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Private Investment Fund Tax & Accounting Forum

ANALYSIS OF RECENT COURT DECISIONS AFFECTING PRIVATE INVESTMENT FUNDS, PIF TAX AND ACCOUNTING

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Today's Speakers

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Prior to joining Prospect, Maury served as the Partner-in-Charge of the NYC Tax Department and the Partner-in-Charge of the Alternative Investment Group Tax Department at Marcum, LLP. Before joining Marcum, he was the Principal-in-Charge of the worldwide tax practice at Rothstein, Kass & Company, PC and a member of the executive board. Maury started his career at an Internal Revenue Agent advancing to the role of classroom instructor and reviewer of income tax audits. He completed his military service as an Officer in the United States Army Reserve and the New Jersey Army National Guard.

Maury received a BS degree from Seton Hall University and a JD degree from Seton Hall University School of Law. He is a Certified Public accountant in New Jersey and New York. Maury is a member of the New Jersey Bar.

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Mark is a tax partner at the law firm of Mayer Brown. Mark's professional practice focuses on the tax consequences of a variety of capital markets products and strategies, including over-the-counter derivative transactions, swaps, tax-exempt derivatives and working with credit funds, offshore insurance companies and hedge funds. Prior to joining Mayer Brown, Mark was a partner at another International law firm, served as a Managing Director at Deutsche Bank, general counsel of a credit derivative company and, prior to that, Mark was a partner at Deloitte, where he led the Capital Markets Tax Practice. Mark began his legal practice at Skadden Arps and then worked at Weil Gotshal.

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Amanda H. Nussbaum is the chair of Proskauer's Tax Department and also co-chairs the Not-For-Profit / Exempt Organizations Group. Her practice concentrates on planning for and the structuring of domestic and international private investment funds, including venture capital, buyout, real estate and hedge funds, as well as advising those funds on investment activities and operational issues. She represents many types of investors, including tax-exempt and non-U.S. investors, with their investments in private investment funds.

Amanda has been recognized as a leading tax practitioner by Chambers USA and Global, The Legal 500, The Best Lawyers in America, and New York Super Lawyers. In 2023, she was named by Crain's New York Business to the list of Leading Women Lawyers; she was named "Tax Lawyer of the Year" at Euromoney's 2024 Women in Business Law Awards. She was also recognized by Law360 as a 2023 Tax MVP.

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YA Global I: Understanding its Implications for Funds

Background: Overview of Applicable Tax Rules

Investment Activities Are Not a Trade or Business

- Management of investments in the US is not a USTB even though it may involve substantial time and activity.
- Merchant banking rises above investment activities.
- The analysis turns on factors such as:
  - Whether services are provided to customers
  - Time and effort devoted to lending and banking activities
  - Whether fees are charged to securities issuers
  - Whether the securities are purchased from issuers or in secondary market transactions
  - Whether capital is directly provided to customers
  - Whether the taxpayer advertises, solicits business, has a reputation as a capital provider

Activities of Agents

- Authorities attribute activities of agents to the foreign principals, but when this imputation will occur is uncertain.
- If the agent is an independent agent, it is less likely that the agent's activities will be imputed to the non-US principal.
  - There have been instances in which the Internal Revenue Service has been successful in imputing an independent agent's activities to a principal. *De Amodio v. Comm'r*, 34 T.C. 894 (1960), aff'd, 299 F.2d 623 (3rd Cir. 1962).
  - The IRS previously had taken the position that offshore funds originating loans in the united States through the activities of a U.S. manager are engaged in a lending trade or business. AM 2009-010.
- If the agent is a dependent agent, its activities will be imputed to the non-US principal.

The Facts of *YA Global*

YA Global: Background

- 4 tax years at issue: 2006, 2007, 2008 & 2009.
- YA Global was a Cayman Islands company taxable as a partnership for US tax purposes.
- Yorkville Advisors, a US partnership, served as the sole general partner of YA Global & its investment manager.
- YA Global had the right to provide intermediate instructions to Yorkville and impose investment restrictions on Yorkville's activities undertaken on behalf of YA Global.
- YA Global had no employees and acted solely through Yorkville.

