Tax Considerations for 2016

Schulte Roth & Zabel

25TH ANNUAL

PRIVATE INVESTMENT FUNDS SEMINAR

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Tax

Mergers & Acquisitions

Private Equity

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Noah's practice focuses on tax aspects of domestic and cross-border mergers and acquisitions, joint ventures, spinoffs, restructurings and workouts, and private equity fund formation issues. He has advised on complex transactions including the public acquisition of Safeway Inc. by Albertsons and a consortium led by Cerberus Capital Management LP; the sale of Orchard Brands Corporation to Bluestem Group Inc.; the acquisition by Cerberus of the automotive interiors business of Visteon Corporation; Tiptree Financial Inc.'s sale of subsidiary Philadelphia Financial Group Inc. to funds managed by the Tactical Opportunities Group of The Blackstone Group LP; and the sale by Cerberus, its affiliate The Traxis Group BV and Blue Bird Corporation of the outstanding capital stock of School Bus Holdings Inc., an indirect parent company of Blue Bird, to Hennessy Capital Acquisition Corp.

A member of the Tax Section of the New York State Bar Association, Noah is recognized as a leading lawyer by *The Legal 500 United States* and *New York Super Lawyers*, and he is also listed in *Private Funds Management*'s "30 Under 40: The 30 Most Influential Private Equity Lawyers Under the Age of 40." He is the co-author of "The Demise of CoCos and the Tax Consequences of Exchanging Convertible Debt" (Practicing Law Institute, Corporate Tax Practice Series).

Noah earned an LL.M. and a J.D., *cum laude*, from the New York University School of Law, where he was a Robert McKay Scholar. He holds a B.A., *cum laude*, from Duke University, where he made the Dean's List with Distinction.

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Real Estate Capital Markets & REITs

Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of investment fund managers, including Senator Investment Group LP's sale of a minority stake to The Blackstone Group LP, Caxton Associates LP's sale of a minority interest to the Petershill II Fund affiliated with the Goldman Sachs Group Inc., and Credit Suisse's sale of Strategic Partners to Blackstone. Philippe advises on the tax aspects of securitizations, including his representation of affiliates of Fortress Investment Group LLC and affiliates of Highbridge Capital Management in the securitization of their leveraged facilities. He has also advised multiple alternative asset managers on the formation and structuring of funds, including Engineers Gate with the launch of a quant fund, Clearfield Capital with the launch of a hedge fund, Warlander Asset Management LP with the launch of a credit fund, and SG Capital Partners in the formation of a new fund; Gunnar Overstrom, formerly a partner at Maverick Capital Ltd., in the formation of Three Corner Global Investors LP; Junto Capital Management LP on the launch of Junto Capital Partners LP and Junto Offshore Fund Ltd.; Trian Fund Management LP on all aspects of launching new co-investment hedge funds; Sachem Head Capital Management LP with the launch of hedge funds and the establishment of long/short equity funds; and Capstone Investment Advisors LLC, JANA Partners, MKP Capital Management LLC and Scopia Fund Management LLC in their respective sales of a passive minority interest to Neuberger Berman Group-managed private equity fund Dyal Capital Partners. Philippe's recent real estate transactions include advising the Related/Oxford joint venture developing Hudson Yards on closing nearly $1.4 billion in equity investments and debt financing for the center's first tower, and advising Oxford in over $5 billion in financing of three office towers, a retail center and a residential building for the project; advising Arel Capital in a number of equity investments, including operating multi-family properties with significant retail components and ground-up development projects for modern condominium buildings in Manhattan and Brooklyn; and advising Perella Weinberg Partners on the acquisition of 50-percent ownership of interests in two hotels and the structuring of a REIT joint venture with Loews Corporation.

Chambers USA, *The Legal 500 United States*, *New York Super Lawyers* and *Tax Directors Handbook* have recognized Philippe as a leading lawyer. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and also speaks at prominent industry events, including PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2015 conferences in New York and San Francisco. He also recently presented on topics including FATCA, customized solutions for investors, and management company structuring and operations.

Philippe earned his LL.M. in taxation and his J.D. from New York University School of Law. While pursuing his J.D., he was the recipient of a Gruss Fellowship. He obtained his B.S., *summa cum laude*, from Adelphi University.

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Nick principally advises investment management clients on the structuring of U.K. management companies, covering all relevant partnership and tax issues. He also advises more widely on U.K. and international tax issues relating to the taxation of private investment funds, and their U.K. investors and managers.

Listed in *The Legal 500 UK* as a leader in his field, Nick is a Chartered Tax Adviser and an associate of the Chartered Institute of Taxation, the leading body in the United Kingdom for taxation professionals dealing with all aspects of taxation. He also is a member of the Tax Committee of the Alternative Investment Management Association. He has written and spoken about U.K., EU and international tax issues for various publications and engagements, particularly in regards to how changes in tax codes and regulations affect hedge funds and their U.K. managers.

