

Private Funds & Financial Product Update

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Today's Speakers



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Mark is a tax partner at the law firm of Pillsbury Winthrop Shaw Pittman. 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 Pillsbury, 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 and then worked at Weil Gotshal.



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Nora Burke, Pillsbury's Head of Tax, is experienced in federal income tax planning for business and financial transactions, including mergers and acquisitions, lending transactions and securities offerings for both domestic and international clients. She also provides strategic counsel to emerging companies and their founders. Nora regularly advises on the tax aspects of public and private M&A transactions for clients in a wide variety of industries, including technology, media and biotechnology, assisting with both acquisition structure and post-acquisition integration of the acquired business.

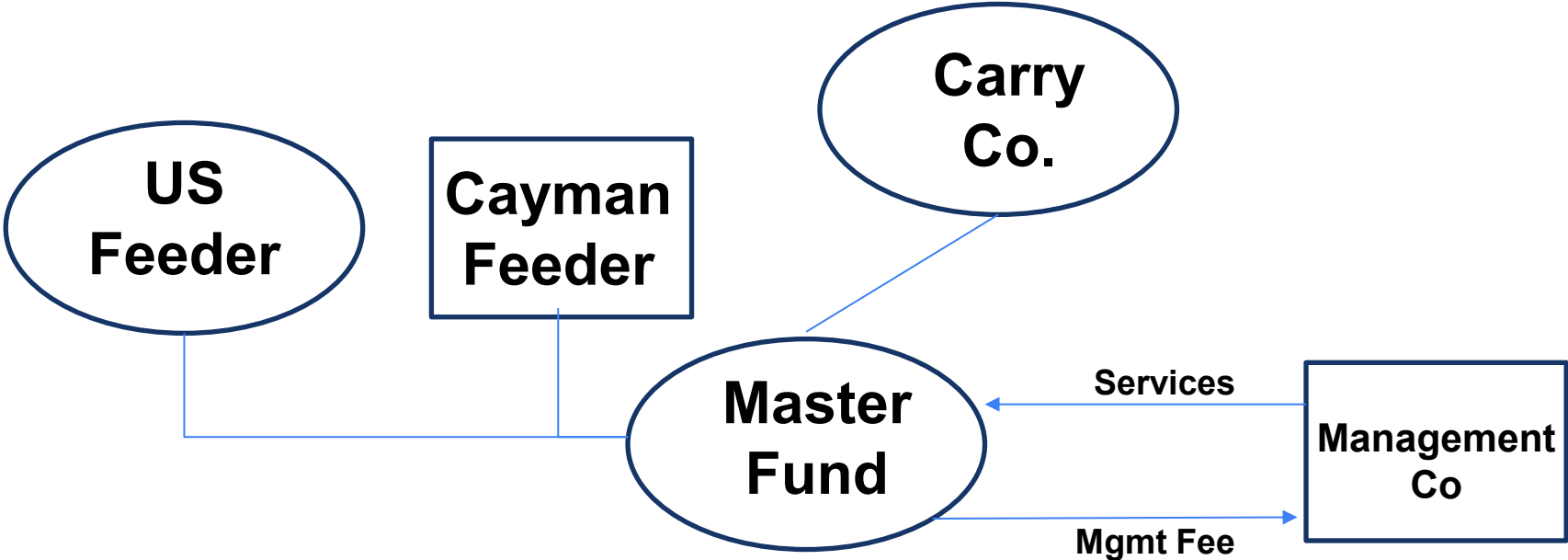
Topics To Be Covered

- **New(ish) NYC UBT Private Fund Audit Strategy**
- **Liberty Global & Tax Planning**
- **Developments Affecting Digital Assets**
- **Litigation Finance Funds – Current Issues & Opportunities**

New NYC UBT Audit Strategy



Typical Entity Structure for Private Funds with NY Offices



NYC UBT Considerations for Typical Structure

- **Management Co. is subject to NYC UBT on management fee, net of applicable expenses**
- **Management Co. bears cost of office, operating expenses and employee compensation, reducing net income subject to NYC UBT.**
- **Carry Co. receives carried interest as a passive investor & does not incur expenses.**

NYC UBT Audit Strategy

- **NYC Department of Finance has been asserting that Fund expenses should be allocated to Carry Co. and not Management Co. (Section 482-like reallocation)**
- **Responding to NYC UBT audits:**
 - **Documentation requires expenses to be borne by Management Co.**
 - **Substance of arrangement supports this allocation. Management Co. is responsible for trading and investments. Carry Co. is a passive investor.**
 - **If ownership of Management Co. & Carry Co. vary, a stronger position exists to fight reallocation**

