

Tax Considerations In Structuring US-Based Private Equity Funds

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In forming a US-based private equity fund, the fund sponsor must address tax and other structuring issues at four levels: the investor level, the fund level, the portfolio investment level and the fund manager level. This article principally addresses the investor level tax issues that a fund sponsor will typically face when determining what type of entity the fund will be and in which jurisdiction it will be formed.

Case Scenario

A group of US-based investment professionals (the sponsor) seek to organize a group of US and non-US investors to invest in a private equity fund (the fund) with a view to making equity investments principally, although not exclusively, in the US. Investments may be made in a broad range of businesses eg mature, start-up, industrial, financial, technological, biochemical. Investments typically will be held for the medium to long-term, will include some management rights, and may or may not include control investments. The goal is to improve performance of the respective businesses and sell at a profit after holding an investment for several years.

The target investor group will include local and foreign institutions (pension funds, insurance companies, charities and foundations), individuals, governmental entities and perhaps other private equity funds.

A typical business arrangement for the fund would be as follows: The sponsor would be paid a flat management fee (eg 1% of committed capital) and would also be entitled to a share of the profits (typically 20% after investors have realized a preferred return on and the return of their capital invested) on the overall investment portfolio.

Investor Level Issues

In structuring the fund, there is a basic set of investor expectations that must be met, as well as issues specific to particular investor groups.

Tax Objectives of Most US Investors

Most US investors will share the following common tax objectives when investing in the fund:

- the fund itself should not bear tax;

- passthrough of capital gains and losses, allowing individuals to enjoy favorable rates of tax on capital gains (as described more fully below);
- minimization of “phantom” income (ie the allocation of profits to the investor that are included in the investor’s taxable income without the receipt of cash);
- no tax-reporting obligations in non-US jurisdictions; and
- no tax on gains in non-US jurisdictions or, if taxes are incurred, the ability to credit those taxes against US tax on the gain.

Specific Tax Objectives of Certain US Investors

In addition, there are certain specific requirements unique to certain classes of US investors, particularly pension plans, private foundations, charitable trusts and other tax-exempt investors.

Unrelated business taxable income (UBTI) concerns: Certain US investors who are generally exempt from tax in the United States are taxable in respect of UBTI. In this context, UBTI will not include dividends, interest and capital gains from the fund’s investment activities, but will include all or a portion of the income that the fund earns from investments that are in whole or in part financed with indebtedness (called unrelated debt financed income (UDFI)). UBTI may also include business income allocable to the fund from, for example, an operating partnership in which the fund is an investor. Charitable remainder trusts are particularly sensitive to UBTI and UDFI because receipt of an allocation of any such income causes the CRT to be taxable on all of its income.

The sponsor will generally be required under the fund’s limited partnership agreement to avoid or minimize UBTI, or may be required to give certain investors the right to opt out of UBTI-generating investments. Alternatively, US tax-exempt investors may be given the option of investing in the fund through a non-US feeder corporation established primarily for non-US investors, eliminating the flow-through of taxable income to the tax-exempt investor.

Employee Retirement Income Security Act of 1974 considerations: As a consequence of ERISA’s complex rules and high standards of conduct, many fund sponsors attempt to structure their funds to be exempt from ERISA’s requirements. The two most utilized exceptions for commingled private equity investment funds are the “operating company” exception (ie venture capital operating company (VCOC) and real estate operating company (REOC)) and “significant participation” exception (also referred to as the 25% test). If benefit plan investors (eg pension funds, IRAs, insurance company separate accounts, and non-US pension funds) account for 25% or more of fund capital the fund will not satisfy the 25% test exception. In that case, the fund’s governing documents generally will require the sponsor to operate the fund so that the fund qualifies under ERISA regulations as a VCOC or REOC. Very often the structure needed to be employed to comply with the VCOC or REOC rules conflict with the structure being utilized to achieve tax objectives. Careful consideration of these often competing objectives should be taken.

Tax Objectives of Most Non-US Investors

Most non-US investors will share the following common tax objective when investing in the fund:

- no US taxation of gains;
- by investing through the fund, the investor's tax position in the investor's home jurisdiction is not worse than if the investor made an investment in the portfolio company directly; and
- anonymity, ie no obligation to disclose the identity of the fund's investors to taxing authorities.