Nick completed his legal training at the College of Law and graduated from Corpus Christi College at the University of Oxford.

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Practice

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David concentrates his practice on tax issues related to formation and operation of onshore and offshore investment funds and their investment managers; tax considerations related to employee and executive compensation, including deferred compensation programs; and partnership taxation.

Recognized by *The Legal 500 United States* as a leading lawyer, David has spoken on tax issues related to running investment management firms and their funds, and he is a contributor to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He is a member of the American Bar Association and the New York State Bar Association.

David holds an LL.M. in taxation and a J.D., *magna cum laude*, from New York University School of Law, where he was a Florence Allen Scholar and Order of the Coif, and an A.B., *cum laude*, from Harvard University.

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Shlomo C. Twerski

Shlomo is co-head of the Tax Group at Schulte Roth & Zabel. He focuses his practice on the tax aspects of onshore and offshore investment funds, registered investment companies and business development companies, private equity partnerships, real estate and corporate transactions, restructurings and workouts, securitizations, and existing and emerging financial instruments. He also provides ongoing tax advisory services to a number of hedge fund managers regarding fund structuring and formation, distressed debt investments and other complex transactions.

Recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 United States* and the *Tax Directors Handbook*, Shlomo is a member of the Tax Section of the New York State Bar Association. He regularly speaks at industry conferences and events, and his most recent presentations have addressed hedge fund and management company structures, funds in the energy space, tax considerations for private investment funds and FATCA. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) as well as various SRZ alerts.

Shlomo earned his J.D. from Hofstra University School of Law.

Tax Considerations for 2016

I. Partnership Audits

A. On Nov. 2, 2015, the Bipartisan Budget Act was signed into law, effectively repealing TEFRA with respect to partnership tax returns filed for taxable years starting after 2017. Under the new regime, tax adjustments and collections are made at the partnership level rather than at the partner level, unless the partnership elects to pass adjustments through to its partners.

B. The new partnership audit procedures generally apply to all partnerships.

C. Partnerships with 100 or fewer partners can elect out of the procedures if each of the partners is an individual, a C corporation, a foreign entity that would be treated as a C corporation if it were domestic, an estate of a deceased partner or an S corporation.

1. In the case of a partner that is an S corporation, each S corporation shareholder is counted as a partner in determining whether the partnership has 100 or fewer partners.

2. Partnerships with partners that are other partnerships, trusts or pension trusts cannot elect out.

3. The election to opt out of the new rules must be made each year with a timely filed return for such taxable year, and notice thereof needs to be provided to the partners.

4. The election must include a disclosure of the name and taxpayer ID of each partner of the partnership, including each S corporation shareholder in the case of an S corporation partner.

D. Instead of appointing a tax matters partner, a partnership must designate a partnership representative who will have sole authority to act for and bind the partnership and all its partners in all audit and adjustment proceedings.

1. The partnership representative does not need to be a partner but must have a substantial presence in the United States.

2. No notice of an audit needs to be given to the partners. In addition, no appeals process exists if a partner disagrees with the result of an audit.

3. In the absence of a designation of a representative by the partnership, the Internal Revenue Service ("IRS") has the authority to select any person as the partnership representative for a partnership.

E. Following a partnership audit, the IRS will issue a Notice of Proposed Partnership Adjustment setting out the "imputed underpayment" required to be paid by the partnership.

1. An imputed underpayment is determined by netting all adjustments at the partnership level and multiplying by the highest tax rate for individuals or corporations for the reviewed year.

   (a) If an adjustment involves reallocation of an item to another partner, only the tax increase, not the net adjustment, enters into the calculation of the imputed underpayment.

   (b) Disregarding offsetting allocations in such situations has the effect of taxing the same income twice.

2. The partnership has 270 days to demonstrate to the IRS that its tax rate should be lower and the imputed underpayment should be reduced.

   (a) An imputed underpayment may be reduced to the extent that it is allocable to a partner that is a "tax-exempt entity" (e.g., the U.S. government, a tax-exempt U.S. organization, a foreign person or entity, etc.), a partner that is a C corporation (in the case of ordinary income) or an individual with capital gains or qualified dividends.

   (b) If any partner files an amended return for the reviewed year taking into account its allocable share of the adjustments and pays tax thereon, that payment can offset the partnership's imputed underpayment.

F. As an alternative to the partnership paying the imputed underpayment, the partnership may elect within 45 days after the date of a Notice of Final Partnership Adjustment to pass the adjustment through to its partners who were partners for the reviewed year.

1. The adjustment is passed through to the partners by issuing a statement to the reviewed year partners with their share of adjustments. The reviewed year partners are required to take the adjustments into account on their returns in the adjustment year (rather than amend their returns for the reviewed year).

