Sunrise Series: Preparing for year-end tax planning

Year-end tax planning and updates

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October 22, 2019

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Tax controversy update

October 2019

IRS Enforcement overview

Current Enforcement Landscape

— New Leadership

— Growing support from Congress for an increase in IRS enforcement

— Enactment of Taxpayer First Act of 2019

— Improving partnership tax compliance is a central area of focus:

  - changes made to key partnership tax forms to improve information that is gathered on partnerships

— Elective, multi-year training program to be implemented.

  - Participants to earn the equivalent of an “light” LLM degree, with an initial focus on partnership issues.

Centralized Partnership Audit Regime Updates

— New procedures for updating Schedule K-1 information after the due date of the partnership return

— Issuance of Draft Form 8985 (Partnership Push Out Summary), Form 8985-V (Tax Payment by a Pass-Through Partner) and Form 8986 (Partner’s Statement Required under Section 6226)

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IRS LB&I campaigns

SECA Tax Campaign

— Significant increase in IRS activity related to the Self-Employment Contributions Act tax.

Form 1120-F Campaigns

— Focus on Delinquent Returns, Non-Filers and Withholding Tax Refunds

— Recent TIGTA report examines effectiveness of Form 1120-F Non-Filer Campaign

Virtual Currency Campaign

— Campaign will address noncompliance related to the use of virtual currency through multiple treatment streams including outreach and examinations. Taxpayers with unreported virtual currency transactions are urged to correct their returns as soon as practical. The IRS is not contemplating a voluntary disclosure program specifically to address tax non-compliance involving virtual currency.

— Revenue Ruling 2019-24--first IRS guidance issued on virtual currency since IRS Notice 2014-21

— See also Frequently Asked Questions and Answers on virtual currency on IRS website: https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions

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Cleansing the carry

Overview of carried interest legislation

New section 1061 recharacterizes certain net long term capital gains that do not have a holding period of more than 3 years as short term capital gains

— Gains “with respect to” applicable partnership interests (APIs)

— APIs are partnership interests that are **directly or indirectly transferred to, or held by**, a **taxpayer** in connection with the performance of **substantial services** by the **taxpayer or a related person** in any “**applicable trade or business.**”

— Aspects to focus on here:

- Taxpayer
- Indirectly…held by
- Related person

— Key Exception: Commensurate with Capital

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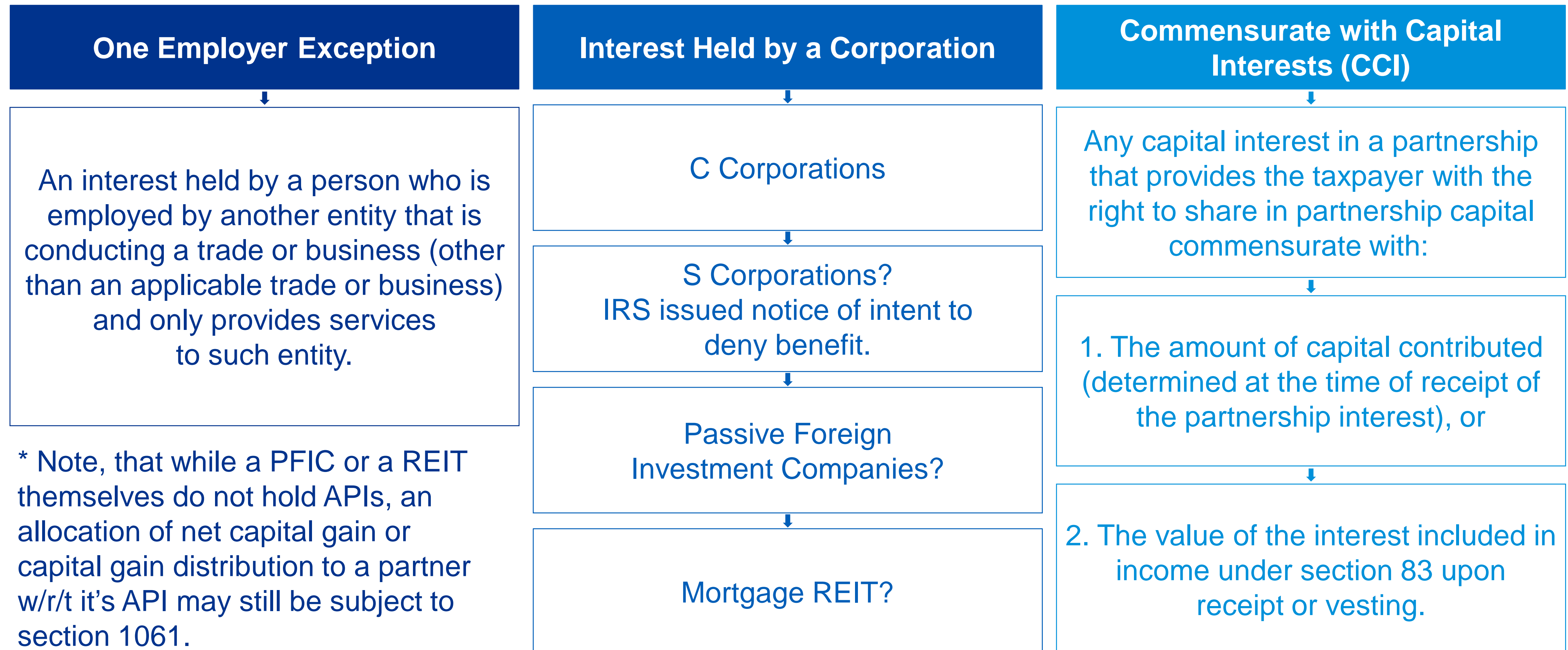
Exceptions

An API does not include:



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Carried interest

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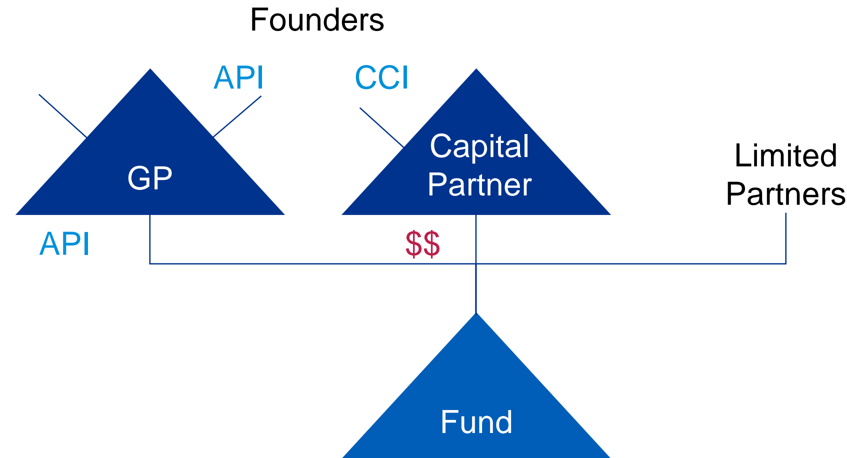
New funds structuring



CCI and API Interests are held in separate tax persons

— Founders contribute cash directly to Fund for LP interest

— Founders capitalize GP and GP is issued a profits interest in Fund

Advantages of Separating CCI from API

— Clearly identified distributions

— Clearly identified long term capital gains subject to recharacterization (or not) as tax allocations are made with respect to each separately-held interest and separate Schedule K-1s are issued for each

Possible Disadvantages of Separating CCI from API

— Does separation raise other issues? e.g., Rev. Proc. 93-27

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New funds structuring (continued)

Does the Founder have to separate the API and the CCI geographically?

