZATION?

Capital gains subject to recharacterization under Section 1061 do not include:

- Long-term capital gains determined under Section 1231 or Section 1256,
- Qualified dividends, and
- Any other capital gain that is characterized as long-term or short-term without regard to the holding period rules under Section 1222, e.g., gains under the Section 1092(b) mixed straddle rules.
### Domestic Considerations

**CARRIED INTEREST RULES**

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<th>DESCRIPTION</th>
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<td>Section 1061 does not apply to investments not held on behalf of third-party investors. Proposed regulations are silent on implementation of this rule</td>
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Domestic Considerations
CARRIED INTEREST RULES

CAN WE STRUCTURE CARRY WAIVERS UNDER THE PROPOSED REGULATIONS?

- The preamble confirms that carry waivers are acceptable, provided there is sufficient entrepreneurial risk with respect to the ability to receive carry in the future.

- The preamble indicates that the principles described in the fee waiver proposed regulations are applicable to the determination of entrepreneurial risk with respect to carry waivers.

- Generally, any waived carry can only be covered with appreciation generated subsequent to the waiver.
DO NON-TAXABLE TRANSFERS TRIGGER GAIN RECOGNITION UNDER SECTION 1061?

- The transfer of an applicable partnership interest to a “related person” may result in short-term capital gain recognition under Section 1061.

- Recognized gain is the excess of net built-in gain in assets with a holding period of less than three years over the amount of recharacterized gain recognized on the transfer under general rule.

- A related person includes a spouse and lineal descendants, as well as a colleague who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

- The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of the provision (that is, amounts are not double-counted).
Domestic Considerations
CARRIED INTEREST RULES

ARE THERE SPECIAL RULES RELATED TO HOLDING PERIOD DETERMINATIONS?

- Consistent with general partnership principles, upon the sale of an asset by a partnership, the partnership’s holding period in the asset is the relevant holding period.

- Consider GLAM 2020-005, which provides that a “meaningless gesture” transaction creates a split holding period in corporate stock.
Domestic Considerations
CARRIED INTEREST RULES

WHEN IS A PARTNERSHIP INTEREST A “SPECIFIED ASSET?”

A partnership interest will be considered a specified asset:

- To the extent a partnership holds assets that are defined as specified assets.
  - For example, an interest in a partnership whose assets consist solely of corporate stock will be considered a specified asset.
  - A publicly traded partnership which under Section 7704(b) means any partnership if interests in such partnership are traded on an established securities market or readily tradeable on a secondary market (or substantial equivalent thereof).
  - A widely held partnership is considered a specified asset.

- There is a lack of clarity around the meaning of the term “widely held.”
- Consider changes contained in the original legislative history and Blue Book.
Domestic Considerations
SECTION 163(j) PLANNING

BASIS ADJUSTMENTS UPON DISPOSITION OF PARTNERSHIP INTERESTS

- Excess business interest expense (EBIE) reduces a partner’s basis in its partnership interest.
- A “disposition” of the partnership interest results in a reversal of this basis adjustment.
- Under the 2018 proposed regulations, a disposition of “all or substantially all” of the partnership interest was required to reverse the basis adjustment.
- The final regulations adopt a proportionate approach to partial dispositions of partnership interests.
- The proportionate approach will allow taxpayers to recoup suspended interest more quickly than under the 2018 proposed regulations.
- However, the proportionate approach also eliminates the ability to utilize the suspended interest against ordinary income to the extent of future excess taxable income.
Domestic Considerations
SECTION 163(j) PLANNING

DEBT-FINANCED PARTNERSHIP DISTRIBUTIONS

- Treas. Reg. §1.163-8T and Notices 88-20, 88-37 and 89-35 provide guidance to taxpayers about how to allocate interest expense among expenditures.

- To more accurately account for the types of expenditures made by passthrough entities, Treasury and the IRS published proposed regulations that would apply before applying Section 163(j).

- The proposed regulations generally mirror Notice 89-35 with two modifications:
  - Instead of allowing use of the optional allocation rule, passthrough entities are required to apply a rule that is similar to the optional allocation rule.
  - Instead of allowing use of any reasonable method to allocate excess interest expense, the passthrough entity must allocate EBIE based on the adjusted tax basis of the passthrough entity’s assets.
Domestic Considerations

SECTION 163(j) PLANNING

PASSIVE INVESTORS IN TRADING PARTNERSHIPS

- The 2018 proposed regulations created rules that could result in certain taxpayers being subject to both Section 163(j) and Section 163(d).
  - The Section 163(j) business interest limitation would apply at the entity level, and
  - The Section 163(d) investment interest limitation could then apply at the individual partner level.
- Thus, the 2018 proposed regulations would effectively create a double-layered limitation for partners subject to the Section 163(d) limitation.
- Under the 2020 proposed regulations, a trading partnership would be required to bifurcate its interest expense from a trading activity between partners that materially participate in the trading activity and partners that are passive investors.
- Thus, the 2020 proposed regulations eliminate this potential double-application of Section 163 limitations.
EXCESS BUSINESS INTEREST EXPENSE IN TIERED PARTNERSHIPS