2. An imputed underpayment is collected together with the partner's tax due for the adjustment year.

3. This special election removes partnership-level liability for the adjustments but makes the partnership responsible for identifying the reviewed year partners and appropriately allocating the adjustment among those partners.

4. The cost of making this election is that interest on an imputed underpayment is determined at the partner level at a rate that is 2 percent higher than the normal underpayment rate (i.e., short-term AFR + 5 percent).

G. A partnership can file an administrative adjustment request, i.e., an amended return, for any partnership taxable year.

1. Adjustments that result in underpayments will cause tax to be due at the partnership level or may be passed through to the partners under the election discussed above.

2. Adjustments that result in a refund must be passed through to the partners as additional deductions in the current year.

3. Any underpayment is paid by the partnership when the administrative adjustment request is filed.

H. The new partnership audit rules are effective for returns filed for taxable years starting after Dec. 31, 2017, although partnerships may elect to apply the new rules to any returns filed for taxable years beginning after Nov. 2, 2015.

II. Inversions

A. The IRS and Department of the Treasury announced in Notice 2015-79 that they will issue regulations to address transactions that are structured to avoid the purposes of Section 7874, as well as certain post-inversion tax avoidance transactions. They also announced certain corrections and clarifications that Treasury and the IRS intend to make with respect to certain rules announced in Notice 2014-52.

1. Notice 2014-52: Notice 2015-79 builds on Notice 2014-52, issued in November 2014, which effectively prevents certain inversion transactions by causing them to fail the threshold tests in Section 7874 of the Internal Revenue Code (the "Code") for what constitutes an inversion as well as diminishing the effectiveness of certain post-inversion tax-minimization strategies historically employed by inverted companies, particularly those that allow inverted companies to access cash "trapped" in offshore entities.

    (a) Rules That Impact Whether a Transaction Constitutes an Inversion

        (i) Regulations under Sections 7874 and 367 expanded with regard to pre-inversion "skinny-down" distributions

        (ii) Regulations under Section 7874 targeting so-called "cash-box" inversions

        (iii) Regulations under Section 7874 targeting "spinversions"

    (b) Rules Limiting Certain Post-Inversion Tax Strategies

        (i) Regulations under Section 956 expanded to cover "hopscotch" transactions

        (ii) Regulations under Section 7701(l) expanded to limit post-inversion de-controlling of controlled foreign corporations ("CFCs")

        (iii) Regulations under Section 304 limiting transactions designed to remove untaxed foreign earnings and profits while bypassing tax in the United States

2. Notice 2015-79: Similar to Notice 2014-52, Notice 2015-79 proposes rules that will make it more difficult for companies to successfully invert, as well as curtailing certain tax benefits for inverted companies.

    (a) Rules That Impact Whether a Transaction Constitutes an Inversion

        (i) Limit ability to use a "third country" as the new parent in an inversion transaction

        (ii) Disregard all assets (active or passive) transferred to the foreign party to an inversion with a principal purpose of avoiding the purposes of Section 7874 (i.e., inflating the value of the foreign company to avoid the shareholder thresholds for an inversion)

        (iii) Strengthen "substantial business activities" exception by requiring the parent to be subject to tax as a resident in its country of organization

    (b) Rules Limiting Certain Post-Inversion Tax Strategies

        (i) Expand the scope of "inversion gain" for which current U.S. tax must be paid to include certain indirect income inclusions, such as those from CFCs of the inverted U.S. companies

        (ii) Require that built-in gain in CFC stock be recognized in certain cases, without regard to the amount of deferred earnings of the CFC

(c) Favorable Changes

(i) Provide that assets used in an active insurance business within the meaning of the PFIC rules as well as certain banking or insurance assets held by domestic corporations are not treated as passive assets for purposes of Notice 2014-52 "cash box" rule.

(ii) Added de minimis exception for "skinny down" transactions of a U.S. company acquired by a foreign company for all or mostly cash.

(d) Effective Date: The rules are generally applicable to transactions completed on or after Nov. 19, 2015, though taxpayers may elect the application of the favorable rules above for transactions completed prior to such date. The rules that curtail certain post-inversion tax strategies also apply prospectively, but only to companies which inverted on or after Sept. 22, 2014 (the date of the prior inversion Notice).

(e) The Notice indicates that Treasury and the IRS expect to issue additional guidance to further limit inversions and post-inversion tax planning, particularly with respect to strategies that shift tax on U.S. operations to lower-tax jurisdictions through intercompany debt or otherwise (i.e., "earnings stripping").

III. Proposed Regulations Under Section 707 Relating to Management Fee Waivers

A. On July 22, 2015, Treasury and the IRS released proposed regulations (the "Proposed Regulations") under Section 707 of the Code that are intended to provide guidance on when a compensation arrangement between a partnership and a partner will be treated as a disguised payment for services.

1. The Proposed Regulations are generally intended to address so-called "management fee waivers," in which management companies waive their right to receive a portion of their management fees in exchange for a profits interest in the fund.