— Legislative history contains language suggesting interest can be bifurcated; statute does not.

— Separation yields a certainty.

— Separation also removes complications associated with having one basis and one capital account for federal income tax purposes.

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Tax treatment of reinvested carry

In many hedge funds, the sponsor's carry allocations are automatically reinvested.

— A CCI is determined at the time of receipt of such partnership interest.

— A CCI requires a contribution of capital in exchange for a qualifying interest.

  - Earnings on reinvested carry is economically similar to earning the carry, taking a distribution, and recontributing it for a capital interest.
  - But that, in fact, has not happened.
  - Prior versions of carried interest legislation affirmatively provided mechanisms to include earnings as "qualified capital"; TCJA did not

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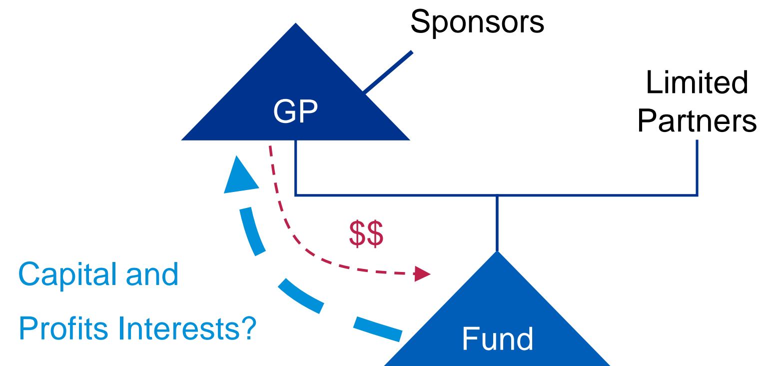
Existing interests

Blended API and CCI



There is no grandfather rule for existing partnership interests.

As such, fund sponsors may presently hold a single interest in an existing fund representing both the sponsor's contributed capital and the sponsor's entitlement to carry or incentive allocations.

- What happens if taxpayer is allocated in 2019 a LTCG with a holding period of < 3 years? Does taxpayer have to recharacterize its LTCG as STCG?
- Can the GP do self help now to substantiate that some, none, or all of the <3 Year LTCG is not subject to recharacterization?
  - Can you bifurcate the API from the CCI?
  - Legislative history contains helpful language; statutory language is not as clear.

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Blended interests

Sponsor capital and carried interests in one of three ways:

1. Separate Taxpayer Approach
   - Sponsors contribute capital to the fund and receive their incentive interest through a distinctly separate regarded entity.
   - General Partner holds capital interest.
   - “Carried Interest Partner” holds incentive.
   - Distributions and allocations of gain, since made to separate legal entities, are easily traced to API or CCI.
2. Separate Class Approach
   - Sponsors contribute capital to the fund and hold their capital and incentive interests through the same tax entity, but separate and distinct legal interests are issued.
   - Example: GP is issued Series A Units for its capital interest and Series B Units for its carried interest.
   - Typically have distinct separate cash distribution entitlements and as such cash can be traced.
   - Tax allocations historically may have been made by first determining the total entitlement of each class of unit, and then combining them in order to apply the “target” allocation. Consider whether tax allocations for 2019 and forward should be separated and made with respect to each class of interest.

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Blended interests (continued)

3. Single Interest Approach
   - Sponsors contributed capital to the fund and receive an interest that has the capital allocations and carried interest allocations embedded in one legal class of interest
   - Private equity typically has distinct cash distribution entitlements with respect to capital and carry;
   - Hedge funds typically do not have distinct cash distribution entitlements
   - Tax allocations historically have been made by determining the total entitlement of the one interest to apply the “target” allocation.
     - Consider whether tax allocations for 2019 and forward should be separated and made with respect to each class of interest.

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Blended interests (continued)

3. Single Interest Approach (continued)
   - Earnings on reinvested incentive allocations are problematic under the new law.
     - Section 1061 does not provide an exception for previously-taxed incentive that is left in the Fund.
     - As such, future earnings on these amounts arguably remain subject to the 3 year gain recharacterization rules.
     - Particularly problematic within a hedge fund structure; private equity structures more often distribute sales proceeds attributable to carry (beware reinvestment of undistributed cash to satisfy future GP capital calls).
   - At a minimum, partnership interests in hedge funds that are part-API and part-CCI should be analyzed to determine each portion as at 12/31/17 (and calculated forward) in order to substantiate <3 year LTCG that is *not* subject to recharacterization.

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Year-end tax considerations

Estimates and elections

Tax estimates are a proactive approach to managing investor and general partner expectations before year-end.

- Manage investor expectations
- Update partner information
- Compare preliminary taxable income to book income
- Monitor tax adjustments as year-end approaches
- Review prior year tax adjustments for possible reversals and impact on taxable income
- Evaluate current tax adjustments through interim testing period
- Review of withdrawing partners to determine potential impact of fill up/fill down allocation of gains and losses
- Consider impact anticipated redemption requests will have on the fund from tax perspective
- Develop understanding of how interim taxable income will be allocated amongst investors
- Work with tax advisors to plan tax lot relief methodologies
- Execute strategies to recognize gains/losses for income tax purposes (wash sale / straddle planning)
- Issue tax estimates to investors before year-end
- Meet and discuss with your tax advisor in advance
- Monitor trading activity periodically before year-end – no surprises!

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Power of estimates

- Only way to truly know how all tax effects will blend and tier to partners
- Provide a “heads-up” to GP members
- Ability to get in front of issues while there is still time to address them
- Avoid surprises

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Wash sale/constructive sale planning

Harvesting losses

— At the end of the year, many funds are looking for ways to make their year end tax results match their book results or reduce the tax burden their investors will incur.

— Many investors have seen positive fund performance in 2019 and expect to have to pay some tax

- Goal in 2019 should be aimed at reducing short-term gains to the extent they'll be allocated to investors remaining in the fund

— In reviewing their YTD results funds may realize they have net realized gains but their portfolio is full of unrealized losses in securities they frequently trade and/or believe will turn to make a profit in the future.

— Funds want to harvest their unrealized losses and place their remaining investors in a better tax position but don't want to lose exposure to the securities they currently hold in their portfolio.

— Knowing they cannot simply sell off the unrealized loss positions and repurchase the securities without triggering a wash sale (under IRC Section 1091), depending on your portfolio there may be alternative strategies that don't require being naked for greater than 30 days.

