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K&L GATES

Session IV

ERISA and Tax Developments

Joel D. Almquist, Partner, K&L Gates LLP

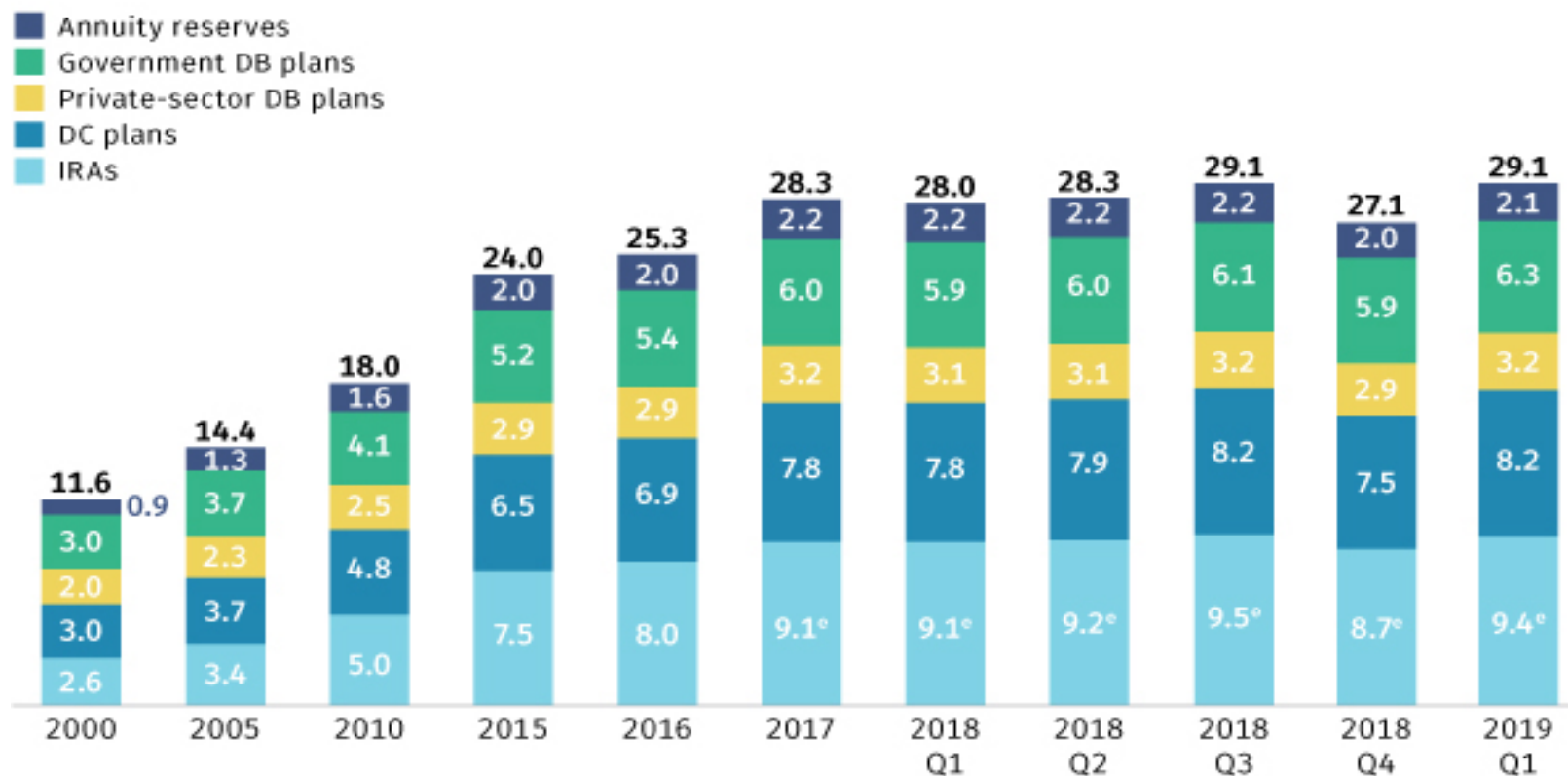
Robert L. Sichel, Partner, K&L Gates LLP



ERISA Developments



ERISA INVESTORS ARE LARGE ASSET OWNERS



Source: Investment Company Institute, "Retirement Assets Total \$29.1 Trillion in First Quarter 2019".

https://www.ici.org/research/stats/retirement/ret_19_q1



THE ERISA SPACE IS BEING DISRUPTED

Defined Benefit Plans

Closing for new employees

Freezing benefits

Terminating

Outsourcing

Defined Contribution Plans

Moving to collective investment trusts

Constructing more “advanced” target date funds

Adding lifetime income

Outsourcing

Considering new structures (e.g., multiple employer plans)