YA Global: Off-Shore Investor Structure

- YA Global had a several non-US limited partners, but YA Offshore was the largest investor.
- YA Offshore was treated as a corporation for US tax purposes.
- YA Offshore was a typical offshore feeder into which the non-US investors invested their money.
- YA Offshore contributed the capital contributions that it received to YA Global.
- YA Offshore had substantial expenses ($12 million in 2007 & $22 million in 2008).

YA Global: Activities

- YA Global provided capital directly to microcap and low-priced public companies in the OTC public markets through "standby equity distribution agreements" ("SEDAs"), convertible securities & straight debt.
- SEDAs & converts allowed YA Global to purchase securities at a discounted price (PIPES: public issuers, private equity securities).
- YA Global and/or Yorkville frequently received fees for capital structuring in the form of cash, stock or warrants.
- When Yorkville received fees in excess of its costs, such fees triggered a management fee offset provision in the YA Global partnership agreement or had to be remitted to YA Global. But in practice, fees did not exceed expenses by much.

YA Global Activities (Continued)

- When YA Global purchased securities under the SEDAs or exercised its conversion rights, it frequently sold the equity securities that it received.
- Investment horizon was usually 12 to 24 months.
- Fees paid to Yorkville were for due diligence, structuring and providing commitments to make capital contributions and/or loans.
- Yorkville received $33.4 million in 2006, $25.3 million in 2007 & $29.6 million in 2008.
- 25 SEDA transactions in 2006, 19 in 2007 & 9 in 2008.
- 202 convert deals in 2006, 116 in 2007 & 111 in 2008.

Yorkville Advisors: Activities on Behalf of YA Global

- Yorkville received market standard 2% fee/20% carried interest from YA Global.
- Yorkville employed over 50 employees in each year.
- Yorkville paid over $15 million in salaries.
- Yorkville "devoted most of its activities to YA Global" in each year.
- Yorkville's work on behalf of 3 other funds was *de minimis*.

YA Global: Tax Reporting, IRS Audit & Issues Presented

YA Global's Tax Reporting

- YA Global filed a US Internal Revenue Service Form 1065 in each year.
- YA Global did not treat any income it earned as ECI.
- Income was treated as portfolio interest or non-taxable capital gains.
- YA Global used accrual accounting & did not designate any securities as held for investment.
- YA Global did not file IRS Forms 8804 because it took the position that it did not have ECI to allocate to non-US partners.

CCA 201501013: The IRS Audit

- YA Global was audited & in 2015, the IRS released a Chief Counsel Memo stating its views.
- The IRS concluded that the fund's "lending" and "underwriting" activities were a USTB that did not constitute "trading in stocks and securities" for purposes of the section 864(b)(2)(A) safe harbors.
  - The IRS looked to Treas. Reg. §1.864-4(c)(5)(i)(b) and section 166 factors to determine whether loan origination was a USTB.
  - The IRS indicated the fund primarily looked to profit from earning fees, a spread and interest payments.
- The IRS alternatively concluded that even if the fund's activities did constitute "trading in stocks and securities," the fund did not qualify for the trading safe harbor because its manager was not an independent agent and because the fund's "underwriting" activities made it a dealer.

Issue 1: The Agency Issue

The Imputation of Yorkville's Activities to YA Global

- Discussion is premised on conclusion that if Yorkville is an independent contractor, YA Global would not be attributed with Yorkville's activities and YA Global would not be considered to be engaged in a USTB.
- Investment management agreement (IMA) specifically referred to Yorkville as YA Global's agent.
- YA Global retained the right to specify investment restrictions.

Issue 2: The US Trade or Business Issue

Facts the Court Found Relevant to the USTB Issue

- SEDAs & converts provided YA Global with the right to buy stock at a discount to FMV.
- Yorkville received fees for capital structuring services.
- YA Global PPM called fees payable to YA as “banker’s fees” (YA clients testified that no services were provided).
- YA Global received compensatory warrants.
- SEDAs and converts not exercised until YA Global was ready to sell.
- Yorkville was heavily involved in negotiating transactions.