*** Note: The following pages describe certain trading strategies which managers may see in the market. These are described for discussion purposes only. KPMG does not endorse the use of any trading strategies and technical arguments could be made to disclaim the expected tax benefits of many of these trading strategies.**

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Wash sale strategies

1. Double-Up

Trade Example: On January 1, 2019, the Investor bought 100 shares of XYZ at $100 per share (Block 1). XYZ is now trading for $60, so there is a $4,000 unrealized capital loss. Today, the Investor buys 100 more shares of XYZ at $60 (Block 2). After 31 days, the Investor can sell Block 1 and realize a loss at that point. The loss recognized will vary with the stock price after the 31 days. In the alternative, the Investor could also double-up with the purchase of call options.

Economic Risk: Twice the exposure for 31 days.

Tax Analysis: The Investor can specifically identify which block of shares is sold in a given transaction.

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Wash sale strategies (continued)

2. Double-Up and Sell Call Options

Trade Example: On January 1, 2019, the Investor bought 100 shares of XYZ at $100 per share (Block 1). XYZ is now trading for $60, so there is a $4,000 unrealized capital loss. Today, the Investor buys 100 more shares of XYZ at $60 (Block 2) and sells a call option on 100 shares of XYZ. The call option sold is structured to be a qualified covered call ("QCC") under the straddle rules. The strike and maturity of the call option are chosen to meet the Investor's risk preferences. After 31 days, the Investor can sell Block 1, repurchase the call option and realize a loss at that point. The loss recognized will vary with the stock price and option price after the 31 days.

Economic Risk: Between one and two times the exposure for 31 days. The Investor can sell extra call options in order to bring their initial delta as close to one as possible.

Tax Analysis: The Investor can identify which shares are sold in a given transaction. QCCs are not straddles and losses on them can be recognized before gains on offsetting positions, as long as the offsetting position remains unhedged for 30 days.

Caution: Larger Straddle Rule – If the Investor had increased his exposure by buying calls instead of stock, the written calls may not be QCCs. QCC status does not apply to options that are considered part of a larger straddle, which in this case could include the purchased calls. See Rev. Rul. 2002-66 where covered calls that were written along with the purchase of puts were ineligible for QCC exception to the straddle rules. In such a case any excess loss realized on closing out the written call position may be deferred under the straddle rules to the extent of the unrealized gain on the purchased call. Also, losses arising from straddle transactions may be subject to special rules for "reportable transactions." Note special year-end rule regarding QCCs if gain is realized.

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Wash sale strategies (continued)

3. Sell Stock and Sell Puts

Trade Example: On January 1, 2019, the Investor bought 100 shares of XYZ for $100. XYZ is now trading for $60, so there is a $4,000 unrealized capital loss. Today, the Investor sells the shares of XYZ at $60 and sells a put option on 100 shares of XYZ and collects the premium. Upon the sale of the stock, the Investor should recognize the $4,000 loss. The strike and maturity of the puts are chosen to meet the Investor's risk preferences. After 31 days, the Investor can repurchase the put option and the stock. Depending upon the option price at that time, the Investor may recognize a gain or loss on the option.

Economic Risk: Somewhat less than one times the exposure for 31 days, depending upon the delta of the put options. The Investor can sell extra put options in order to bring their initial delta as close to one as possible.

Tax Analysis: Under Revenue Ruling 85-87, if there is a "substantial likelihood" that the put options will not be exercised, the sale of the puts should not trigger the wash sale rules. Investor will need to consult with their advisors regarding the amount by which the option can be struck in-the-money and not considered to be to be "substantially likely" to be exercised. Factors to consider in this determination include strike price, maturity of the option contract and the underlying volatility of a particular stock.

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Wash sale strategies (continued)

4. Double-Up, Sell Calls, Buy Puts

Trade Example: On January 1, 2019, the Investor bought 100 shares of XYZ for $100 (Block 1). XYZ is now trading for $60, so there is a $4,000 unrealized capital loss. Today, the Investor buys 100 shares of XYZ at $60 (Block 2), sells a call option on 100 shares of XYZ and buys a put option on 100 shares of XYZ. The put and the call should have different strikes. The options have maturities of at least 32 days. The strikes and maturities of the options are chosen to meet the Investor's risk preference. Prior to the options expiration, and at least 31 days after the additional shares were purchased, the Investor can sell Block 1, cash settle the options and then recognize the loss. The loss will equal $4,000 if the stock is still trading at $60 and the options have not moved in value.

Economic Risk: Close to one times the exposure during the life of the options.

Tax Analysis: Under the wash sale rules (particularly Treas. Reg. Sec. 1.1091-1(g)), a short sale is treated as closed out when entered into. Therefore, if the Investor had sold XYZ short, instead of entering into the options trade, the wash sale rules would disallow the loss. The options, however, are unlikely to be construed as a short sale. Consequently, the wash sale rules should not disallow the loss on the sale of Block 1.

Note, any loss resulting from Block 1 and the options will be subject to the straddle rules to the extent of the unrealized gain on Block 2. See Revenue Ruling 2002-66, whereby even if the calls are otherwise qualified in terms of maturity and not being deep-in-the-money, the existence of the put renders the positions part of a "larger straddle" and thus, the calls would not be considered qualifying for the QCC exception to the straddle rules. It's also worth noting that the straddle will toll the stock's holding period for purposes of qualified dividend income. Moreover, losses arising from straddle transactions may be subject to special rules for "reportable transactions." Note, special year-end rule regarding QCCs if gain is realized.

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Wash sale strategies (continued)

5. Sell Stock, Buy Call, Buy Stock

Trade Example: On January 1, 2019, the Investor bought 100 shares of XYZ for $100 (Block 1). XYZ is now trading for $60, so there is a $4,000 unrealized capital loss. Today, the Investor sells the 100 shares of XYZ at $60, and buys a call option on XYZ struck at $60 (with a term greater than 31 days). After 31 days, the option is sold and Investor acquires 100 shares of XYZ at market price (Block 2).

Economic Risk: The number of options purchased can be adjusted to bring the initial delta as close to one as possible.

Tax Analysis: The initial sale of stock followed by the purchase of a call option is a wash sale and the disallowed loss *may be* added to the basis of the call option. The purchase of Block 2 should not be considered substantially identical to the call option (assuming the call is not deep in the money). The subsequent sale of the call option should allow the loss to be recognized at that time.

Note that as a technical matter, this transaction should be able to be accomplished in four days or less. That is, the option can be purchased on day 1, stock sold on day 2, replacement stock purchased on day 3 and option sold on day 4. If this short-term strategy is employed it may be helpful to utilize two trading accounts. If executed in a single account the normal reporting systems of the broker will likely pick up the sale of Block 1 and purchase of Block 2 inside the 61-day period and report it to you as a wash sale (i.e, it reports the wrong wash sale). In addition, losses arising in transactions where the tax basis is not determined solely by reference to the amount paid in cash may be subject to special rules for “reportable transactions.”