Liberty Global & Tax Planning



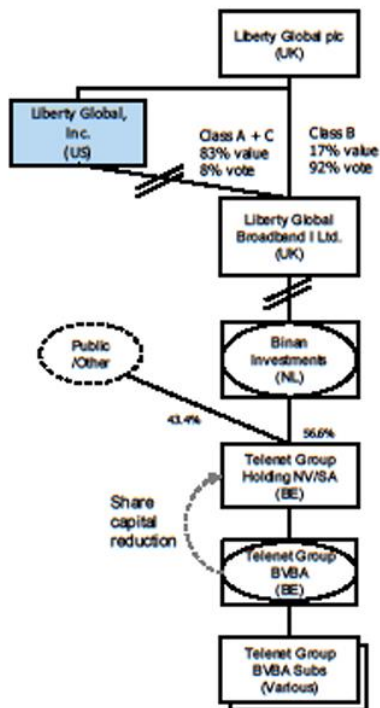
The 10th Circuit and the Economic Substance Doctrine

- **Liberty Global Inc. v. United States No. 23-1410 (10th Cir. 2026)**
- **Interpreting codified economic substance doctrine under §7701(o) (codified in 2010)**
- **Holding raises uncertainty for transactions that technically comply with the Code but produce significant tax benefits**

“Last day of year rule/mismatch”

- **TCJA enacted:**
 - §245A dividends received deduction
 - GILTI regime
- **Mismatch between effective dates**
- **Liberty Global designed “Project Soy” to exploit the mismatch**
- **Goal:**
 - Create additional E&P
 - Convert gain into a §245A dividend
 - Eliminate U.S. tax on approximately \$2.4 billion of gain

Project Soy – Step 1



Step 1

Telenet Group BVBA ("Telenet Group") decreases its issued share capital to its shareholders, Telenet Group Holding NV ("TGH") and Telenet International Finance Sarl ("TIF") (holding 1 share). The amount of the capital decrease is €4.283B.

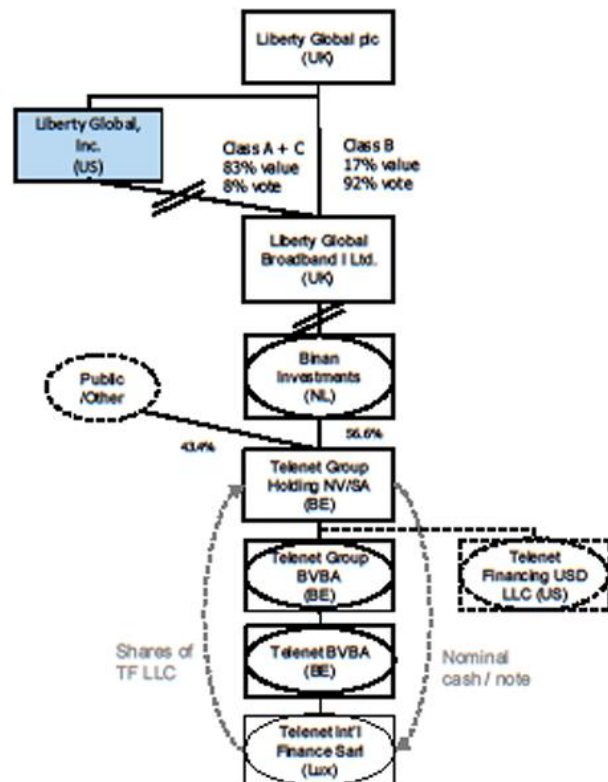
Considerations:

- Two month waiting period after publication in Belgian Official Gazette of notarial deed approving capital decrease
- Requirement that Telenet is below 5x net total debt to consolidated EBITDA (as currently the case currently case)
- No documentation (e.g., IC loan agreement) required from claim of TGH and TIF against Telenet Group created by capital reduction during waiting period

Timing

- *Capital Reduction approved by Telenet Group Holding NV (s/h of Telenet Group BVBA) Board on 12 Oct 2018*
- *Publication in Belgian Gazette occurred 29 October*
- *Deed concluding capital reduction (together with step 3) notarized on 26 December 2018*

Project Soy – Step 2



Step 2

TIF transfers 100% of the outstanding shares of Telenet Financing USD LLC ("TF LLC") to TGH in exchange for cash based on fair market value.