Tax Court Analysis of the USTB Issue

- Court disaggregated question into 3 sub-questions:
  - 1. Were activities regular and continuous and engaged in for the primary purpose of earning a profit?
  - 2. Did the investment exception apply?
  - 3. Did the Code § 864(b)(2) trading safe-harbor apply?
- Q1 answered itself in the affirmative.
- Q2 was challenged by the receipt of fees even when capital had not been put at risk & the fact that fees were paid to Yorkville (who did not put capital at risk).
  - The court noted that Yorkville Advisors at times remitted to YA Global fees that it had received from portfolio companies.
  - Court did not address whether YA Global was engaged in a lending trade or business.
- Q3 was answered in the negative for the same reason as Q2.

Issue 3: The Mark-to-Market Issue

Overview of the Mark-to-Market Rules

- Mark-to-market accounting results in all gains and losses being ordinary in character.
  - The rate benefit of long-term capital gains to non-corporate taxpayers is lost.
- Gains and losses are accelerated relative to accrual accounting.
- Code § 475 mandates the use of mark-to-market accounting for dealers in securities and allows traders in securities to elect to use such accounting.
- Code § 475(c)(1) defines a dealer as a person who buys from OR sells to customers (statute does not require customers on both sides of a transaction.
- Code § 475(b)(1) lists "any security held for investment" as an example of a security to which the mark-to-market rules of Code § 475(a) do not apply.

The Tax Court Holds YA Global is a Securities Dealer

- YA Global promotional materials stressed that firm's market reputation enabled it to work directly with securities issuers.
- The Tax Court held that the portfolio companies from whom YA Global purchased securities were customers of YA Global.
- YA Global was "willing and able" to provide capital to portfolio companies.
- Although the SEDAs and other securities purchase agreements contained investment intent language, none of these agreements referenced Code § 475 (as required by IRS regulation).
  - Purchasers of securities that could be subject to these rules should focus on drafting identification statements precisely if securities are to be properly identified as being marked-to-market.

More on the Bad Debt (Promoter) Authorities

- *Newman v. Commissioner* sets forth the requirements for promoter status:

(1) compensation sought is other than the normal investor's return, and income received is the direct product of the taxpayer's services and not primarily from the deployment of capital;

(2) the activity is conducted for a fee or commission or with the immediate purpose of selling the securities at a profit in the ordinary course of the taxpayer's business; and

(3) the taxpayer had a reputation in the community for promoting, organizing, financing and selling businesses.

The Code § 475 Conclusion Is Counterintuitive

- The Tax Court's analysis on the USTB issue supports the conclusion that YA Global was a promoter, not a dealer in securities.
- One would expect that purchasing securities from a customer means that the "dealer" is purchasing outstanding securities, not originating transactions.
- This factor seems more likely to be treated as a dealer than a merchant banker, using buying as the sole criteria.

Issue 4: The Determination of What Income Should Be Treated as ECI

The Parties' Position on the ECI Items

- IRS asserted that all income, including gain from the disposition of positions was ECI.
- Court recites that the taxpayer did not provide an analysis as to whether any income and gains could be excluded from ECI.
- If Yorkville was an independent agent, then foreign-source income (including capital gains) would not be ECI. Code § 864(c)(4)(B).

The Court's Analysis of the Source of Income

- Because Yorkville devoted virtually of its efforts towards the management of YA Global, the court held that Yorkville was a dependent agent and its office was attributed to YA Global.
- Since the income was recognized under mark-to-market rules, Code § 64 denies capital asset status to the securities held by YA Global.
  - Code § 864(c)(3) other income rule treats income not specified encompassed by personal property dispositions as ECI.
- Based on this, the Tax Court concluded that the YA Global's income from sales of securities was US-source income and treated as ECI under Code § 864(c)(3).
- Court was not required to determine whether special banking rules applied.
- If Taxpayer had briefed a deeper dive into the ECI rules, it might have a basis for excluding certain interest, dividends and gains from its ECI amount.

Issue 5: Should YA Global's Withholding Tax Liability be Reduced by Partner-Level Expenses?

YA Offshore Had Directly Incurred Expenses

- YA Global argued its withholding tax liability should be reduced by the expenses incurred by YA Offshore.
- Regulations allow a partnership's Code § 1446 withholding tax liability to be reduced by partner-level expenses to the extent the partners certify those expense to the partnership under Treasury Regulation § 1.1446-6, but YA Global conceded that no such certification was provided.
- YA Global argued that such expenses should be taken into account under Code § 1464 "as a back-door means of giving effect to [the foreign feeder's] non-partnership deductions despite [the feeder's] failure to have certified those deductions."