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Wash sale strategies (continued)

6. Sell Stock, Enter into Reverse Collars

Trade Example: On January 1, 2019, the Investor bought 100 shares of XYZ for $100 (Block 1). XYZ is now trading for $60, so there is a $4,000 unrealized capital loss. Today, the Investor sells the 100 shares of XYZ at $60, buys a 3-year call option on XYZ struck at $66 and sells a 3-year put option struck at $54 (20% band around the market price). After 31 days, the options are unwound and 100 new shares of XYZ stock are purchased (Block 2). At this point, the $4,000 loss is realized, assuming the stock is still trading at $60 and the options have not moved in value.

Economic Risk: The number of options entered into can be delta adjusted to result in a risk profile very close to one times the exposure during the life of the options. For example, a reverse collar on 125 shares of XYZ may approximate exposure to 100 shares of XYZ.

Tax Analysis: The initial sale of stock followed by the purchase of a call option is a wash sale and the disallowed loss *may be* added to the basis in the call option. The subsequent sale of the call option and purchase of Block 2 should not be a wash sale, so any loss is recognized then.

Note, a sufficient spread in strikes of the options should avoid characterization of the options as substantially identical to the stock. In addition, losses arising in transactions where the tax basis is not determined solely by reference to the amount paid in cash may be subject to special rules for “reportable transactions.”

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Wash sale strategies (continued)

7. Close Short Sale, Buy Put

Trade Example: On January 1, 2019, the Investor sold short 100 shares of XYZ for $100. XYZ is now trading for $140, so there is a $4,000 unrealized short-term capital loss. Today, the Investor buys 100 shares of XYZ at $140 to cover, and buys a put on 100 shares of stock. The Investor ought to be able to recognize the short-term capital loss at that time.

Economic Risk: Less than one times the exposure.

Tax Analysis: While the wash sale rules apply to short sales replaced by another short sale on substantially identical securities, they do not apply to a short sale replaced with a long put position. If a long put is not too far in-the-money it is unlikely to be considered analogous to a short sale.

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Wash sale strategies (continued)

8. Sell Stock, Long Equity Basket Swap

Trade Example: On December 15, 2019, Investor identifies a sub-portfolio of positions within its larger portfolio where each position is trading below its historic tax basis. The Investor is also interested in adding economic exposure to other positions. Investor sells the sub-portfolio at a loss and enters into a total return swap on a basket that includes both the liquidated sub-portfolio and the desired additional positions.

Economic Risk: One times the exposure of the liquidated portfolio *plus* the full exposure of the additional positions.

Tax Analysis: As long as the basket is properly constructed, it should not be considered substantially similar or related property ("SSRP"). See Treasury Regulation Section 1.246-5. SSRP is a more liberal standard than the "substantially identical" test for the wash sale regulations, and as such, the swap should not be deemed a wash sale vs. the sale of the stock portfolio.

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Wash sale strategies (continued)

9. Sell Stock, Long Equity Swap

Trade Example: On January 1, 2019, the Investor bought 100 shares of XYZ for $100 (Block 1). XYZ is now trading for $60, so there is a $4,000 unrealized capital loss. Today, the Investor sells the 100 shares of XYZ at $60, and enters into a total return equity swap on XYZ with an initial price of $60 and a term of one to twelve months. Investor terminates the swap post year-end and immediately acquires 100 shares of XYZ at the then market price.

Economic Risk: One times the exposure.

Tax Analysis: The sale of the stock and entering into the total return swap *likely* trigger the wash sale rule and, if so, the embedded loss is added to the basis of the swap. If Investor has elected to mark its swaps to market pursuant to Prop. Treas. Reg. Section 1.446-3(i), the swap contract will automatically mark-to-market at year end and the embedded loss will be recognized. Note, a side effect of this method is that it transformed a capital loss to an ordinary loss which can be helpful.

* The method of execution in and out of the swap can influence the tax outcome.

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Wash sale strategies (continued)

10. Sell Index ETF, Long Index Option

Trade Example: On January 1, 2019, the Investor bought 100 shares of XYZ Index ETF for $100 (Block 1). XYZ ETF is now trading for $60, so there is a $4,000 unrealized capital loss. Today, the Investor sells the 100 shares of XYZ ETF at $60, and buys a XYZ index call option with a strike of $60 and a term of one to twelve months. Investor sells the index option post year-end and immediately acquires 100 shares of XYZ Index ETF at the then market price.

Economic Risk: One times the exposure.

Tax Analysis: The sale of the ETF and acquisition of the index option should trigger the wash sale rules and the embedded loss is added to the basis of the option. The option, since it's a non-equity option, is a Section 1256 contract subject to annual mark-to-market. Thus, the index option will mark at the close of the year and the embedded loss will be recognized and treated as 60% long-term and 40% short-term (which may be helpful or harmful depending on the circumstances).

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Boxed trades?

Consider boxing positions as an alternative to selling during the year

— During the year when selling positions of sizable tax gains (or losses) consider completely hedging the position and exiting the position economically but not physically (i.e., boxing the trade)

  - Note – boxing short-term positions will terminate the holding period

— During Q4, assess the then current book/tax position (recommend actual estimates)

  - If tax is less than book, release the box and dispose of the position – Trigger Tax Gain
  - If tax is greater than book, keep positions boxed and move gains to next tax year – Do Not Trigger Tax Gain

    — Boxed position is “**Constructive Sale**” – must be unboxed by January 30th of year 2 (shorts must settle by 1/30), and must remain unhedged (with respect to those specific shares) for 61 days.

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Looking ahead: Planning opportunities

988 Election/475 Election

Consider elections and other alternatives to improve your tax position

- Making the 988(a)(1)(b) election on currency forwards used for hedging
  - Currency forwards are often entered into when trading foreign securities in order to offset currency fluctuations in the price of the security
  - Currency forwards are ordinarily marked-to-market and taxed at ordinary rates regardless of holding period
  - Under 988(a)(1)(b), currency forwards retain marked-to-market *but* taxpayers treat gains/losses on certain foreign currency arrangements as capital
    - Gain on currency forwards under the election that are taxed as Section 1256 contracts have capital gain / loss that is 60% long-term and 40% short-term
  - Helps match gains and losses on forward currency contracts with the related equity/debt investment
- Bond funds can opt to make the 475(f)(1) election if the fund is a “trader” for tax purposes
  - Helps match income and expense items
  - Interest income earned on bonds and capital losses recognized upon sale are treated as ordinary income
  - Allows investors to net the two items together on their individual tax returns
  - Doesn’t limit capital losses to $3,000 per year
  - Assuming bond fund doesn’t intend on buying bonds to hold long-term, this option may want to be considered

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PFIC conversion

- Convert offshore investor funds into passive foreign investment companies (PFICs)
  - Investor funds are able to net portfolio deductions (otherwise denied as a miscellaneous itemized deduction) with investment income for a dollar-for-dollar reduction in taxable income
  - Funds also have ability to offset capital gains with portfolio deductions
  - In years of economic loss, investors will be unable to recognize any taxable loss until disposition of PFIC interest
  - Many deductions are lost at the state level
  - Interest expense limited by 163(j) may have minimal effect within PFIC
  - Consider effect to carry

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Section 199A

Section 199A provides a potential 20% deduction with respect to an individual’s share of “qualified business income” (“QBI”) from a partnership, S corporation, or sole proprietorship.