- The 2018 proposed regulations reserved on providing any guidance.
- Taxpayers generally applied one of three viable approaches: Aggregate, Entity or Blended Approaches.
- The 2020 proposed regulations adopt the Entity Approach.
  - Under the Entity Approach, if a lower-tier partnership (LTP) allocates EBIE to an upper-tier partnership (UTP), the UTP reduces basis in its interest in the LTP.
  - However, partners of the UTP do not reduce the bases of their UTP interests until the UTP treats such EBIE as business interest expense paid or accrued.
- The 2020 proposed regulations also provide that both the UTP and any direct or indirect partners of the UTP reduce applicable Section 704(b) capital accounts by the EBIE.
- Provided the EBIE is not suspended under Section 704(d), the UTP treats the EBIE as a Section 704(c) built-in loss asset.
- Anti-loss trafficking rules would provide that no deduction is allowed to a transferee partner for any business interest expense derived from a transferor’s share of UTP EBIE.
International Tax Considerations
APPLICATION OF THE CFC ANTI-DEFERRAL RULES INVOLVING DOMESTIC PARTNERSHIPS AND THEIR PARTNERS:

For domestic partnerships that own CFCs, the GILTI final regulations provide that the “U.S. shareholder” partners of the partnership (not the domestic partnership) take into account the tested items for purposes of determining a GILTI inclusion (the domestic partnership does not have a GILTI inclusion).

However, a domestic partnership is treated as owning stock of a foreign corporation within the meaning of Section 958(a) for certain purposes under the regulations (e.g., determining CFC status and controlling domestic shareholder status).

- See Reg. §1.951A-1(e) and the examples thereunder for additional guidance.
International Tax Considerations

APPLICATION OF THE CFC ANTI-DEFERRAL RULES INVOLVING DOMESTIC PARTNERSHIPS AND THEIR PARTNERS:

Under current final regulations, a domestic partnership that owns CFCs has the subpart F inclusion (and such inclusion is allocated to the partners under the partnership rules).

- Consider whether to rely on and apply (subject to certain requirements being satisfied) the proposed Section 958 regulations that would determine subpart F inclusions (and Section 951A tested items) at the “U.S. shareholder” partner level (i.e., U.S. persons who are “U.S. shareholders” would have the subpart F inclusion) along with the impact of these rules.
  - However, a domestic partnership is treated as owning stock of a foreign corporation within the meaning of Section 958(a) for certain purposes under the proposed regulations (e.g., determining CFC status and controlling domestic shareholder status).
  - See Prop. Reg. §1.958-1(d) (and the examples thereunder) for additional guidance.
APPLICATION OF THE CFC ANTI-DEFERRAL RULES INVOLVING DOMESTIC PARTNERSHIPS AND THEIR PARTNERS:

- The new GILTI high-tax election
  - Note - Although a domestic partnership does not have a GILTI inclusion, a domestic partnership can be a controlling domestic shareholder that makes the GILTI election.

- Consider the implications of the repeal of Section 958(b)(4) by the TCJA
  - Review overall group structure to identify potential CFCs, Form 5471 filing obligations (and possible exceptions to filing obligations) and subpart F/GILTI inclusions (assuming Section 958(a) ownership) due to the repeal of Section 958(b)(4).
    - Consider recently issued guidance by Treasury relating to the repeal of Section 958(b)(4) (e.g., Rev. Proc. 2019-40, TD 9908, REG-110059-20 and the instructions to Form 5471; see also TD 9883).
  - Can be a trap for the unwary!!!
International Tax Considerations

ALWAYS CONSIDER THE APPLICATION AND IMPLICATIONS OF THE PFIC REGIME IF A PARTNERSHIP OWNS FOREIGN CORPORATIONS

- This includes the rules relating to determining PFIC status (note that there are special rules for determining PFIC status and exceptions to PFIC status) and certain elections that may be made (e.g., QEF election) and who makes the election and when such election must be made.

- Note that in 2019, the IRS and Treasury issued significant additional guidance relating to PFICs in the form of proposed regulations (See REG-105474-18).
International Tax Considerations

If a partnership with foreign partners has effectively connected income (ECI), U.S. real property interests or FDAP income, consider the numerous issues and rules that may apply depending on the particular facts and circumstances (e.g., withholding under various code sections such as Sections 1441/2 (FDAP), 1445 (FIRPTA), 1446 (ECI) and certain coordination rules, certain exceptions or reductions to withholding (e.g., reduced withholding for FDAP because of a treaty), branch profits tax considerations for foreign corporate partners when partnership is engaged in U.S. trade or business, certain documentation requirements and required return and informational filings, etc.).

- Note that if there is a disposition of a partnership interest by a foreign person, certain other provisions may need to be considered depending on the particular facts (e.g., Sections 897(g), 1445, 864(c)(8), and 1446(f)).

  - Consider the additional IRS/Treasury guidance on how to calculate ECI under the final Section 864(c)(8) regulations and the additional guidance for withholding (including withholding exceptions) by the transferee or partnership under the final Section 1446(f) regulations when a foreign partner disposes of its interests in a partnership engaged in a U.S. trade or business.
Wrap-up
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