Issue 6: What is the Statute of Limitations on Assessment of the Tax Imposed by § 1446?

2006 & 2007 Statute of Limitations

- YA Global asserted that assessments for 2006 & 2007 were time barred by the statute of limitations.
- At issue was whether IRS Form 1065 (which were filed) starts the statute of limitations or whether IRS Form 8804 (which were not filed) starts the statute of limitations.
- IRS Form 1065 is the partnership income tax return.
- IRS Form 8804 shows the amount of ECI withheld on allocations to non-US partners.

Statute of Limitations

- The Court held that the Forms 1065 were insufficient to advise the IRS of the partnership's withholding tax liability.
- YA Global "implicitly denied that it was engaged in a trade or business by reporting no ordinary business income on its Forms 1065."
- Tax Court stated in dicta that a taxpayer might be able to start the running of the period of limitations by filing a Form 8804 showing zero liability, with a factual explanation.
- Execution of the Forms 872-P was sufficient to extent the period of limitations, because the tax imposed by section 1446 was an "income tax."

Issue 7: Should YA Global be Subject to Penalties for Failure to File Forms 8804?

Penalties for Failure to File Forms 8804

- Code § 6651 imposes an addition to tax for the failure to file certain returns.
- The Forms 1065 filed by YA Global did not meet the requirement of a "return."
- YA Global did not have reasonable cause for its failure to file the Forms 8804.
  - Law firm did not conclude that YA Global was not engaged in a trade or business.
  - Accounting firm did reach this conclusion, but YA Global sued the accounting firm in 2015, and did not establish when it became aware of the facts supporting the lawsuit.