- Effectively **reduces highest federal tax rate to 29.6%** (80% of 37%).
  - Limited to 50% of W-2 wages (and/or other limitations, if applicable), for taxpayers with taxable income above certain thresholds
- Applies to direct lending
- Final Section 199A regulations make clear that the activities of originating loans is not a specified service trade or business (“SSTB”)
- Sales of originated loans will also not cause an SSTB (this is a change from the proposed regulations which permitted only “negligible sales”

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Section 199A

Section 199A also provides a 20% deduction against certain REIT and PTP income

- Qualified REIT Dividends (not QDI and with respect to REIT stock held 45 days or longer)
- Qualified PTP Income (distributive share of the PTP's QBI)

— Effectively **reduces highest federal rate to 29.6%** (80% of 37%)

- **No W-2 limitation** for REIT and PTP income
- Non-REIT pass-through structures available for bricks & mortar real estate
  - Utilize alternative limit of, sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.

— Mortgage REITs as well as conventional REITs qualify

— Private REITs and public REITs qualify

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Match tax character

Make the most of tax character matching

- STCG – STCL = Net STCG
- LTCG – LTCL = Net LTCG
- Net LTCG – Net STCL (inefficient use of attribute)
- Net STCG – Net LTCL (efficient use of attribute)
- Net STCG is taxed as ordinary income (~ 40.8%, including NII tax)
- Net LTCG is taxed as LTCG (~23.8%, including NII tax)
- Capital loss carry overs usable $3k per year against ordinary income

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Qualified opportunity zones

QOZ funds

Tax Reform Permits the Deferral and Potential for Exclusion of Tax Gains by Investing in Qualified Opportunity Zone Funds

— Elect within 180-days from tax gain event, or if applicable, from the last day of the partnership's taxable year.

— Capital gains (short and long term) may be deferred, including net annual Section 1256 gain

— Beware of "Offsetting Position Transactions"

— Can be elected by the partnership or the partner

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Program overview

A taxpayer must sell property to an unrelated person that generates a capital gain and then within 180 days of such sale invest gains in a QOF.

The taxpayer's gain on the initial sale is deferred to the extent the gain is invested in the QOF and the taxpayer makes the 1400Z deferral election on its tax return.

Eligible gains that a taxpayer reinvests into a QOF are deferred and may be partially excluded until the earlier of the date the interest is sold or exchanged or December 31, 2026.

The amount of gain included in income as of December 31, 2026 is:

— The lesser of (1) the deferred gain, or (2) the fair market value of the investment, over

— The taxpayer's basis in the investment.

Gains on a sale of an investor's QOF interest (or under the proposed regulations, capital gains on the sale of QOZ Property allocated to the investor) may be permanently excluded, if the investor has held the QOF interest for at least 10 years.

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What are the potential federal income tax benefits of investing in a QOF ("DRE" benefits)?

Benefit	Details
Deferral ("D") (Benefit #1)	**Gain deferral:** Taxpayer defers capital gains tax on gains invested in the QOF ("deferred gains"). Taxpayer does not receive any initial basis for the deferred gains invested in the QOF.
	Estimated benefit: Capital gains deferred until December 31, 2026
	Benefit description: Time-value of money until December 31, 2026
Reduction ("R") (Benefit #2)	**Basis step-up:** Taxpayer steps-up its basis with respect to the deferred gains invested in the QOF
	Estimated benefit: Basis with respect to deferred capital gains invested in the QOF stepped-up 10% of the deferred gain after 5 years and additional 5% after 7 years of QOF investment
	Benefit description: Amount of deferred gains invested in the QOF that is ultimately recognized is reduced by 10-15%.*
Exclusion ("E") (Benefit #3)	**Appreciation exclusion:** Taxpayer excludes appreciation gain through basis step-up upon disposition of QOF investment after 10 years (or under the proposed regulations, on capital gains allocated from QOZ property dispositions).
	Estimated benefit: 100% basis step-up
	Benefit description: Elimination of tax on appreciation of QOF investment upon disposal after 10 years

*The deferred gain recognized may be further reduced to the extent the fair market value of the investment is less than the deferred gain on December 31, 2026.

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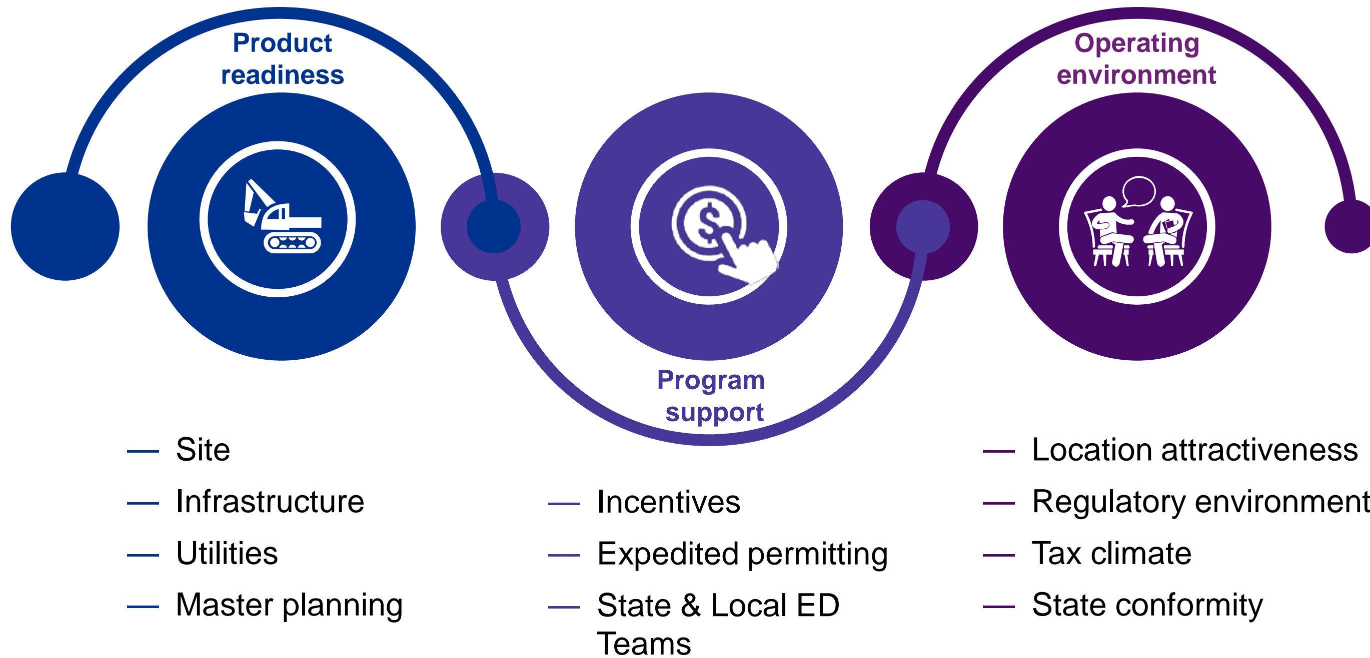
State & Local (S&L) benefit enhancements