2. Although hedge funds have generally not adopted fee waiver programs, such programs are not uncommon among private equity funds. The specific terms of such programs, however, vary widely from fund to fund. Certain funds permit the sponsor to make periodic waiver elections, while others have adopted more of a "baked in" approach, with the waiver amount set at the beginning of the fund. Still others simply increase the economics of the general partner in the waterfall at the inception of the fund and have no concept of a fee waiver in the document.

3. Although the Proposed Regulations apply more broadly to any arrangement between a partnership and partner providing services, the Proposed Regulations were not intended to target standard incentive allocation or carried interest provisions common to hedge funds and private equity funds.

B. An allocation treated under Section 707 as a disguised payment for services will be treated as a payment for services for all purposes of the Code. In particular, the payment will be taxed as ordinary income, be subject to the deferred compensation regimes of Code Sections 409A and 457A (if applicable), and be subject to the applicable capitalization and deduction rules for the partnership.

C. In determining whether an allocation and distribution to a service provider constitute a disguised payment for services, the Proposed Regulations apply a facts and circumstances analysis and offer six non-exclusive factors. The most important factor is whether the arrangement has significant entrepreneurial risk ("SER").

1. An arrangement that lacks SER is treated as a disguised payment for services, whereas an arrangement that has SER will generally not constitute a disguised payment for services. The Proposed Regulations list facts and circumstances that create a presumption that an arrangement does not have SER:

   (a) Capped allocations of income if the cap is reasonably expected to apply in most years;

   (b) An allocation for one or more years under which the service provider's share of income is reasonably certain;

   (c) An allocation of gross income;

   (d) An allocation that is predominantly fixed in amount, is reasonably determinable under all facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider;

   (e) Waiver by a service provider of its right to receive payments for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

   Examples in the Proposed Regulations provide some guidance as to whether certain arrangements have SER. The examples make clear that Treasury is skeptical of arrangements that are based on profits over a period of time that is less than the life of the fund (e.g., 12 months) and for which the general partner has control over when profits are realized. However, the examples also indicate that a 12-month period is not a problem per se, particularly where the fund uses mark-to-market accounting (in the example, the fund makes a Section 475 election), and thus does not have control over whether profits are available to support the allocation.

2. In addition to the lack of SER, the Proposed Regulations list other factors that suggest a disguised payment for services:

   (a) The service provider holds a transitory partnership interest or a partnership interest for only a short duration.

   (b) The service provider receives an allocation and distribution in a timeframe comparable to the timeframe that a non-partner service provider would typically receive payment for services.

   (c) The service provider becomes a partner primarily to obtain tax benefits that would not otherwise have been available if the services were rendered to the partnership in a third-party capacity.

   (d) The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution it receives.

   (e) The arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by related persons, and the terms of the differing allocation or distributions are subject to levels of entrepreneurial risk that vary significantly.

D. The regulations would apply to all arrangements entered into or modified after the date that final regulations are published in the *Federal Register*.

1. If an existing arrangement permits a service provider to waive all or a portion of its fee for any period subsequent to the date the arrangement is created, then the arrangement is considered modified for purposes of the effective date on the date that the fee is waived.

2. Notwithstanding the fact that final regulations may not apply to an existing fee waiver plan, Treasury has indicated that it may still challenge plans lacking significant entrepreneurial risk using the existing statute, as it believes its position is consistent with the legislative history.

E. The Proposed Regulations also announce the intent of Treasury and the IRS to modify Rev. Proc. 93-27, which provides a "safe harbor" that the receipt of a profits interest for services provided to a partnership is generally a non-taxable event (i.e., valued based on liquidation value, which is zero for a true profits interest).

1. The modification to Rev. Proc. 93-27 would remove from this safe harbor a profits interest issued in connection with a management fee waiver program. This modification is very significant because it removes safe-harbor protection even if the fee waiver avoids recharacterization as a disguised fee under the new regulations.

2. Treasury also states that its interpretation of the safe harbor is that it does not apply to transactions in which a service provider (e.g., the management company of the fund) waives the fee and a different entity (e.g., the general partner of the fund) receives the profits interest because: (i) the transaction does not satisfy the requirement that receipt of a profits interest be for the provision of services in a partner capacity; and (ii) the service provider would have effectively disposed of the interest within two years of receipt.

F. Treasury states that the emphasis on SER requires changing an existing provision regarding guaranteed payments under Treas. Reg. 1.707-1.

1. In its current form, Example 2 of Treas. Reg. 1.707-1(c) provides that if a partner is entitled to the greater of a fixed amount or a percentage of partnership profits, the fixed amount is not treated as a guaranteed payment to the extent the amount actually allocated based on such percentage exceeds the fixed amount.

2. The Proposed Regulations modify the example to provide that the entire fixed amount is treated as a guaranteed payment, regardless of partnership profits.