Specific Tax Objectives of Certain Non-US Investors

In addition, there are certain specific requirements unique to certain classes of non-US investors.

Non-US Pension Funds: Unlike their US counterparts, there is no special exemption from US tax for non-US pension funds as a matter of US tax law (and similar rules may apply in other jurisdictions in which the fund invests). However, treaties may eliminate withholding tax on dividends and interest that otherwise may be applicable. These investors may be particularly sensitive to the transparency issues, discussed below, potentially relevant to taxation in their home jurisdictions and the jurisdictions in which the fund invests.

Special needs investors: Certain investors have unique structuring requirements arising from laws in their home jurisdictions. For example:

- in order to avoid penalties under the German Foreign Investment Act, German investors may be required to participate in fund investments through a separate entity established under German law (eg a GmbH & Co KG) that co-invests with the Fund.
- French and Netherlands investors need to invest in a vehicle that is transparent for home jurisdiction tax purposes and possibly for treaty purposes.
- foreign governments and their controlled entities are exempt on investment income from US securities but taxable in respect of income from commercial activities. These investors may need to invest through a parallel fund that excludes "tainted" income or have the right to opt-out of certain investments if the government investor is a controlled entity.

Basic US Tax Regime Applicable to Non-US Investors

The basic US tax regime applicable to non-US investors in US-based private equity funds is that they are exempt from taxation on gains from portfolio investment activities, making the United States a tax haven of sorts for foreign private equity capital. United States tax law provides that a private equity fund that is investing or trading for its own account is not engaged in a trade or business in the United States, even if the fund is managed in the United States, and

is therefore not subject to tax on gains. It is also necessary to consider the tax laws of the state and city where the sponsor is located as different rules may apply, potentially subjecting the fund to state or city tax liability. However, many states and cities, including New York state and New York City, follow the federal treatment.

The significance of this basic US tax regime for non-US investors is that:

- gains are generally exempt from US tax (but see the overriding exceptions below);
- dividends are subject to statutory withholding at 30%, reduced under any applicable income tax treaty between the US and the non-US investor's home jurisdiction, provided that certain basic information about the non-US investor has been provided to the Internal Revenue Service (IRS) under new IRS rules; and
- interest on portfolio indebtedness is exempt from withholding tax, assuming that the information referred to above is provided. (Interest on indebtedness will not be exempt from US withholding tax if the recipient owns 10% or more of the voting power of the issuer. It is not clear whether this test is applied at the fund or investor level). Interest that is not exempt under the portfolio debt exemption may be exempt under a treaty if certification rules similar to the dividend withholding certification rules are satisfied.

There are a number of overriding exceptions to the basic rule exempting non-US investors or a non-US feeder corporation from US taxation, each of which apply in circumstances where the fund is deemed to be engaged in a trade or business and therefore subject to tax. These categories of exceptional taxable income include:

- gain on sales of shares of a US Real Property Holding Corporation (USRPHC) under the FIRPTA rules;
- financing activities (Mezzanine funds and funds that invest in distressed bank loans or similar securities that may involve loan origination, loan syndicate participation, secondary market purchases of revolving loans, commitment or other funding fees and participation on creditor committees raise unsettled questions as to whether such programs constitute exempt investing or taxable financing activities.); and
- fees from portfolio companies.

The fund's partnership agreement usually will prohibit the sponsor from making investments that generate these categories of exceptional taxable income, other than fees from portfolio companies, which typically, are permitted to be earned by the sponsor and then offset in whole or in part against management fees.

Choice of Entity and Jurisdiction

The Base Case – Delaware Limited Partnership

As outlined above, US investors will prefer that the fund be structured as a partnership or entity treated as partnership for US federal income tax purposes. Partnerships are not taxable entities for US tax purposes; instead, each partner includes in its gross income its distributive share of partnership income based generally upon the partnership agreement (hence the reference to partnerships as passthrough entities). Furthermore, a partnership will pass through to the partners the character of its income. As the fund generally will derive most of its gains from securities held for more than one year, US partners who are individuals will be subject to tax on their share of such fund's gains at favorable long-term capital gains rates.