S&L Incentives (Benefit #4)	
	Incentives: Various state and local project incentives and project support described below
	Estimated benefit: Offset 10% - 15% of project costs
	Benefit description: Statutory and discretionary project incentives and cost offsets



- Site
- Infrastructure
- Utilities
- Master planning

- Incentives
- Expedited permitting
- State & Local ED Teams

- Location attractiveness
- Regulatory environment
- Tax climate
- State conformity

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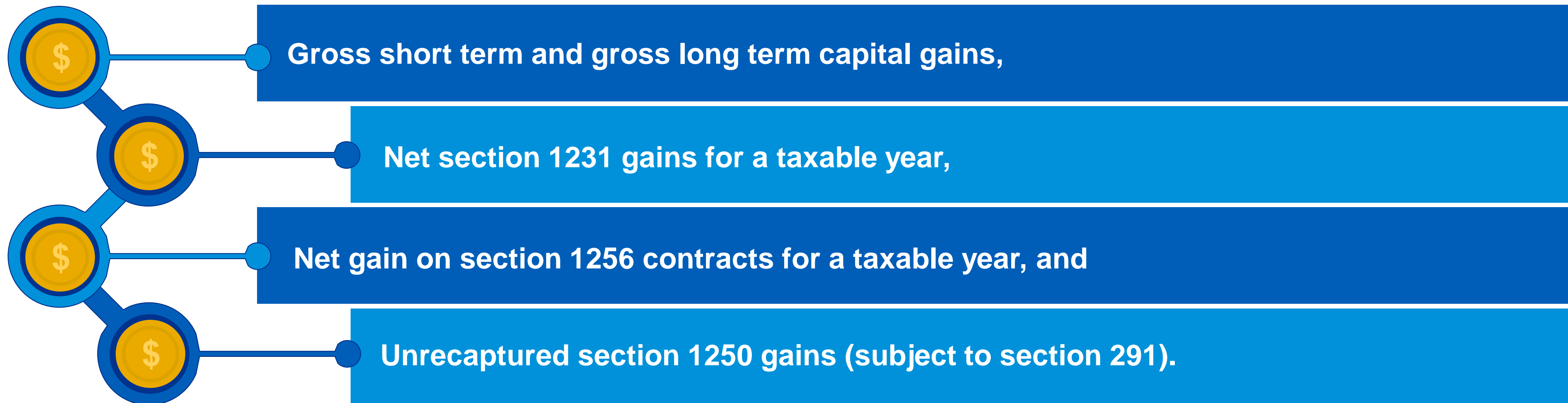
What is an “Eligible gain”?

Gain is eligible for deferral (“Eligible Gain”) if it is from the sale or exchange of property with an unrelated party (not more than 20 percent) and the gain is **treated** as a capital gain for federal income tax purposes, including:



- **Gross short term and gross long term capital gains,**
- **Net section 1231 gains for a taxable year,**
- **Net gain on section 1256 contracts for a taxable year, and**
- **Unrecaptured section 1250 gains (subject to section 291).**

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Special rule for partners

01 If a partnership does not elect to defer all or a part of its eligible gains (including its net section 1231 gain), a partner may elect to defer the amount of eligible gain that is included in the partner's distributive share (taking into account the partner's section 1231 gains and losses).

02 The partner's 180-day period generally begins on the last day of the partnership's tax year.

- A partner who knows (or receives information) regarding the date of the partnership's capital gains and its decision not to elect deferral, may choose to use the partnership's 180-day period (i.e., that partner generally does not have to wait until the end of the year to invest partnership capital gains in a QOF).
- Consider additional partnership information reporting.

03 Similar rules generally apply to S corporations, trusts, and estates.

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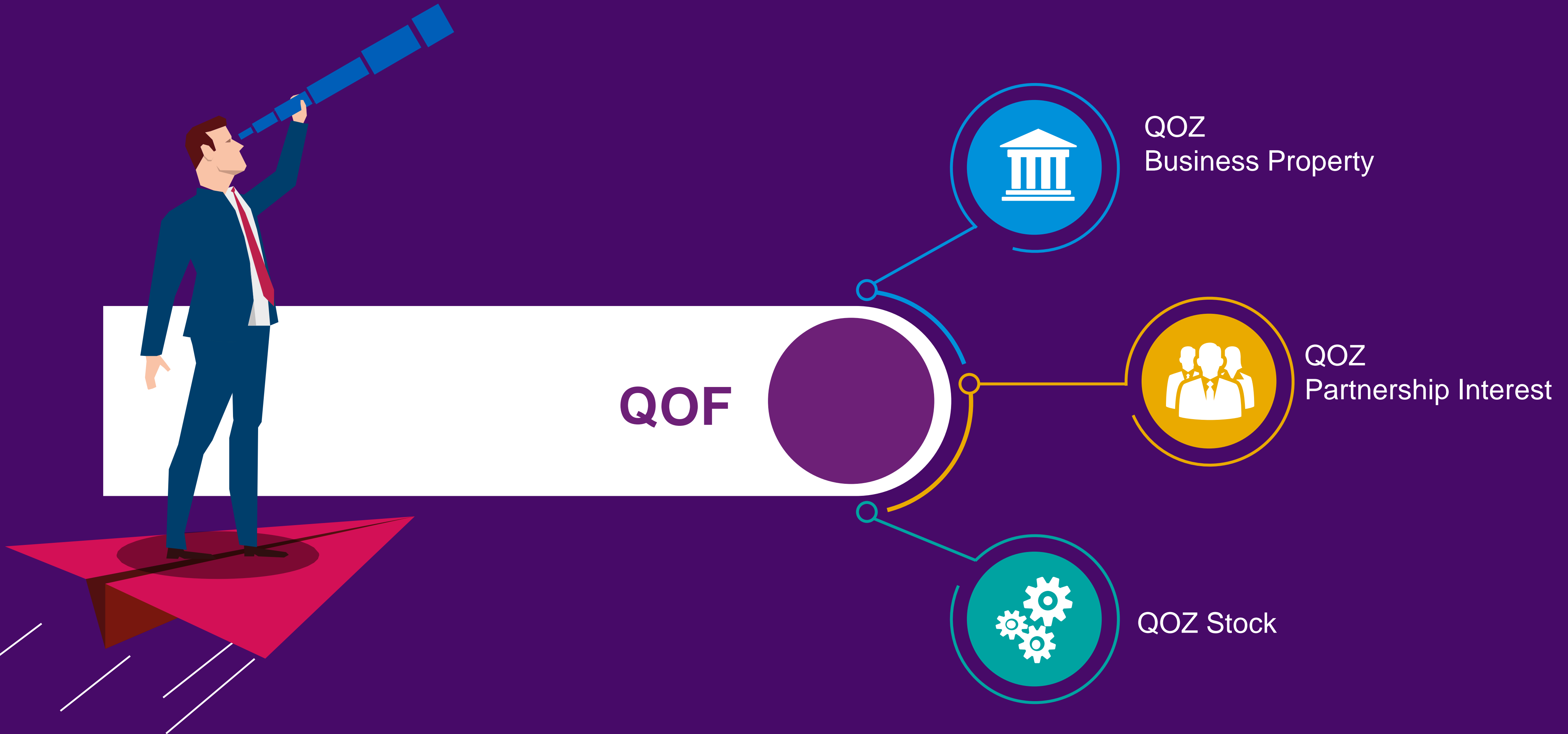
Overview of eligible "QOZ property"