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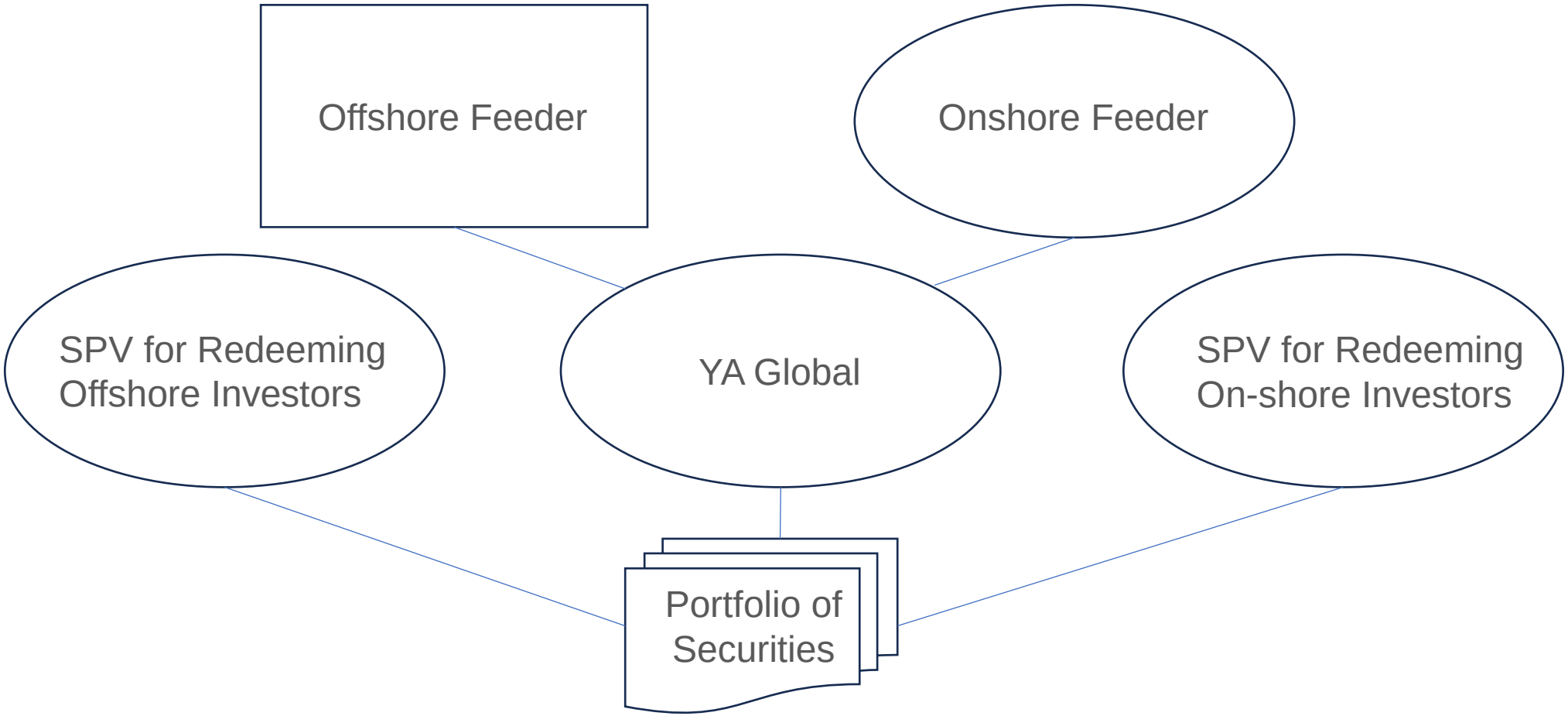
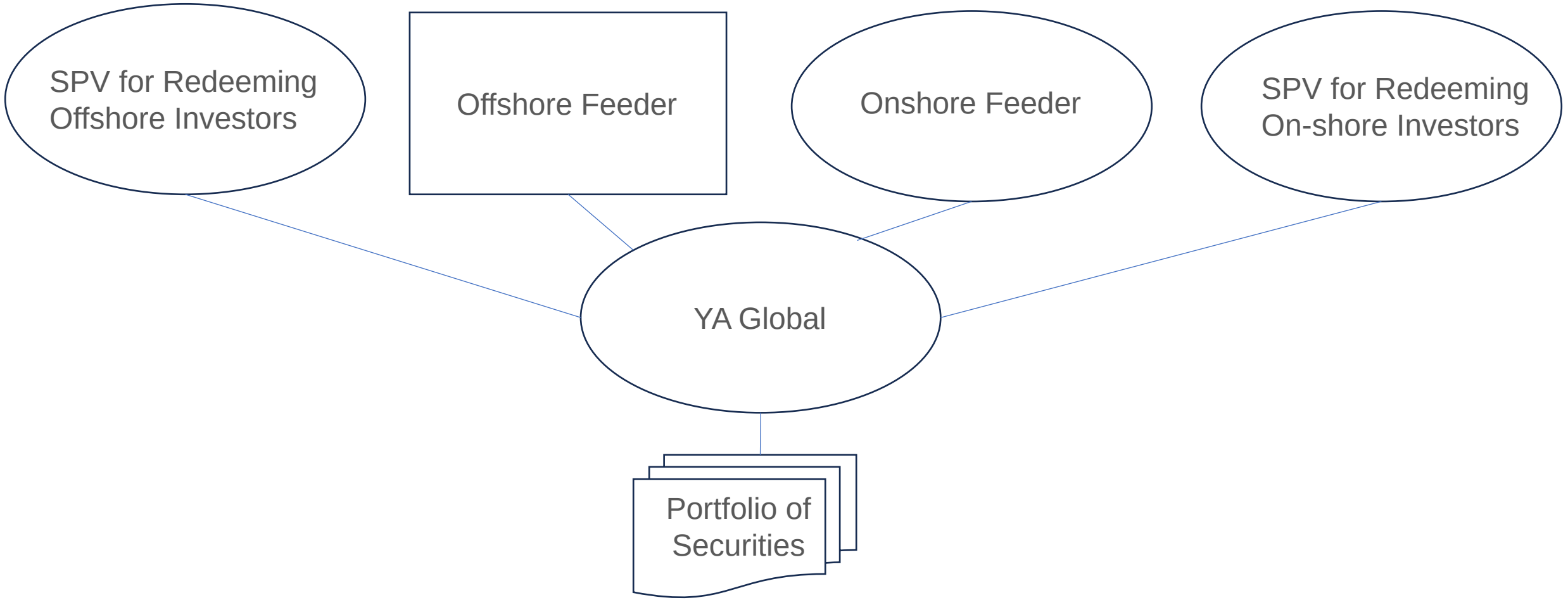
YA Global II: Understanding its Implications for Investors