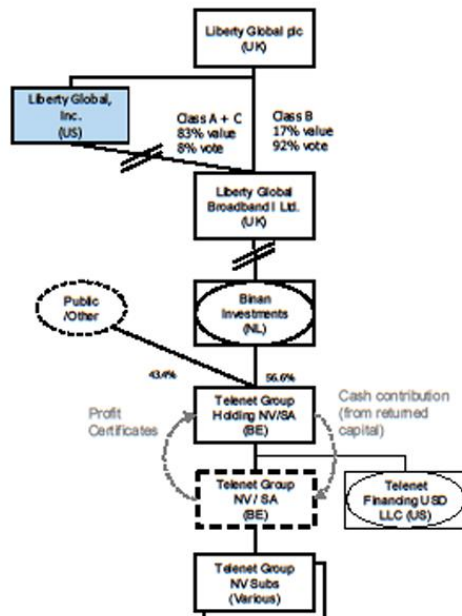
Considerations:

- FMV of TF LLC is expected to be nominal due to back-to-back loan positions
- Transfers will need to constitute a Permitted Disposal
- Covenants:
 - TF LLC shares are pledged, new -NY law security document will need to be entered into by TGH to ensure that the shares remain pledged
 - Designate TF LLC as Permitted Affiliate Parent; LG to coordinate deliverables

Timing

- Documents signed / effective 25 December 2018
- As TGH board has already met for December, minutes won't reflect ratification of step (but has been approved in earlier meeting); final opinion / ratification will follow

Project Soy – Step 3



Step 3

- Upon completion of the capital reduction from Step 1, Telenet Group converts to be an NV/SA under Belgian law.
- At the same time, TNG and TIF use the claim to the amount of the capital decrease as a contribution in return for the newly issued profit certificates from Telenet Group.

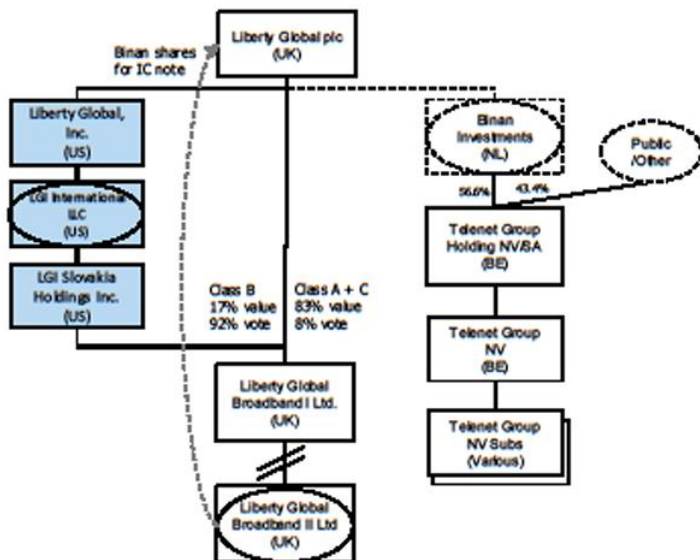
Considerations:

- The amount of the contribution and number of profit certificates to be issued is equal to capital decrease amount (€4.2B); such amount may exceed 50% of the value of outstanding shares, resulting in suspension of (already limited) voting rights of exceeding profit certificates
- Commercial implications of Telenet legal form and name change
- Statement of assets and liabilities of Telenet Group and statutory auditors report required
- LG to coordinate deliverables relating to the security package under the financing docs

Timing

- Will occur as part of one notarial deed, including completion of capital reduction, conversion to NV and profit certificate issuance
- Deed including conversion and profit certificate issuance to be notarized on 26 December 2018 making step 3 effective
- As TGH board has already met for December, minutes won't reflect ratification of step (but has been approved in earlier meeting); final opinion / ratification will follow

Project Soy – Step 4



Step 4

Liberty Global Broadband II Ltd transfers Binan Investments BV ("Binan") to Liberty Global plc in exchange for an intercompany note of €2,899,000,000, equal to the fair market value of Binan.

Considerations:

- UK Tax Considerations
- NL tax and legal
- LG to coordinate with Belgian counsel regarding change in shareholder chain; LG to issue:
 - 1) Transparency declaration to Telenet Group Holding NV and the FSMA within 4 trading days as from the transfer of the shares in Binan
 - 2) The change in the chain of control over Telenet Group Holding NV will have to be included and described in the annual grandfathering notification update in August 2019.