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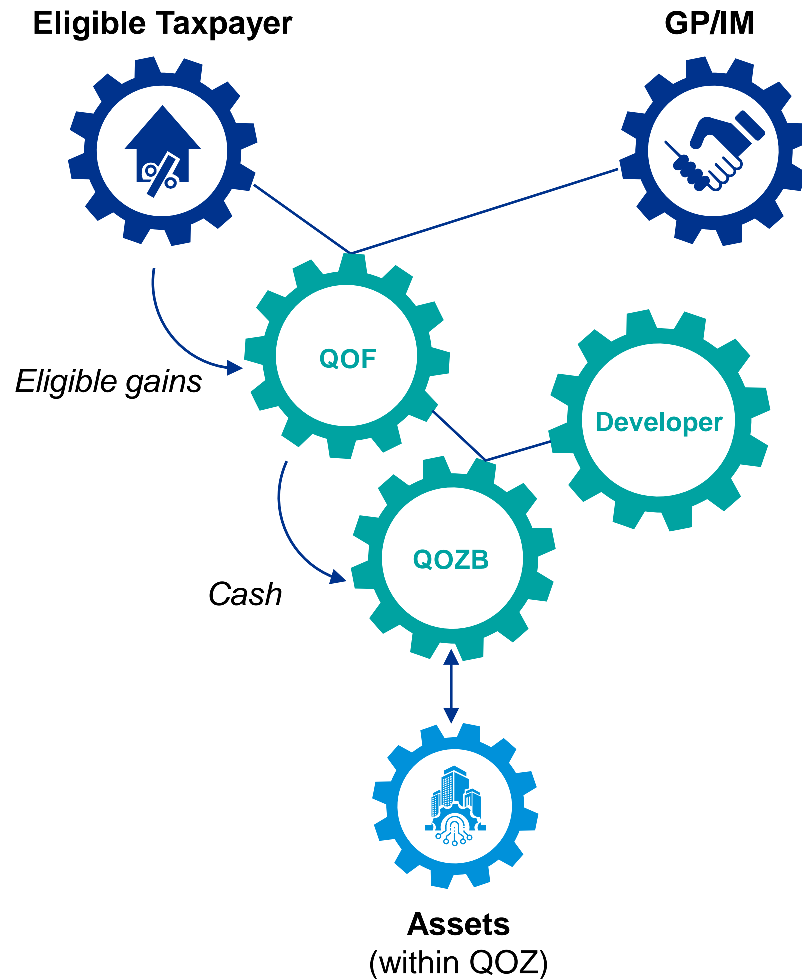
Illustrative two-tier structure for a single development project



- QOF contributes cash to a QOZB, which purchases and develops the project
- QOZB may rely on the "working capital safe harbor"
- Developer may take a promote at the QOZB level
- QOZB may hold intangibles that are used in the business

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Prepare for new tax reporting

New draft Form 1065 and K-1

On September 30, 2019, the IRS released a draft of the tax year 2019 Form 1065, U.S. Return of Partnership Income and its Schedule K-1, Partner's Share of Income, Deductions, Credits, Etc. The changes are intended to assist the IRS in assessing compliance risk and identifying potential noncompliance. Similar changes were made to the draft 2019 tax forms for S corporations. The IRS has not yet released accompanying instructions but described the draft forms as "near-final."

- Schedule K-1 (Form 1065) must now report each partner's **tax** basis capital account rollforward.
- For the tax year 2018, by contrast, a tax basis capital account disclosure was required **only** if a partner had a negative tax basis capital account at the beginning of the year or at the end of the year, and only the beginning and ending negative tax capital accounts were required to be disclosed.

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New draft Form 1065 and K-1 (continued)

In addition, the updated Schedule K-1 (Form 1065) requires that a partnership report each partner’s share of:

- Net unrecognized section 704(c) gain or loss, relating to contributions or revaluations of appreciated or depreciated property, determined both at the beginning and at the end of the applicable taxable year;
- Separate disclosure of items related to section 743(b) adjustments
- Guaranteed payments for services
- Guaranteed payments for capital
- Section 751 “hot” asset gain or loss
- Certain other items

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New draft Form 1065 and K-1 (continued)

The draft 2019 Form 1065 and Schedule K-1 (Form 1065) also require information that could provide certain audit or statistical data points, including:

— The number of foreign partners subject to U.S. federal income tax pursuant to Section 864(c)(8) as a result of a transfer of all or a portion of a partnership interest or receipt of a partnership distribution;

— Whether any transfers between the partnership and its partners were subject to the disguised sale disclosure requirements under Treas. Reg. Section 1.707-8;

— Whether the partnership aggregated or grouped activities for section 465 at risk and section 496 passive activity purposes

— Whether the partnership has more than one activity for Section 465 at risk and Section 469 passive activity purposes

— Whether a decrease in a partner's share of partnership profit, loss, or capital is due to a sale or exchange of a partnership interest

— Whether partnership liabilities include liabilities of a lower-tier partnership

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New draft Form 1065 and K-1 (continued)

— The numerous proposed changes to the updated Form 1065 and Schedule K-1 (Form 1065) likely will add significant additional time to the tax reporting compliance process.

— Partnerships should assess the new changes and discuss with their tax advisor what additional effort may be required to comply with the required reporting.

— It will be important to assess tax reporting and compliance readiness well in anticipation of filing deadlines.

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Section 163(j), Interest expense limitations

In general, a taxpayer is prohibited from deducting business interest expense in excess of the sum of: (1) business interest income, (2) floor plan financing interest, and (3) 30% of adjusted taxable income ("ATI").

For tax years beginning after December 31, 2017, and before January 1, 2022, ATI is taxable income other than:

— (1) items not allocable to a trade or business, (2) business interest income and expense, (3) depreciation, amortization, and depletion, (4) the 20% deduction for qualified business income, and (5) NOLs.

— For tax years beginning after December 31, 2021, depreciation, amortization, and depletion would be deducted in calculating adjusted taxable income.

Applies to tax years beginning after December 31, 2017, so there is no grandfathering of existing debt.

Any disallowed interest may be carried forward indefinitely.

Certain small businesses with average annual gross receipts not exceeding $25 million are exempt from the limitation. I.R.C. §163(j)(3).

— Gross receipts measured under section 448(c) – take into account complex single employer aggregation rules under section 52 or section 414(m) or (o).