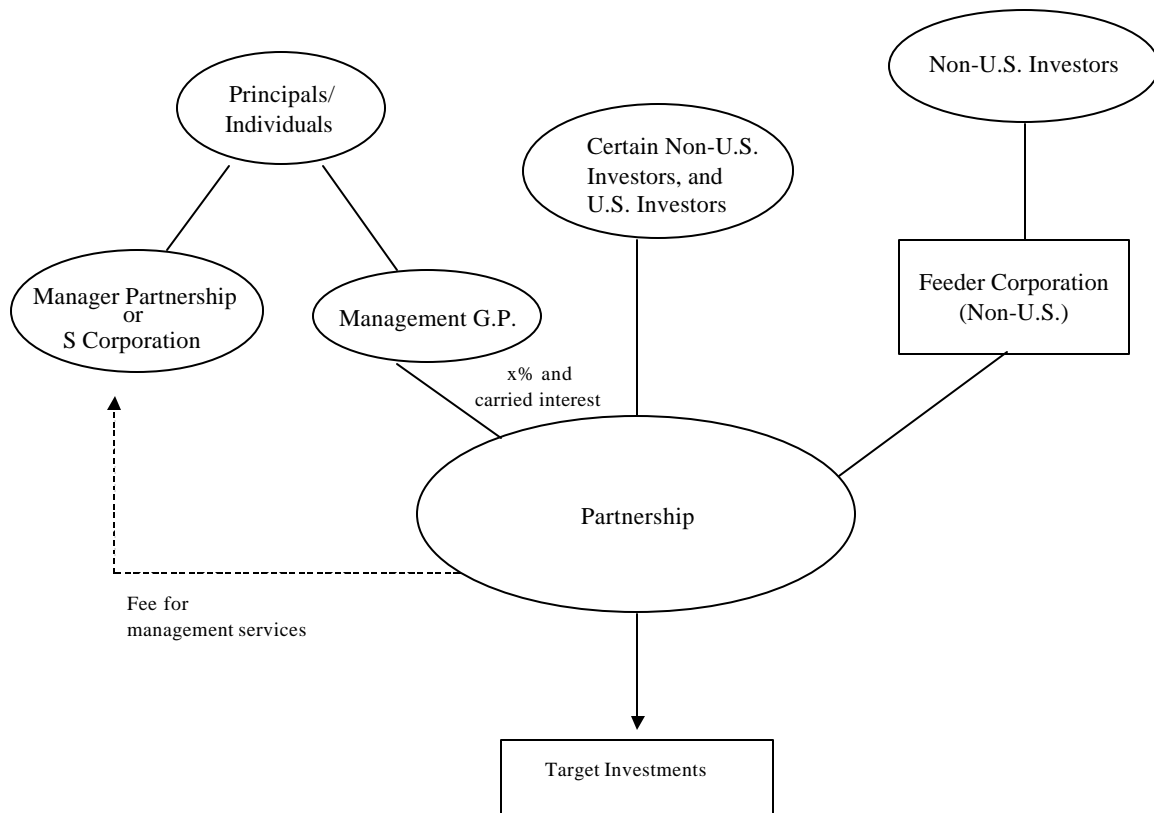
In addition, structuring the fund as a partnership permits the general partner to receive a performance-based allocation of partnership profits (called a carried interest). (More recent funds have permitted the sponsor to waive management fees in exchange for an increased profits interest.) If structured properly, the receipt of the carried interest by the general partner at the inception of the fund will not be a taxable event for US tax purposes. Further, an allocation (and related distribution) to the general partner in respect of its carried interest of partnership gains results in favorable tax treatment for the sponsor compared to the receipt of performance-based fee compensation.

Non-US investors may not want to invest in a US partnership due in part to confidentiality concerns. (While the fund will not be subject to tax, it will be required to file an annual partnership return with the IRS, attaching a schedule K-1 for each limited partner reflecting that limited partner's share of the partnership's income and losses for the year.) These investors may invest in the fund through a foreign "feeder" corporation (usually organized in a tax haven jurisdiction), that in turn invests in the fund. The use of the foreign feeder generally will ensure that the non-US investor's identity will not have to be disclosed to any taxing authority.

Note, however, that the foreign feeder entity may conflict with anti-tax haven legislation in the investor's home jurisdiction and may cut off treaty benefits (for example, with respect to dividends from the United States). As a result, non-US investors are typically given a choice, based on individual circumstances and concerns, to invest either directly in the partnership vehicle or through a feeder vehicle. Alternatively, it may be necessary to offer certain investors the ability to invest in a parallel or co-investment vehicle, which itself acquires an interest in portfolio companies alongside or in parallel with the fund, as discussed below.