IV. Dividend Equivalent Payments: Section 871(m)

A. Introduction

1. In 2010, Section 871(m) of the Code was enacted to treat as U.S. source dividends for U.S. withholding tax purposes:

(a) "Dividend equivalent payments" on "specified notional principal contracts" based on a four-factor statutory definition; and

(b) Substitute dividend payments on securities lending or sale-repurchase transactions.

2. On Sept. 17, 2015, Treasury issued final and temporary regulations (the "Final Regulations" and "Temporary Regulations," respectively, and together the "2015 Regulations") implementing Section 871(m) of the Code.

B. Current Law Overview

1. Under current law, a notional principal contract ("NPC") (generally, an equity swap) is a "Specified NPC" subject to withholding under Section 871(m) if the NPC provides for one or more amounts that may be contingent upon, or determined by reference to, U.S.-source dividends and at least one of the following four factors are present:

(a) In connection with entering into the NPC, a long party to the NPC transfers the underlying security to a short party to the NPC (known as "crossing in");

(b) In connection with the termination of the NPC, a short party to the NPC transfers the underlying security to a long party to the NPC (known as "crossing out");

(c) The underlying security is not readily tradable on an established securities market; or

(d) The underlying security is posted as collateral by a short party to the NPC with a long party to the NPC.

2. The current rules apply to transactions entered into on or before Dec. 31, 2016. Transactions entered into on or after Jan. 1, 2017 will be subject to the 2015 Regulations as described below.

C. The 2015 Regulations

1. Transactions That Can Give Rise to "Dividend Equivalent Payments" ("Section 871(m) Transactions")

(a) A "dividend equivalent" is any of:

(i) A substitute dividend that references a U.S. source dividend made pursuant to a securities lending or sale-repurchase transaction;

(ii) A payment that references a U.S. source dividend made pursuant to a specified notional principal contract (a "specified NPC");

(iii) A payment that references a U.S. source dividend made pursuant to a specified equity-linked instrument (a "specified ELI"); or

(iv) Another substantially similar payment.

(b) An NPC for purposes of Section 871(m) generally means an equity swap.

(c) An equity-linked instrument ("ELI") for purposes of Section 871(m) generally means any financial transaction that references the value of one or more underlying equity securities, potentially including: forward contracts, futures contracts, swaps, options, convertible preferred stock, convertible debt instruments and debt instruments linked to underlying equity securities.

The "portfolio interest" exception to interest withholding will not apply to any dividend equivalent payment under a debt instrument.

2. Miscellaneous Issues Regarding Dividend Equivalent Amounts

   (a) Any gross amount that references the payment of a U.S. source dividend, whether actual or estimated, explicit or implicit, is treated as a dividend equivalent to the extent of the amount determined under the 2015 Regulations.

   For example, the Final Regulations treat a price return swap as a transaction that provides for the payment of a dividend equivalent because the anticipated dividend payments are presumed to be taken into account in determining the other terms of the NPC.

   (b) A dividend equivalent with respect to a Section 871(m) transaction is reduced by the amount of any deemed dividend arising from adjustments of convertible debt instruments and other ELIs under Section 305 of the Code, such as a change to the conversion ratio or conversion price of a convertible debt instrument. Such a deemed dividend may still be subject to withholding under other Code sections.

   (c) A payment referencing a distribution on an underlying security is not a dividend equivalent subject to Section 871(m) to the extent that the distribution would not be subject to U.S. withholding if the long party owned the underlying security directly.

3. The "Delta" and "Substantial Equivalence" Tests

   (a) An NPC or an ELI is a specified NPC or specified ELI subject to Section 871(m) if the instrument has a "delta" of 0.8 or greater in the case of a "simple contract," or if a "substantial equivalence" test is satisfied in the case of a "complex contract," which is in each case determined at the time of the instrument's "issuance."

      (i) A "simple contract" is a contract that: (i) references a fixed number of shares (that is known when the contract is issued) of one or more issuers to determine the payments under the contract; and (ii) has a single maturity or exercise date on which all amounts are required to be calculated.

      (ii) A contract can still be a simple contract if it has a range of potential exercise dates (such as an option) as long as amounts due under the contract are determined by reference to a single, fixed number of shares on the exercise date.

      (iii) A "complex contract" is any contract that is not a simple contract, e.g., if the number of shares of stock referenced by the contract is not fixed, but rather varies based on the payoff amount, time of payout or some other factor.

   (b) The "delta" of a simple contract is generally a measure of how sensitive the fair market value of an instrument is to changes in the fair market value of the underlying security, generally ranging from 1 (completely dependent on the value of the underlying security) to 0 (completely independent of the value of the underlying security).

   (c) For a complex contract, the "substantial equivalence" generally measures the correlation between the value of the contract and the value of the shares used to hedge the contract at various testing prices. If this correlation is greater than the equivalent calculations performed for a simple contract specified ELI or a specified NPC, then the complex contract is a specified ELI or a specified NPC, as applicable. Treasury has invited comments to the "substantial equivalence" test.