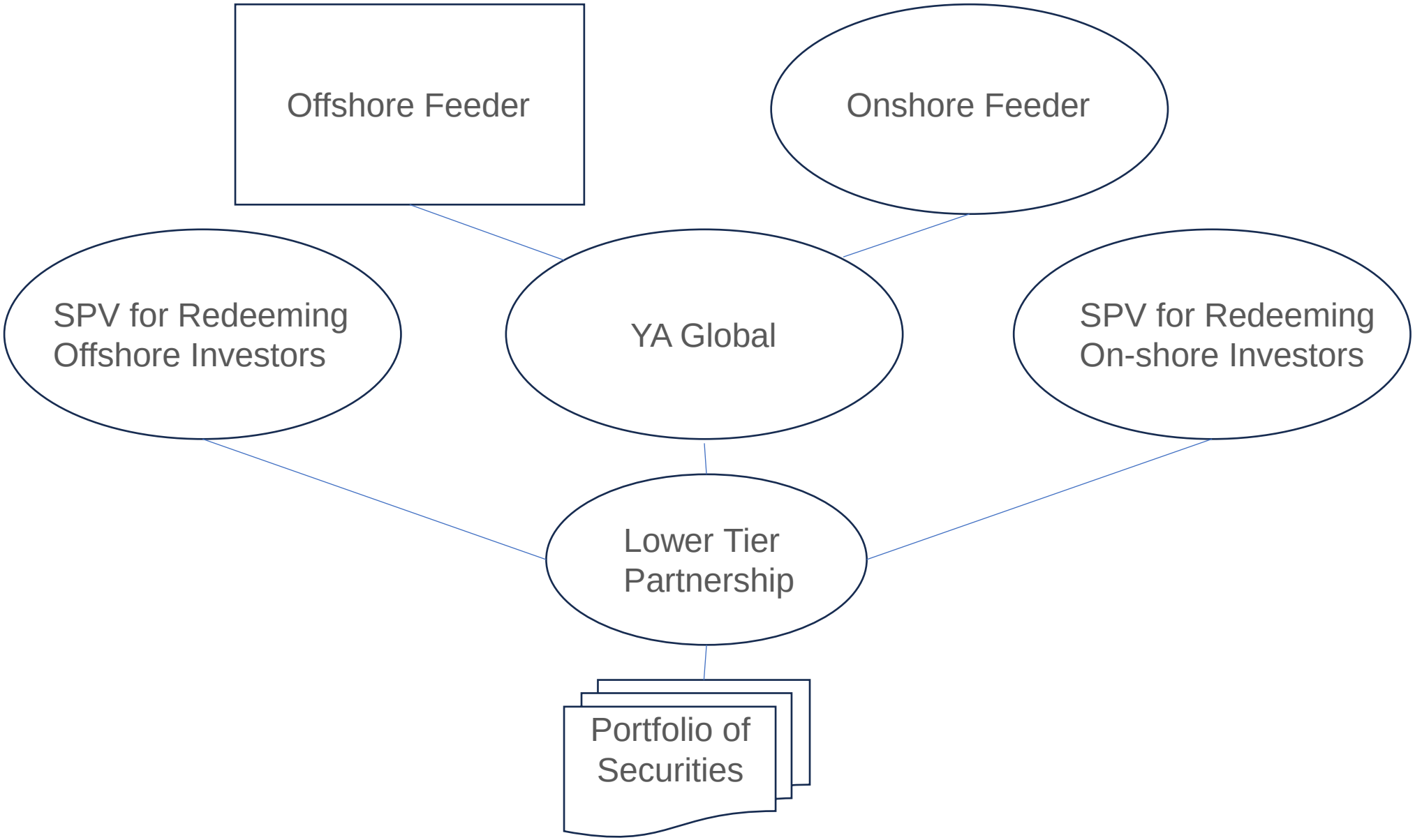
Taxpayer's Contention of the Facts



IRS's Contention of the Facts



Third Possible Interpretation of the Facts



Rules Cited by the Court

- Code § 704(e) treated a person as a partner with a capital interest as a partner if capital was a material factor in the production of partnership income.
- Withdrawing partners had the option of taking interests in securities directly.
- Court believed counsel had conceded the issue as whether the SPVs were partners.
- Terms of participation agreements were crucial – if SPVs were co-owners, court would not have treated SPVs as partners.
- YA Global issued Schedule K-1s to SPVs.
- Court held open that a lower-tier partnership existed.