Timing

- Deed of transfer to be executed by NL notary on 28 December 2018

Project Soy

- **Taxpayer conceded Steps 1–3 had:**
 - **no meaningful economic effect**
 - **no substantial non-tax business purpose**
- **Entire purpose was tax planning**

The Question

- **Not: Did the taxpayer literally satisfy the Code?**
- **Instead: Is §7701(o) “relevant” to these transactions?**
- **Taxpayer argued: Doctrine did not apply to “basic business transactions”**
- **Government argued: No categorical exceptions to application of doctrine – it gets applied to all transactions**

The Holding

- **Economic Substance Doctrine applies**
 - **Transactions that mechanically comply with the Code are not exempt**
- **Therefore:**
- **Project Soy viewed as one integrated transaction**
 - **§245A deduction denied**

The Dissent

- **Majority effectively eliminates threshold relevance inquiry**
- **If every tax-motivated transaction can be tested under §7701(o):**
 - **Why did Congress say: "...transaction to which the economic substance doctrine is relevant..."**

Questions Remain

- **Would the outcome have been different if LGI had litigated the case differently?**
- **For what type of transactions is the Doctrine not relevant?**
- **Is there potential for a circuit split?**
- **How much does this case really change**

What's Next?

- **Questions practitioners should ask when undertaking planning:**
 - **Would client do transaction absent tax benefit?**
 - **Does transaction materially change economics?**
 - **Is business purpose contemporaneously documented?**
 - **Does each step have independent significance?**

Digital Asset Update



***Paschall v. Comm'r* – Rent Mistakenly Treated as Staking Rewards**

- **Taxpayer lent digital token assets to eToro, a blockchain validator**
- **eToro was required to post Cardano tokens to blockchain to collateralize its staking decisions**
- **eToro transferred between 75% & 90% of staking rewards to token lender as “rent” for the use of the tokens**
- **Taxpayer did not report the “rent” as taxable income**
- **Court framed the issue as to whether the taxpayer was engaged in proof-of-stake activities**

***Paschall v. Comm'r* – Court Analysis of Staking Rewards**

- **Court employed a 3-part analysis to determine if staking rewards should be taxable upon receipt:**
- **Did the taxpayer obtain dominion & control over the rewards?**
 - Court held “yes” because the Cardano tokens could be sold for cash
- **Could the staking rewards be characterized as a non-taxable receipt?**
 - Court rejected stock-on-stock dividend analogy (which made sense because the taxpayer did not receive the tokens from the blockchain)
- **Could the staking rewards be analogized to crops or mineral extraction?**
 - Court rejected this analogy (which, again, made sense because the taxpayer did not receive the tokens from the blockchain. It received compensation for the use of its tokens).

The PARITY Act Would Create Statutory Rules for Crypto

- **Staking Rewards – Taxpayers could elect to recognize income when rewards are sold in exchange for treating gain as ordinary for dispositions of rewards within 5-year election period**
- **Dispositions of tokens for goods or services – Gain would be recognized with no de minimis exception**
- **Trading Safe-Harbor – Extended to crypto trading (leaves open whether pre-effective date trading creates US trade or business)**
- **Crypto lending – Section 1058 would be extended to include digital assets**
- **Wash sales & Constructive sales – rules would be extended to digital assets**
- **Mark-to-Market – rules would be made available to digital asset traders**

Litigation Finance Update



Overview of Litigation Funding

- Litigation funding from outside investors is historically more common in countries with restrictions on contingent fee arrangements.
- Contingent fee arrangements are not uncommon in the USA.
- Nevertheless, litigation funding is rapidly increasing in the USA.
- Funding provided to both lawyers and plaintiffs.
- Basic Issues: (i) characterization, (ii) character and timing of income/expense, and (iii) source or ECI.