4. Determining Delta/Substantial Equivalence

    (a) The determination of whether an instrument is a specified ELI or a specified NPC is made only on the date the instrument is "issued."

        An instrument is treated as issued when it is issued, entered into, purchased or otherwise acquired at its inception or original issuance, including an issuance that results from a deemed exchange pursuant to Section 1001 of the Code.

    (b) If one of the parties to a transaction subject to Section 871(m) is a broker or dealer, that party is required to determine whether a potential Section 871(m) transaction is a Section 871(m) transaction and report the timing and amount of any dividend equivalent to the other party.

    (c) If neither or both parties are dealers or brokers, then the short party must make such determination and provide such reporting.

5. Baskets, Indices and Miscellaneous Situations

    (a) Baskets: If a short party issues a contract that references a basket of 10 or more underlying securities and hedges the contract with an exchange-traded security that references substantially the same underlying securities, then the short party may use the hedge security to determine the delta of the contract it is issuing.

    (b) Combined Transactions: If a long party (or a related person) enters into two or more transactions that reference the same underlying security and the transactions were entered into in connection with each other, then the transactions are combined and treated as a single transaction for purposes of Section 871(m).

        (i) If a broker does not have actual knowledge that multiple transactions were entered into in connection with each other, the broker may generally presume the transactions were not entered into in connection with each other if either: (i) the transactions were entered into two or more business days apart; or (ii) the transactions are held in different accounts.

        (ii) The Final Regulations do not provide for the netting of a taxpayer's long and short positions, though the preamble to the Final Regulations leaves open the possibility of more expansive rules in the future.

    (c) Transactions Referenced to Partnership Interests: Section 871(m) only applies to payments on an NPC or ELI that references a payment on a partnership interest when the partnership: (i) is a trader or dealer in securities; (ii) holds significant investments in securities; or (iii) holds an interest in a lower-tier partnership described in (i) or (ii).

        A partnership is considered to hold significant investments in securities if either 25 percent or more of the value of the partnership's assets consist of underlying securities or potential Section 871(m) transactions, or the value of the underlying securities or potential Section 871(m) transactions equals or exceeds $25 million. In this case, dividend equivalent payments are determined by looking through to such partnership's underlying assets.

    (d) Indices: Transactions that reference a qualified index are generally excepted from Section 871(m). The qualified index exception is designed to provide a safe harbor for widely used passive indices that reference a diversified portfolio of long positions, and is not intended to apply to any index that: (i) is customized or reflects a trading strategy; (ii) is not generally available; or (iii) targets dividends.

(e) Anti-Abuse Rule: The IRS Commissioner may treat any payment on a transaction as a dividend equivalent if the taxpayer entered into or acquired the transaction with a principal purpose of avoiding Section 871(m). The IRS may also avail itself of general common law and statutory rules in order to challenge transactions that are designed to avoid the application of Section 871(m).

V. Deferred Fees

A. Who Is Subject to Section 409A?

Service providers who are subject to U.S. income tax and who account for gross income from the performance of services using the *cash method of tax accounting* are generally subject to Section 409A.

1. Employees described above are subject to Section 409A.

2. Cash method providers of investment management services (e.g., investment management firms or consultants who provide investment management services) are subject to Section 409A, even if they would otherwise satisfy the requirements to meet an independent contractor exemption from Section 409A.

3. Partners are generally not subject to Section 409A with respect to partner compensation arrangements, other than certain "guaranteed payments."

B. Who Is Subject to Section 457A?

Service providers who are subject to U.S. income tax and who account for gross income from the performance of services *to a nonqualified entity* using *any method of tax accounting* are generally subject to Section 457A.

1. Employees described above are subject to Section 457A.

2. Providers of investment management services (e.g., investment management firms or consultants who provide investment management services) are subject to Section 457A, even if they would otherwise satisfy the requirements to meet an independent contractor exemption from Section 409A.

3. Partners are generally not subject to Section 457A with respect to partner compensation arrangements, other than certain "guaranteed payments."

C. Nonqualified Entity

1. Any foreign corporation unless substantially all of its income is:

(a) Effectively connected with the conduct of a trade or business in the United States and is not otherwise exempt from U.S. federal income tax; or

(b) Subject to a comprehensive foreign income tax.

This generally means that the corporation is eligible for the benefits of a comprehensive income tax treaty with the United States, where the income is taxed and the corporation is not treated materially more favorably than other corporate taxpayers

2. Any partnership where more than 20 percent of its income is allocated to:

(a) Foreign persons with respect to whom such income is neither subject to a comprehensive foreign income tax nor "effectively connected income"; and

(b) Tax-exempt U.S. entities, unless the income is "unrelated business taxable income" that is taxable to such entities.