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Section 163(j), Interest expense limitations (continued)

- Net U.S. business interest expense limited to 30% of “adjusted taxable income” (“ATI”)
  - Unlimited carryover of disallowed interest.
  - By election, interest incurred in connection with a real property trade or business (as defined under Section 469(c)(7)(C)) could be excluded from this limitation.
  - Proposed regulations – Section 163(j) is applicable at the trader fund level. IRS indicates its view in preamble to proposed regulations that any deductible interest expense derived from a trader fund is subject to section 163(d) limitations at the partner level.
  - In investor funds Section 163(j) is only applicable for corporate partners, at the corporate partner level.
  - There is seemingly no change in the treatment of investment interest (non-business interest) under Section 163(d).

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Section 163(j), Interest expense limitations (continued)

The section 163(j) limitation applies first at the ***partnership level.***

Disallowed "excess business interest Expense" ("EBIE") is allocated to the partners in the same manner as the partnership's non-separately stated taxable income or loss.

— A partner generally is required to reduce the basis in its partnership interest by the amount of any allocated EBIE.

— That basis reduction is reversed to the extent the EBIE that remains is not treated as "paid or accrued" (compare "allowed as a deduction") at the time of a disposition of the partnership interest.

EBIE is "freed up" for potential deduction in future years (i.e., treated as paid or accrued) only to the extent the same partnership generates more ATI than it needs to deduct the full amount of its business interest expense ("excess taxable income" or "ETI") or the same partnership generates excess business interest income ("EBII").

ETI and EBII is allocated to partners in the same manner as the partnership's non-separately stated taxable income or loss (proposed regulations provide 11-step method for this determination).

— Hedge fund 163(j) calculation is an annual calculation; does not follow "break period" allocation scheme.

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Section 163(j), Interest expense limitations (continued)

Partnership reports any section 163(j) items on a Schedule K-1

- Regardless of whether a partnership has business interest expense, information reporting is required regarding Excess Taxable Income.
  - Partners *can* use ETI from a partnership in their own section 163(j) computations.
  - Partners *cannot* derive their share of ETI from the distributive share items on a Schedule K-1; if ETI is not reported to the partners they must assume it is zero.
- In 2019 partners may have their first release of carried forward limitation (EBIE may be freed up for potential deduction)

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Mid-term gains and losses

Section 1061 recharacterizes certain net long term capital gains with a holding period less than 3 years as short term capital gains (“Mid-Term Gains”)

— Gains “with respect to” applicable partnership interests (APIs)

— APIs are partnership interests that are directly or indirectly transferred to, or held by, a taxpayer in connection with the performance of substantial services by the taxpayer or a related person in any “applicable trade or business.”

- **Partnerships will need to report mid-term gains separately if any carried interest may be present.**

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Multiple trades or businesses

- Section 512(a)(6) requires an organization subject to the unrelated business income tax under section 511, with more than one unrelated trade or business, to calculate unrelated business taxable income (UBTI) separately with respect to each trade or business
- **Notice 2018-67:** An exempt organization may aggregate its UBTI from its interests in multiple trades or businesses conducted by lower-tier partnerships if one of two tests is met:
  - A **de minimis test**, which the exempt organization satisfies if it holds directly no more than 2% of the profits interest and no more than 2% of the capital interest of the partnership; or
  - A **control test**, which the exempt organization satisfies if it directly holds no more than 20% of the capital interest and does not have control or influence over the partnership.

An exempt organization may aggregate all partnership interests meeting the de minimis or control test and treat the aggregate group of qualifying partnership interests as comprising a single trade or business for purposes of section 512(a)(6).

For a partnership interest acquired **prior to August 21, 2018**, an exempt organization may treat **each partnership interest** as comprising a single trade or business for purposes of section 512(a)(6)—regardless of whether it meets the de minimis or control test and regardless of whether or not there is more than one trade or business directly or indirectly conducted by the partnership or lower-tier partnerships.

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Multiple trades or businesses (continued)

- Notice 2018-67 is partner friendly but probably does not reduce the reporting requirements for the partnership
- **Partnerships should be prepared to detail UBTI from multiple trades or business along with allocable deductions**
  - A safe harbor included in the Notice is to report the 6-digit NAICS (North American Industry Classification System) code for each unrelated trade or business

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CFC/Downward attribution/GILTI

— **Downward Attribution Caused Many More Controlled Foreign Corporations**
  - Change to “US Shareholder” definition – now vote OR value
  - Attribution of ownership is now permitted downward from foreign entities
  - Net effect is more CFCs
  - Rev. Proc. 2019-40 provides limited relief for Form 5471 filing (relief for “foreign controlled CFCs”)
  - **Final GILTI regulations apply an aggregate approach for U.S. partnerships** (i.e., treat them like foreign partnerships for GILTI and Subpart F pick-up purposes)
    - This creates the potential for more PFICs – need for PFIC testing
    - Continue to test for CFC at the U.S. partnership level – which determines partnership’s requirement for Form 5471 filing
    - Notice 2019-46 allowed some electivity (and penalty protection) for 2018 tax year

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Tax planning for investor redemptions

Hedge funds

Full vs. partial redemptions

— In a year with substantial full or partial redemptions, a Hedge Fund should evaluate the past results of the Fund with current year results to determine the potential tax implications to the redeeming partners.

— There are potential tax planning options to recognize gains or losses that can help effectively manage the tax implications of full or partial redemptions in Hedge Funds that use securities aggregation to allocate tax gains and losses.

— Full Redemptions:

- The Fund should evaluate whether or not the redeeming partner has unrealized built-in gains or losses.
- Does the Fund allocate gains/losses using full or partial netting, with stuffing allocations?
- If the partner has an unrealized built in gain, does the Fund project to have enough gains to “fill-up” the redeeming partner?
- If the partner has an unrealized built in loss, does the Fund project to have enough losses to “fill-down” the redeeming partner?

— Partial Redemptions:

- Does your LPA allow for fill-up/fill-down on partial redemptions?

— Is partner taking a partial or full redemption?

- Partial redemptions likely results in less realized gains allocated to the partner (assuming positive UGLA).

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Redemptions

Example:

— Hedge Fund has three partners with the following built-in gain and loss balances as of 12/30/2019.

- Partner 1: ($ 50)
- Partner 2: $ 75
- Partner 3: $ 20

— Hedge Fund currently has $50 of net realized gains through 12/30 and unrealized gain positions of $125

— Partner #2 is fully redeeming at year end.

— The fund includes fill-up/down provisions when allocating realized gains and losses.

Allocations:

— No additional trades: Partner 2 is allocated the $50 net realized gains, and recognizes a $25 gain from the liquidating distribution of cash in excess of basis. Hedge Fund does not step up the basis of its assets, meaning Partner 2's remaining $25 gain remains "inside" the fund to allocate to the remaining partners.

— Fund sells $25 of additional unrealized gain positions: Partner 2 is allocated all $75 dollars of gains realized during the year, and recognizes no additional gain on receipt of its liquidating cash distribution. Partner 2 has recognized all of its share of "inside" gains and leaves none behind for the remaining partners.

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