Diagram A is an example of a basic private equity fund structure with a single Delaware limited partnership and an offshore feeder corporation for non-US investors.

Basic Private Equity Fund Structure



Factors Affecting The Choice Of Jurisdiction

US investors largely will be indifferent to the place of organization of the fund. Typically, especially if the sponsor is a US-based organization, the fund will be structured as a US limited partnership because of the developed body of US partnership law. However, a number of factors may cause the sponsor to consider forming the fund in a non-US jurisdiction:

Investment Company Act considerations: The fund typically will be structured to avoid registration under the US Investment Company Act of 1940. If the sponsor is seeking to avoid registration by restricting the number of investors in the fund to not more than 100, using a non-US jurisdiction provides an advantage. Under the Investment Company Act, non-US investors will count toward the 100-person limit if the fund is a US-based entity, but they will not count if the fund is formed in a non-US jurisdiction. Similarly, if the fund relies on the so-called qualified purchaser exemption, the asset-based qualified purchaser test must be met by all investors in a US-based fund, but only by US investors if the fund is formed in a non-US jurisdiction.

Publicly traded partnership rules: If there are concerns that, because of the manner in which investors are permitted to transfer or redeem interests in the fund, the fund would be

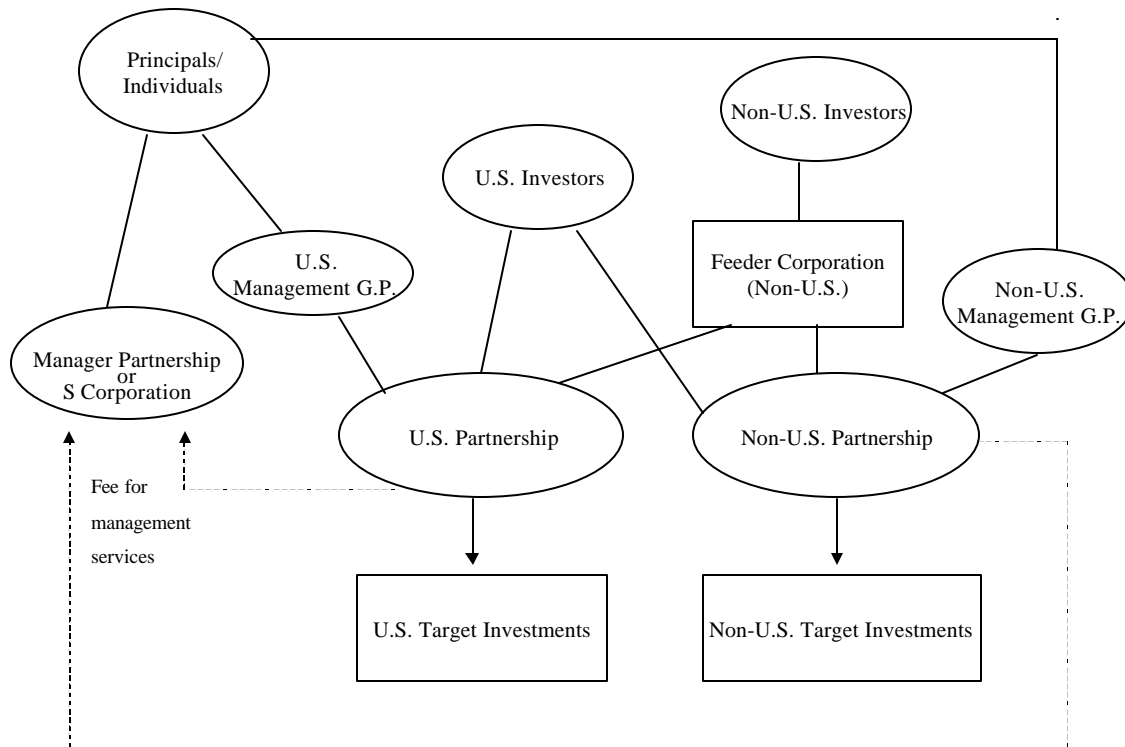
characterized as a publicly traded partnership for US tax purposes, organizing the fund in a non-US jurisdiction may be prudent (although publicly traded partnership issues are not likely in most private equity funds).