D. What Is a Deferral of Compensation Under Section 409A?

1. Compensation will be considered deferred if the service provider has a *legally binding right* to the compensation in one taxable year and payment either *is* or *may* be made after the later of:

(a) The 15th day of the third month following the *service provider's* first taxable year in which there is no longer a substantial risk of forfeiture attached to the right to the payment; or

(b) The 15th day of the third month following the *service recipient's* first taxable year in which there is no longer a substantial risk of forfeiture attached to the right to the payment.

2. A *legally binding right* does not exist if the service recipient can unilaterally reduce or eliminate the compensation, using a facts and circumstances test.

3. A s*ubstantial risk of forfeiture* exists if the service provider's rights to the compensation are conditioned on:

(a) The future performance of substantial services by an individual; or

(b) The occurrence of a condition related to the purposes of the compensation, where forfeiture is a substantial possibility.

E. What Is a Deferral of Compensation Under Section 457A?

1. Compensation from a *nonqualified entity* will be considered deferred if the service provider has a *legally binding right* to the compensation in one taxable year and payment is made after 12 months following the *service recipient's* first taxable year in which there is no longer a substantial risk of forfeiture attached to the right to the payment.

2. A *legally binding right* does not exist if the service recipient can unilaterally reduce or eliminate the compensation, using a facts and circumstances test.

3. A s*ubstantial risk of forfeiture* ***only*** exists if the person's rights to compensation are conditioned on the future performance of substantial services by an individual.

F. What Are the Consequences of a Section 409A Violation?

1. All compensation deferred under the plan for the current year and all previous years is included in current income, to the extent not subject to a substantial risk of forfeiture and not previously included in income.

2. *Interest at the underpayment rate + 1 percent* is charged on the underpayments of tax on such amounts had such amounts been included in income for the year deferred.

3. An *additional tax equal to 20 percent* of the amount included in income under 1 above is added to the current year's tax.

G. What Are the Consequences of Having Compensation Taxed Under Section 457A?

If the amount is not paid by the end of the service recipient's tax year following the year in which the compensation is no longer subject to a substantial risk of forfeiture, ***either***:

1. Amounts are included in income for the year in which the services are rendered (*i.e.,* ***taxed as accrued***); or

2. If the amount is not determinable, then:

   (a) Such amount is included in current income for the year in which such amount becomes determinable;

   (b) Interest at the underpayment rate + 1 percent is charged on the underpayments of tax on such amount had such amount been included in income for the initial year in which the services generating such compensation were rendered; and

   (c) An *additional tax equal to 20 percent* of the amount included in income under (a) above is added to the current year's tax.

H. Common Compensation Caught Up in the Section 457A Net

1. "Traditional" hedge fund deferred compensation

2. Incentive fees from "side-pocket" investments

3. Compensation based on a multi-year performance period

4. Employee deferred bonuses from certain portfolio companies or "nonqualified" management companies

I. Taxation of Maturing Deferrals

1. Taxable no later than 2017, whether or not paid by Dec. 31, 2017

2. Side-pocket or non-fund investment value still must be paid

   (a) Can pay in kind

J. Tax Planning by Manager for Maturing Deferrals

1. Investing in offshore fund in 2017 with a QEF election: deferred fee expense reduces QEF income inclusion for 2017

2. Charitable contributions (limits on what people can get a deduction for)

3. If the deferral arrangement is not "back-to-back" with the management company's partners, the management company can pay out other expenses (e.g., employee bonuses) by Dec. 31, 2017

4. Election to go on accrual method

   (a) Consider whether to elect for 2016 or 2017.

   (b) If back-to-back deferral arrangement, partner taxation on distributions would not match up with the accrual method 4-year spread.

      (i) The management company's partners are taxed on the accrued amount ratably over four years, beginning with the year of accounting method change. Cash must be distributed, however, based on the deferral plan in effect.

      (ii) If the partners elect to "re-defer" the receipt of their share of the deferred fees from the management company, such election must push back their distribution dates by a minimum of five years and must be made a year in advance of the distribution date. Such action would generally leave sizeable assets sitting in the management company for several years.

K. Asset Allocator Diligence

1. What is the manager looking to do with the deferred fees? Note that potentially half of the amount or more will be paid to the government in taxes.

2. What percentage of the fund do the fees represent/how will the manager liquidate the portfolio in order to pay the deferred fees?

VI. United Kingdom: 'Disguised Investment Management Fees' and 'Performance-Related Returns'

Over the past 12 months, the United Kingdom has introduced what is in effect a comprehensive new regime for the taxation of sums received by investment managers for the provision of investment management services in the United Kingdom. The new regime is to be introduced in three stages: (i) new rules on taxation of "disguised investment management fees" that were effective April 6, 2015 (the "DIMF" rules); (ii) new rules on the taxation of carried interest (which are referred to as "performance-related returns" or "performance-linked rewards") that were effective Oct. 22, 2015; and (iii) new rules on "income-based carried interest" that will be effective April 6, 2016.