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Loper Bright Enterprises v. Raimondo

Effect on Federal Income Tax Regulations

Loper Bright Enterprises V. Raimondo A Red Herring?

- Is the Supreme Court decision in Loper important or just another Red Herring?
- The Petitioners in Loper were Atlantic herring fisherman who challenged a regulation that would require the fisherman to pay for observers required by a fisheries management plan.
- The lower Court ruled that even if the statute governing the regulation was ambiguous, the Court should defer to EPA's permissible interpretation under the Chevron Doctrine.
  - The Chevron Doctrine conflicts with the Administrative Procedure Act.

Loper Bright Enterprises V. Raimondo A Red Herring? (Continued)

- Chevron U.S.A. Inc. v Natural Resources Defense Council has been the law of the land since it was decided 1984.
  - The decision relinquished a court's independent judgment to fill the void created by an ambiguous statute under the following conditions:
    - The statute must be AMBIGUOUS – if the intent is clear that is the end of the case for better or worse!
    - The regulation created must be a "permissible" interpretation.
    - If the interpretation is permissible, it does not matter that a court exercising independent judgment may have reached a different conclusion.

Loper Bright Enterprises V. Raimondo A Red Herring? (Continued)

- The Loper Decision
  - The Supreme Court overrules the Chevron doctrine.
  - The Administrative Procedure Act controls.
  - Under the Administrative Procedure Act, courts retain the right to exercise their independent judgment when a statute is ambiguous.
  - Three judges dissented and all were appointed by a Democratic Administration.
  - Does this decision really matter in federal income, estate and gift tax cases?

Treasury Regulations

- Section 7805 of the Internal Revenue Code grants the Secretary of the Treasury the express power to prescribe all needful rules and regulations.
- Regulations:
  - Any Internal Revenue Code section may give the Secretary very broad powers to prescribe regulations or very limited and precise authority to prescribe regulations for that section.
  - Regulations may be issues as final, temporary or proposed.
  - The Secretary generally cannot apply regulations retroactively but the Secretary is authorized to permit taxpayers to apply regulations retroactively.

Treasury Regulations (Continued)

- More on Regulations:
  - Congress may grant the Secretary specific authority to apply regulations retroactively.
  - Temporary regulations must expire within three years beginning after November 20, 1988.
  - Regulations may be invalid, amended, withdrawn or declared obsolete.
  - All regulations, final, temporary and proposed are published with a preamble that provides the background for the regulations and explains the provisions in the regulations.
  - Final and temporary regulations are issued through a Treasury Decision, but proposed regulations are not.

Treasury Regulations (Continued)

- More on Regulations:
  - Proposed regulations are prospectively effective, but the Secretary may suggest that the proposed regulations reflect the current position of the IRS and the Secretary may indicate that taxpayers can rely on proposed regulation.

Revenue Rulings and Private Letter Rulings

- Revenue Rulings and Private Letter Rulings are issued pursuant to the statutory power granted in Section 7805 of the Internal Revenue Code.
- Revenue Rulings may be amplified, clarified, distinguished, modified, obsoleted revoked, superseded, supplemented and suspended.
- Sometimes Revenue Rulings are invalid.
- Revenue Rulings are frequently cited in court cases and do have precedential value pursuant to Regulation Section 601.601(d)(2)(V).
- Private Letter Rulings cannot be used or cited as precedent.

Applying the Loper Decision to Treasury Regulations

- Step 1: Determine if the statute is ambiguous with respect to the specific issue.
- Step 2: Determine if the Committee Reports for the Public Law that includes the statute clarifies the ambiguity.
- Step 3: Determine if regulatory authority is broadly granted within the statute itself or specifically limited and precise (e.g., regulatory authority is limited to a subsection).
- Step 4: Determine if the regulation you do not like is outside the scope of the specific and precise regulatory authority granted.
- Step 5: Determine if the regulation that you do not like fills an uncontemplated ambiguity in the statute.
- Step 6: Contest the regulation and go to court.