DISRUPTION EXAMPLE: OUTSOURCING

“Outsourced chief investment officers” or “OCIOs” are advisory firms that help institutional investors, such as endowments, foundations, and pension plans, select investment managers and make other investment-related decisions, such as asset allocation and rebalancing decisions



OUTSOURCING TREND

- According to data from *Pensions & Investments*, OCIO managers reported a 23% surge to \$1.74 trillion in assets managed worldwide for institutions in the fiscal year ended March 31, 2018
- Top three OCIO firms: Mercer (\$212 billion under management, up 34.6% from last year); Russell (\$163.8 billion, up 32.4%); and Aon Hewitt (\$151.8 billion, up 47.5%)
- Goldman Sachs Asset Management broke into the top five ranking, moving up from seventh place, due in part to the acquisition of Aptitude in July of 2017



DIFFERENT SERVICE OFFERINGS

Advisory (non-fiduciary)

- Consultant advises the plan
- Plan's internal fiduciary (e.g., retirement committee) considers the advice when making decisions
- Contract provides that consultant is not a fiduciary

Advisory (fiduciary)

- Consultant advises the plan and serves as a co-fiduciary with the plan's internal fiduciary
- Most common arrangement
- Sometimes referred to as "3(21) services"

Discretionary (fiduciary)

- Consultant makes all decisions for the plan and may sign documents on the plan's behalf
- Sometimes referred to as "3(38) services"
- "True" OCIO



CONSIDERATIONS (FOR INVESTMENT MANAGERS AND OCIO FIRMS)

- Client contract
 - OCIO's form vs. investment manager's form
 - Specific matters to address
- ERISA prohibited transaction considerations
 - Example: Can the investment manager execute trades with a broker-dealer that is affiliated with the OCIO firm or clear swaps through a clearing member that is affiliated with the OCIO firm?
- ERISA duty of prudence considerations
 - Example: Can the investment manager purchase securities issued by the OCIO firm and its affiliates?



DISRUPTION EXAMPLE: CONSIDERING NEW STRUCTURES

- A “multiple employer plan” or “MEP” is a single retirement plan utilized by two or more employers
- Different from a multi-employer plan (union/Taft-Hartley)
- Traditionally offered by trade associations and professional employee organizations and used by smaller employers
- Pros & cons
 - Risk reduction
 - Cost
 - Customization
 - Administrative tasks (plan audit, Form 5500, hiring and monitoring service providers)



GOING FORWARD

- Some think MEPs are going to be widely used
- Legal and regulatory changes would be helpful
 - SECURE Act
 - IRS regulations
 - Executive order
- Firms should stay on top of these developments and consider strategy (e.g., what products and services will MEPs need)





Tax Developments



WHICH OF THE FOLLOWING INVOLVE TAX CONSIDERATIONS?

- QUARKS
- IBORS
- HARD FORKS
- LOCK BOX
- MUONS
- AIRDROPS
- GILTI
- SAURON
- CFC SUBS
- QOF
- HEARTBEATS



IBORS

- IBOR: Inter Bank Offered Rate
- IBORs being replaced with qualified rates
- Newly proposed regulations deal with issues arising when such a replacement is made
 - Alteration of the terms of a debt instrument to make such a replacement is not a “modification” and does not result in an exchange – Prop. Regs. section 1.1001-6
 - Resulting FMV of revised instrument must be “substantially equivalent”
 - REMICs – regular interests in REMICs maintain their status despite changes from IBOR to a fixed or other variable rate – Prop. Regs. section 1.860G-1
 - OID – rules provided for calculating original issue discount when instrument transitions from IBOR-referencing rate to a different rate – Prop. Regs. section 1.1275-2
 - Examples of qualified rates: SOFR, SONIA, TONAR, SARON, SOPRA and HONIA



CRYPTOCURRENCY – HARD FORKS AND AIRDROPS

- Revenue Ruling 2019-24 -- Taxation of Hard Forks and Airdrops
- Hard Fork: cryptocurrency on a distributed ledger undergoes a protocol change resulting in a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger
- Airdrop: a distribution of units of a cryptocurrency to the ledger addresses of current holders. A hard fork followed by an airdrop results in the distribution of units of the new cryptocurrency to addresses containing the legacy cryptocurrency.
- Situation 1: A holds units of Crypto M. Crypto M hard forks resulting in the creation of Crypto N, but no units of Crypto N are airdropped or otherwise transferred to A.
- No gross income to A.
- Situation 2: B holds units of Crypto R. Crypto R hard forks resulting in the creation of Crypto S, and units of Crypto S are airdropped to B's ledger address, and B has the ability to dispose of Crypto S units.
- B has gross income, ordinary in character, equal to the fair market value of the Crypto S units received. B's tax basis in Crypto S units is equal to the amount included in income.



GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI)

- **Controlled Foreign Corporation:** a CFC is any foreign corporation owned more than 50% (by vote or value) by “United States shareholders” on any day during the taxable year of the foreign corporation.
- **United States shareholder:** any U.S. person (including a U.S. partnership) who owns 10% or more of the vote or value of stock of the foreign corporation
- United States shareholders are taxed on the CFC’s Subpart F income and GILTI without the need for a distribution from the CFC
- GILTI generally includes all net operating income (taking into account allocable interest deductions) of a foreign corporation not otherwise taxed to US shareholders in excess of a 10 percent return on the adjusted cost basis of the tangible assets of the company used in the production of such operating income
- At the time of enactment, it appeared that GILTI provisions would apply to a domestic fund (e.g., a private equity fund) that holds more than 50% of the stock of a non-US corporation, and also could apply to a domestic fund holding 10% or more (by vote or value) of the stock of a non-US corporation if after accounting for other US shareholder groups such non-US corporation were a CFC



GILTI

- Fund would be required to include on the K-1s of the investors and general partners of the fund their allocable share of the non-US corporation's GILTI on an annual basis
- Recently issued Final Regulations modify the treatment of domestic partnership for purposes of applying the GILTI tax regime and for determining the status of a person as a US shareholder of a CFC.
- A domestic partnership that owns a foreign corporation is treated as an entity for purposes of determining whether the partnership and its partners are US shareholders, whether the partnership is a controlling US shareholder, and whether the foreign corporation is a CFC. However, such domestic partnership is treated as an aggregate of its partners for purposes of determining its partners' GILTI inclusions.
- If a US partnership with 5 partners owns 10% of a CFC, the US partnership is a US shareholder of the CFC, but – for purposes of GILTI inclusion – no US partner includes GILTI because no US partner has a 10% stake in the CFC.



OFFSHORE SUBSIDIARIES OF RICS

- Are deemed income inclusions from a RIC's offshore subsidiary “good income”, or is such income only good income if it is distributed?
- The IRS issued final regulations -- Treas. Reg. § 1.851-2(b)(2) -- addressing this issue on March 19th of this year.
- The regulations provide that amounts deemed included in gross income for the taxable year are treated as dividends only to the extent that, such income is distributed to the RIC.
- The regulations also provide that, if an amount is deemed included in gross income of a RIC and is derived with respect to the RIC's business of investing in stock, securities, or currencies, then the amount is good “other income” even without a distribution.
- In the case of a RIC that invests in a CFC subsidiary for purposes of gaining investment exposure to commodities (which would not produce qualifying income if held directly by the RIC) and that invests the balance of its assets in a manner that serves to support its commodities-focused investment strategy, the question presented is whether the deemed inclusions from the subsidiary are derived with respect to the RIC's business of investing in stock, securities, or currencies.



QUALIFIED OPPORTUNITY FUNDS

- In April 2019, the IRS issued proposed regulations that allow the deferral of all or part of a gain that would otherwise be includible in income but that is invested into a Qualified Opportunity Fund (QO Fund). The recognition of this pre-acquisition gain is deferred until the investment is sold or exchanged or Dec. 31, 2026, whichever is earlier. If the investment is held for at least 10 years, investors may be able to permanently exclude post-acquisition gain from the sale or exchange of an investment in a QO Fund.
- Qualified opportunity zone business property is tangible property used in a trade or business of the QO Fund if the property was purchased after Dec. 31, 2017.
- A key part of the guidance clarifies the "substantially all" requirements for the holding period and use of the tangible business property:
 - For use of the property, at least 70 percent of the property must be used in a qualified opportunity zone.
 - For the holding period of the property, tangible property must be qualified opportunity zone business property for at least 90 percent of the QO Fund's or qualified opportunity zone business's holding period.
 - A partnership or corporation must be a qualified opportunity zone business for at least 90 percent of the QO Fund's holding period.



HEARTBEAT TRADES

- Section 852(b)(6) – no gain is recognized by a RIC when it distributes assets in-kind “if such distribution is in redemption of its stock upon the demand of the shareholder.”
- Heartbeat Trade - an investment in an ETF by an Authorized Participant followed – after a brief period of time – by a redemption, which is paid by distributing assets in kind.
- Fits the terms of Section 852(b)(6)
- Lots of recent publicity about these trades
- Is the Authorized Participant acting as a shareholder?



WHAT THEY ARE

- QUARKS -- any of a number of subatomic particles carrying a fractional electric charge, postulated as building blocks of the hadrons.
- IBORS – interbank offered rates
- HARD FORKS – a cryptocurrency thing
- LOCK BOX – it holds the key
- MUONS -- elementary particles similar to the electron, with an electric charge of $-1 e$ and a spin of $1/2$, but with a much greater mass. Classified as leptons.
- AIRDROPS – another cryptocurrency thing
- GILTI – global intangible low-taxed income
- SAURON – The Lord of the Rings
- CFC SUBS -- offshore subsidiaries of RICs
- QOF – qualified opportunity funds
- HEARTBEATS – ETF shareholder redemptions



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