A. Disguised Investment Management Fees

1. Under the DIMF rules effective April 6, 2015, all sums arising to an individual for the provision of investment management services that are "untaxed" (the sums arising could be by way of profit allocation, loan, advance, dividend or in any other form) are, subject to two exceptions set out below, treated as the profits of a trade carried on by that individual. The individual is likely to be subject to tax on the profits of this deemed trade at rates of 45 percent income tax and 2 percent national insurance contributions (NIC). Sums arising to the individual manager are "untaxed" unless the manager is already chargeable to income tax and NIC on the sums as employment income or trading income.

2. The exceptions to the taxation of a sum arising to a manager under the DIMF rules are: (i) if the sum arising is an arm's-length return on an investment made by the manager in the fund (the investment being of the same kind of investments in the fund made by external investors); or (ii) if the sum

arising is "carried interest." A sum will be "carried interest" if it is a "profit-related return" — that is, a sum that arises only if the fund has profits for a period and which is variable, to a substantial extent, by reference to those profits, provided that the returns to external investors are also determined by reference to the same profits. However, a sum will not be "carried interest" if, at the time that the manager became party to the arrangements or began to perform investment management services, there was "no significant risk" that the sum would not arise.

3. Where a sum is treated as profits of a deemed trade under the DIMF rules, the deemed trade is treated as carried on inside or outside the United Kingdom to the extent that the manager performs the investment management services from which the sum is treated as arising inside or outside the United Kingdom. For a U.K. tax resident manager, this will mean that all of the sums arising (all of the profits of the deemed trade) are subject to U.K. income tax and NIC. However, for a non-U.K. tax resident manager — e.g., a U.S.-based manager — who spends some amount of time in the United Kingdom, there remains the possibility that the manager may be subject to tax under the DIMF rules on sums arising to him to the extent that those sums are considered to arise from investment management services that he performs in the United Kingdom. In most cases, however, it is considered that such a manager may be able to avoid taxation under the business profits article an applicable double tax treaty between the United Kingdom and the manager's jurisdiction of residence, which would generally provide that the manager would be subject to U.K. taxation only to the extent that he had a "permanent establishment" in the United Kingdom. If the manager's time spent in the United Kingdom is sufficiently limited to avoid the creation of a "permanent establishment," sums arising to that manager for the provision of investment management services in the United Kingdom should not be liable to taxation under the DIMF rules.

B. Carried Interest or 'Performance-Related Returns'

1. As described above, sums arising to a manager that are "carried interest" are excluded from taxation as profits of a deemed trade under the DIMF rules. However, with effect from Oct. 22, 2015, the United Kingdom introduced a new stand-alone capital gains regime for the taxation of carried interest.

2. Under this new regime, all amounts of carried interest — as defined in the DIMF rules — arising to a manager on or after Oct. 22, 2015 are subject to a capital gains tax ("CGT") charge of 28 percent.

3. If the manager is also subject to other tax charges on the carried interest (e.g., if the carried interest is wholly or partly comprised of interest or dividends, on which the manager may be chargeable to income tax, or an allocation of realized capital gains, on which the manager may be separately chargeable to CGT), the manager may make a claim for credit for those other taxes against the CGT charge in order to avoid potential double taxation.

4. One important feature of the new carried interest CGT charge is that where the investment management services that give rise to the carried interest are performed in the United Kingdom, a non-U.K. domiciled manager will not be able to use the remittance basis of taxation to defer the CGT charge on carried interest. This is a significant difference from the position that prevailed prior to the introduction of this new carried interest CGT charge, where the remittance basis was available to a non-U.K. domiciled manager to the extent that the carried interest comprised an allocation of capital gains arising from the realization of non-U.K. situs assets or non-U.K. source income.

C. Income-Based Carried Interest

1. Further draft legislation issued alongside Finance Bill 2016 sets out additional changes to the taxation of carried interest arising on or after April 6, 2016.

2. Under these new rules, sums arising to an individual from the performance of investment management services will qualify as carried interest (and so be excluded from the charge to income tax and NIC under the DIMF rules, but be subject to CGT under the new carried interest CGT charge) only if the fund has an average value-weighted holding period for its investments of at least three years. Where the average value-weighted holding period of the fund's investments is between three and four years, partial CGT treatment will be available, but full CGT treatment (i.e., full exclusion from income taxation under the DIMF rules) will be available only if the average value-weighted holding period of the fund's investments is at least four years. There are complex rules setting out how the average value-weighted holding period of fund's investments is to be calculated.

3. The U.K. government has been clear, in putting forward its proposals, that the income-based carried interest rules are intended not to affect carried interest in private equity funds, where the average investment-holding period is more than four years, but are intended to stop funds with a shorter-term "trading strategy" (such as hedge funds) from giving managers rewards that benefit from CGT treatment.

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