Non-US portfolio investment activities: If the fund intends to invest in non-US corporations, use of a US partnership could be detrimental to US-taxable investors and the sponsor. Understanding this issue requires an understanding of the US tax treatment of US shareholders of controlled foreign corporations (CFCs). A CFC is a foreign corporation owned (directly, indirectly or under applicable attribution rules) more than 50% by vote or value by US persons who own at least 10% of the corporation's voting power. Gain recognized by a US shareholder on the sale of the shares of a CFC will be recharacterized and taxed as ordinary income (at higher rates than capital gains) to the extent of the CFC's accumulated earnings. For purposes of determining whether a foreign corporation is a CFC (that is, whether it has a majority of US shareholders), a US partnership is treated as a single US shareholder (regardless of whether any of the partners in the partnership are US persons). By comparison, a partnership that is organized in a non-US jurisdiction will not itself be treated as a US shareholder for CFC determination purposes (even if all of the partners in such partnership are US persons). Instead the US ownership of a foreign portfolio company owned by a non-US partnership is determined at the partner level, as though each partner owned an interest in the portfolio company in proportion to its interest in the partnership. Thus, by organizing the fund as a non-US partnership, the likelihood that a foreign portfolio company acquired by the fund would be classified as a CFC might be remote. (Note that the general partner of the non-US partnership also should be organized as a non-US entity.)

Unless the sponsor insists on utilizing only one investment vehicle, the fund's partnership agreement will typically permit the sponsor to establish alternative investment vehicles when necessary to accomplish a regulatory or fiscal objective that cannot be achieved by the US fund. Such alternative investment vehicles include parallel partnerships formed to avoid CFC status of a particular foreign portfolio company, as the need arises. However, use of the parallel vehicle to address CFC issues might perhaps be subject to challenge if the performance results of the "main" fund and the parallel vehicle are aggregated (as investors would expect).

Diagram B is an example of a private equity fund structured with basic parallel or co-investment vehicles.

Parallel Investment Structure



Even without regard to the issues US investors present, non-US investors may have concerns with investing through a US limited partnership. As noted earlier, one such concern involves the disclosure requirements that may be applicable to non-US investors in the fund, although this concern could be addressed with the use of a non-US feeder vehicle. More significantly, a US limited partnership may present tax problems for certain non-US investors in their home jurisdictions, where favourable tax treatment may depend upon the transparency of the partnership vehicle applying home jurisdiction (rather than US) legal principles. For instance, the UK, the Netherlands and France require transparency of a partnership or hybrid entity in order for an investor who is a resident of those jurisdictions to obtain more favorable tax treatment of capital gains. While each of those jurisdictions recently appears to recognize the transparency of a US limited partnership, such recognition may not apply for all purposes. For example, France may not permit treaty claims for non-US investors in a US partnership and may not recognize the transparency of a US partnership with respect to French investor treatment. In addition, in the absence of transparency in the investor’s home jurisdiction, the investor may be deprived of the ability to claim benefits under a treaty the United States maintains with the investor’s home jurisdiction under the US hybrid entity rules.

Alternative Jurisdictions and Co-Investment Entities

After considering all of the above factors (or where a parallel fund is utilized), consideration might be given to organizing the fund in a non-US jurisdiction such as the British Virgin Islands or the Cayman Islands. Each of these has a limited partnership law that is in substance very

similar to Delaware partnership law. However, use of such an entity is not without potential problems. For instance, certain non-US investors may be disadvantaged in their home jurisdictions due to anti-tax haven legislation in such jurisdiction, which could result in denial of certain otherwise-available, favorable home jurisdiction tax treatment or income imputation. In addition, certain jurisdictions in which the fund may invest might impose penalties on tax haven residents investing in the jurisdiction. Others might deny transparency to such entities with the results outlined earlier. Finally, while US investors generally will be indifferent to the use of a non-US partnership, additional reporting will be imposed on US investors with respect to an investment in a non-US partnership.