Final Thoughts on the Loper Decision

- **Even if the rationale of the Loper case does not apply, remember this very important fact:**
  - **Even Regulations and Revenue Rulings that appear to fall within the power granted in Section 7805 of the Internal Revenue Code may be invalid!**
    - **Vogel Fertilizer Company v. United States – Regulation Section 1563(a)(2).**
    - **Grecian Magnesite Mining Industrial Shipping Co SA v. Commissioner of Internal Revenue Service – Revenue Ruling 91-32.**

SECA Compliance: Overview and Analysis of Recent Court Cases

Background

- The Tax:
  - Social security (6.2% of income, up to a cap) and Medicare (1.45%, uncapped), imposed on the "employer" and "employee."
  - Additional 0.9% "employee" side Medicare tax for income in excess of a threshold, results in 3.8% Medicare tax.
- The Rules:
  - General rule: employment tax imposed on wages and net earnings from self-employment.
    - Exclude from employment tax "…the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments…"
  - Net investment income: 3.8% on various types of passive income.

Background (Continued)

- The Planning Opportunity:
  - Organize a business as a limited partnership.
  - Service provider partners hold interests as limited partners.
  - Service provider partners earn base compensation as “guaranteed payment” (subject to employment tax) and participate in remining profit by way of distributions not subject to self-employment tax.

Historical Perspective

Year	Action
1950	Social Security amendment extended coverage to self-employed persons.
1977	Code amendment excluded from employment taxes a limited partner's distributive share of tax items from a limited partnership, other than guaranteed payments.
1997	Proposed regulations that would narrow the scope of "limited partner" for employment tax purposes.
1997	Moratorium on regulations related to the definition of limited partner for purposes of the "limited partner exception" to employment taxes.
2010	American Jobs and Closing Tax Loopholes Act of 2010 included language to impose self-employment tax on limited partners of certain limited partnerships.
2013	President Obama's budget proposed expanding employment tax to most partners regardless of whether the entity is a limited partnership.
2021	President Biden's American Families Plan proposed subjecting active pass-through business income to net investment income tax.

The Courts Step In

- Interpreting the rule of no employment tax on "…the distributive share of any item of income or loss of a limited partner, as such":
  - 2011: *Renkemeyer*
    - Law firm organized as an LLP.
    - Court based conclusion on Congressional intent to exclude earnings of an investment nature.
  - 2017: *Castigliola*
    - Law firm organized as a general partnership, and then converted to PLLC.
    - Court looked to whether a member was the "functional equivalent" of a limited partner, focusing on each member's participation in management and control.
  - 2023: *Soroban*
    - Investment firm organized as an LP.
    - Concluded "limited partner, as such" requires a functional analysis test in determining whether a partner is a "limited partner" for employment tax purposes.

The Courts Step In (Continued)

- **Status of pending or ongoing cases challenging *Soroban:***
  - **2023: *Sirius***
    - **Appeal from Tax Court is currently before the 5th Circuit Court of Appeals.**
  - **2023: *Denham***
    - **Before Tax Court, pending decision.**
    - **Post trial briefs submitted in early August 2024.**
  - **2023: *Point72 Asset Management***
    - **Cross motions for summary judgement have been filed and are under seal. Cross-motions will likely submitted by the end of January 2025.**
  - **2024: *Riverstone Equity Partners***
    - **Tax Court petition filed November 5, 2024.**

SECA Compliance Campaign Status

- New guidance expected soon as the IRS listed regulatory guidance on §1402(a)(13) as a priority on the 2024-2025 Priority Guidance Plan.
- The IRS has also announced a temporary pause on its SECA compliance campaign, though it will continue those audits already underway.
- Many additional cases are pending in Exam and Appeals.

Managing SECA Compliance – Operational Considerations

- Understand the capacity in which someone is acting. Ensure that it is consistent with the operating agreement and other organizational documents. Don't conflate roles.
- If a limited partner is also providing services, ensure their compensation is appropriate for the market. The IRS takes issue with a lack of, or below-market compensation.
- Ensure that the GP is receiving a distribution or guaranteed payment for the services it renders to the partnership.

Navigating Uncertainty

- Consider tax return preparer's comfort level.
- Structural Options:
  - LP now and wait for additional guidance.
  - LLC now and convert to LP later.
  - Other (S corporations and/or tiered partnership agreements).

THANK YOU

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