Litigation Funding - Example

- **Typical Transaction**
 - **Investor provides cash to a lawyer or plaintiff in exchange for a share of contingent fee or litigation recovery.**
 - **The investor's right to payment is non-recourse. Thus, if the lawyer or plaintiff does not win the case or settle, the investor gets nothing.**
- **If the litigation is successful, investor returns are calculated based on several different formulas ranging from a fixed percentage to complex waterfalls.**

Novoselsky v. Commissioner

- In ***Novoselsky v. Commissioner***, TC Memo 2020-68, the IRS successfully challenged a litigation finance transaction structured as a loan.
- The facts of that case are as follows:
 - During 2009 through 2011, the taxpayer, an attorney, executed “litigation support agreements” with various individuals and entities. Under those agreements, the individuals and entities made upfront payments to the taxpayer to support the costs of litigation.
 - If the litigation was successful, the taxpayer was obligated to pay the counterparty, from his award of attorney’s fees and costs, the initial payment advanced to the taxpayer, plus a premium. However, if the litigation was not successful, the taxpayer had no obligation to return any funds to the counterparty.
 - The taxpayer did not report any of the funds advanced to him pursuant to the agreements in which he had no obligation to repay the counterparty on his tax returns. The IRS audited his returns and found that the payments were not loans and that he was required to include them in gross income.

Novoselsky v. Commissioner (continued)

- **The Tax Court held for the IRS that the payments the taxpayer received from the third parties constituted gross income to the taxpayer and not loans. Specifically, the payments were not loans because any obligation for the taxpayer to repay was contingent on future events, and therefore did not constitute debt for federal income tax purposes.**
- **In addition, the Tax Court held that the payments under the litigation support agreements did not represent bona fide loans under factors used by federal courts to distinguish between debt and other payments because: (i) the taxpayer did not execute a formal promissory note; (ii) no fixed schedule for repayments was established; (iii) the taxpayer provided no collateral or security; and (iv) no payments of principal or interest were ever made.**

The use of forward contracts

- **In order to avoid the immediate taxability of upfront payments where the transaction is structured as a sale, many litigation financings are structured as forward contracts.**
- **Forward contracts must be over “property.”**
- **Under this structure, the litigation funder makes an upfront payment for a payment determined with reference to portion of the plaintiff’s case or a portion of the law firm’s contingent fee when the lawsuit is resolved.**
- **The litigation funder is treated as having made a financial wager, in which it makes the upfront payment, and in return receives the right to receive an uncertain amount if there is a recovery.**

The use of forward contracts (continued)

- **By structuring the litigation financing as a forward contract, the party being funded would not be taxed on the upfront payment and the parties would be taxed on their net recoveries at the end of the transaction.**
- **In order to receive the advantage of no immediate tax on the upfront payment under a forward contract structure, it is critical that the transaction properly be treated as a forward contract (i.e., reflects that recovery is subject to variation and not guaranteed).**
- **If the litigation financing is treated as a sale of the underlying claim, the upfront payment will be immediately taxable to the party being funded.**

Litigation Funding – Characterization

- **Whether an arrangement is a “sale” depends on the transfer of benefits and burdens/rights and obligations. Many advisors take the position that the funding arrangements are not likely treated as a sale of the litigation claim (or a portion thereof) because the more complex waterfall return formulas do not replicate the litigation claim.**
- **Even a straight pass-through lacks the rights the owner of a litigation claim would normally possess.**

Litigation Funding – Character and Timing

- If derivative, then the investor can argue that they recognize a capital gain at settlement under Section 1234A assuming that they hold the investments as capital assets and/or the underlying claim relates to a capital asset.
- If debt, then the return would likely be treated as ordinary income applying accrual principles.
- If sale, then investor holds the litigation claim directly. Is there a § 1001 event when the claim becomes fixed? If not, realization occurs at settlement. Section 1234A? Origin of the claim doctrine?

Litigation Funding – Source / ECI

- **If the investor is off-shore, consideration will need to be given regarding whether the income generated by the litigation funding transaction is effectively connected to a US trade or business (ECI).**
- **Many advisors take the position that passively investing in litigation funding rights is not sufficiently active to constitute a trade or business.**
- **If, however, the advance fundings are treated as loans, then the investor could be treated as being engaged in a lending business.**

Master Service Organizations

- **The newest iteration is the MSO transaction.**
- **In an MSO transaction, the law firm separates claim origination and many other processes from the practice of law.**
- **The MSO enters into a [contingent fee] contract with the law firm to provide non-legal services to the law firm.**
- **The investor purchases stock/partnership interests in the MSO.**
- **Lawyers sell “personal goodwill” to the MSO and report the gain as capital gain.**

Disclaimer

- **These materials are provided by the presenters, do not necessarily reflect the views of their respective firms and reflect information as of the date of presentation.**
- **The contents are intended to provide a general guide to the subject matter only and should not be treated as a substitute for specific advice concerning individual situations.**

Thank You!