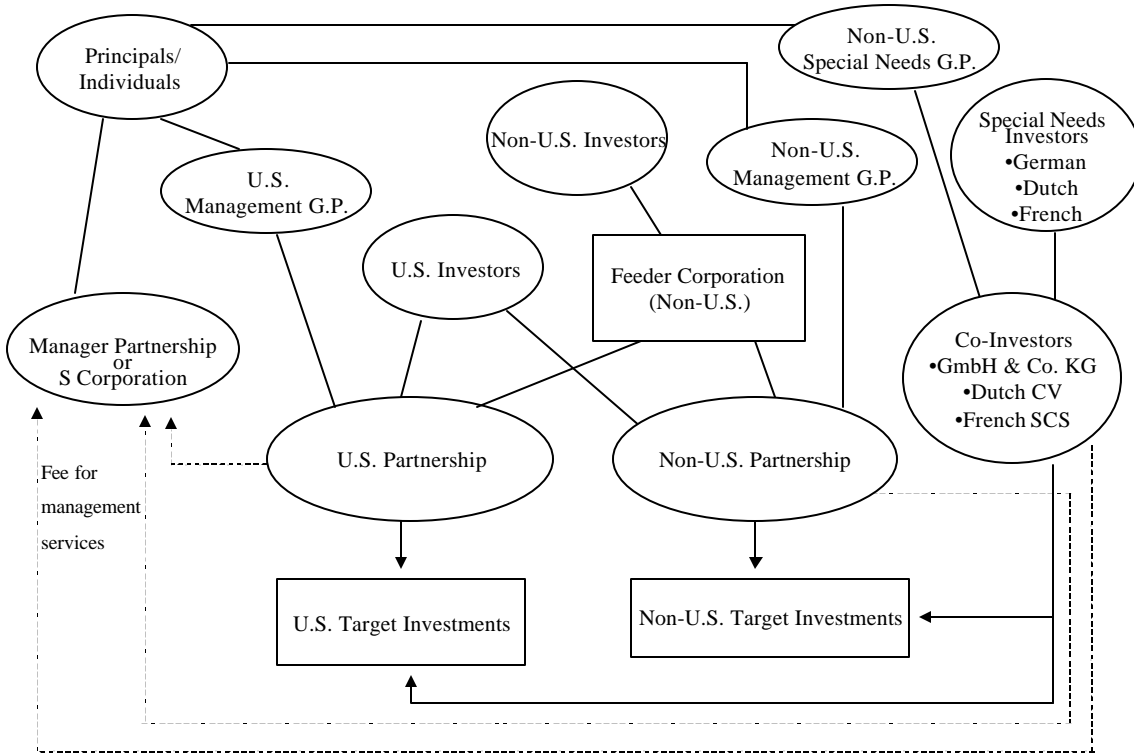
Organizing the fund in certain other non-US jurisdictions may avoid these issues while also addressing any issues raised by the use of a US limited partnership. These possible compromise jurisdictions include the UK and Canada. Each of these jurisdictions has a limited partnership law, although not as flexible as that of Delaware or the tax haven jurisdictions. For instance, UK limited partnership law currently limits the number of partners permitted in the partnership to 20 (although recent proposed amendments would eliminate this limitation). Canadian partnership law construes participation in management of a partnership narrowly, which in certain circumstances may cause the sponsor and even limited partners participating on an investor advisory committee to risk losing their limited liability protection. Transparency issues further complicate the stacking of non-US partnerships for purposes of using feeder vehicles or selecting a jurisdiction for the sponsor's vehicle.

Additional co-investment entities may be required for certain non-US investors. For instance, as mentioned earlier, German investors who invest in non-German investment funds that are not registered, or white funds, under German law will be subject to significant tax penalties. Those penalties could be avoided if the sponsor forms a special-purpose GmbH & Co. KG for German investors, which would co-invest with the fund (subject to certain limitations). French and Dutch investors may require similar special purpose vehicles organized as transparent entities under the laws of France or the Netherlands, respectively.

Diagram C is an example of a parallel and co-investment structure with separate feeder entities and parallel fund vehicles designed to accommodate the needs of non-US investors.

Diagram C

Parallel and Co-Investment Structure



Conclusion

The presumptive use of US and tax haven partnerships as effective vehicles for private equity funds requires close scrutiny in light of the myriad tax concerns such entities may raise for fund investors. Fund sponsors need to be able to balance the need for legal certainties against the different tax needs of investors as dictated by tax rules in the investors' home jurisdictions, as well the tax regimes of jurisdictions in which the fund's target portfolio companies are located. The evolution of tax regimes throughout the world to deal with hybrid entities and the increased focus of such regimes on perceived tax haven abuses continue to challenge previously accepted norms. However, with careful planning, even special-needs investors should be able to invest in pooled private equity opportunities on a tax-effective basis.

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