U.S. Private Equity Funds: Selected Regulatory and Tax Issues

By: Filippo M. Cinotti, Esq.*

The private equity industry has grown tremendously during the past 15 years and is expected to continue growing at a steady pace for the next 10. Growth will likely be fueled both in the United States and Europe by a narrowing in the perceived risk differential between private and public equity investments, easier access to private equity funds for investors and premium performance over investments in public equities.

The object of this article is to provide an overview of the regulatory and tax issues arising from structuring, and investing in, US sponsored private equity funds. Private equity funds typically are structured to invest in equity interests of portfolio companies that are not publicly traded. This is in contrast to the investment strategies of hedge funds, which generally invest in publicly traded securities. The securities and tax issues of hedge funds are somewhat different from those relating to private equity funds and will not be covered in this article.

I. Regulatory Considerations

1. Securities Registration

Interests in private equity funds are typically offered and sold to US investors without registration, provided that certain requirements set forth by the federal securities laws are met. Regulation D of the Securities Act of 1933 ("Securities Act") provides for a safe harbor for issuers of private equity interests in the United States. [1] The safe harbor requirements generally put a restriction on the manner in which the interests can be offered and the identity and number of the investors.

a. Manner of the Offering

---

* Filippo M. Cinotti is a New York attorney whose experience includes the representation of private equity sponsors in connection with the formation of private equity funds and the representation of US and European investors in connection with the evaluation and negotiation of their private equity fund investments.

[1] In the case of non-U.S. offerings, sponsors of private equity funds usually rely on Regulation S of the Securities Act. Regulation S provides for restrictions that are similar to those applicable to an offering in the United States pursuant to Regulation D. To fall within the scope of the Regulation S exemption, there may be no "directed selling efforts" in the United States with respect to the equity interests being offered. Directed selling efforts include any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States. In general, any U.S. activity that would constitute general advertising or general solicitation for Regulation D purposes would also amount to directed selling efforts.

The offering and sale of securities not involving any "public offering" is exempt from registration under the Securities Act. General solicitation or general advertising would be viewed as a "public offering". Thus, sponsors of private equity funds (hereinafter referred to as "Sponsors") should make sure that no general solicitation or general advertising occur during the course of soliciting potential investors.[2] Examples of general solicitation and general advertising would be any articles, press conferences and other advertisements on newspapers, institutional trade publications and the internet.

b. Identity and Number of Investors

The interests should also be offered and sold only to "accredited investors" and up to 35 unaccredited investors. The definition of "accredited investors" generally includes banks, investment companies, insurance companies, certain tax-exempt organizations and individuals whose net worth exceeds $1 Million (or meet certain income thresholds) as well as corporations with total assets in excess of $5 Million.[3]

2. Investment Company Act

Sponsors should avoid registration of the fund as an investment company. Registration could result in onerous limitations on transactions with affiliates of the fund and a prohibition on performance fees (i.e., carried interest). To avoid registration as an investment company two requirements have to be met: (1) the fund must not be making or proposing to make a public offering and (2) either (a) the fund's interests are not owned by more than 100 beneficial owners or (b) all of its investors must be "qualified purchasers." In counting the number of beneficial owners, Sponsors should be aware of complex 'look through' rules that apply for certain investors who own 10% or more of the voting securities of the fund and for parallel or alternative vehicles formed for the purpose of investing in the fund. "Qualified purchasers" include individuals owning at least $5 million in investments and entities that own and invest at least $25 million.

3. Registration as Investment Adviser

In general, large investment advisors, such as general partners and managers of private funds, must register as such with the SEC, unless an exemption is available.[4] An

---

[2] Private equity interests should be marketed to investors only if they (a) have a pre-existing business relationship with the fund's sponsor (or the fund's placement agent) and (b) are reasonably believed to be accredited investors.

[3] The sponsor should also consult with local counsel to make sure that the private placement qualifies with the applicable State securities ("Blue Sky") laws. 4 It should be noted that registered investment advisers generally are not allowed to receive performance-based compensation, except from certain qualified clients and subject to certain conditions. In addition, the manager and the general partner of the fund will be subject to extensive books and records requirements and oversight by the SEC through its inspection program.

[4] It should be noted that registered investment advisers generally are not allowed to receive performance-based compensation, except from certain qualified clients and subject to certain conditions. In addition, the

exemption is available for investment advisers with fewer than 15 clients and who do not hold themselves out to the public as an investment adviser. A private equity fund is usually counted as a single client so long as the Sponsor's advice is given based on the fund's general objectives rather than the individual objectives of its investors.[5]

4. Registration as Broker-Dealer

Under US federal law, persons who are in the business of purchasing and selling securities must register as brokers-dealers, unless an exemption is available. In the private equity arena, employees of the manager or the general partner of a private equity fund who offer interests in the fund might be considered brokers. A safe harbor exists for certain "associated persons" of the fund provided that certain conditions are met. The most important of these conditions prohibits an associated person from receiving commissions or other transaction-based compensation. In addition, the associated person has to perform substantial duties for the issuer other than sales activities to qualify under the safe harbor.

II. Private Equity Fund Level Tax Issues

Some of the most important tax issues relating to the formation of private equity funds are as follows: a. Qualification as a Partnership Most US sponsored private equity funds are structured as limited partnerships or LLCs classified as partnerships for tax purposes.[6] The objective of this choice of structure is to assure that no additional layer of tax will be imposed at the fund level (i.e., the fund will be treated as transparent for tax purposes). b. Choice of Jurisdiction The majority of the private equity funds operating in the United States are formed under Delaware law. Private equity funds with a substantial number of US taxable limited partners seeking to invest in low tax non-US jurisdictions, however, are often formed as offshore entities (i.e., Caymand Islands, Bermuda, Guernsey). This choice of location has the advantage of minimizing risks relating to the possible application of the Controlled Foreign Corporation [7] ("CFC") regime, which could result in phantom income to the investors.[8]

---

manager and the general partner of the fund will be subject to extensive books and records requirements and oversight by the SEC through its inspection program.

[5] There is no bright line rule for determining whether a private equity firm is holding itself out to the public as an investment adviser as such determination is very fact intensive.

[6] It should be noted that certain foreign jurisdictions, such as Canada, do not recognize LLCs tax treaty benefits. Thus, private equity funds (and general managers) seeking to invest in these foreign jurisdictions should avoid being organized as LLCs.

[7] A Controlled Foreign Corporation is a non-US corporation in which more than 50% of the total vote or value of the corporation stock is owned (directly or by attribution) by a 10% US shareholder. A private equity fund organized as a US partnership would be regarded as a US shareholder. Thus, for example, if a US fund, organized as a Delaware Partnership, owned 51% of the voting stock of a non-US portfolio company (treated as a corporation for US tax purposes), such portfolio company would be a CFC.

[8] If a portfolio company is a CFC, the US taxable partners of the fund could be taxed currently on certain passive income earned by the portfolio company (including interest, dividends, certain rents, and royalties) and gains from the sale of the stock of the portfolio company could be treated as a taxable dividend.

III. Investor Tax Issues

The four principal categories of investors in private equity funds are non-US investors, US taxable investors, US tax-exempt entities and foreign governments. Each category of investor has its specific needs and concerns which the fund structure should address.

1. Non-US Investors

Non-US persons are generally subject to a 30% (or lower rate under an applicable tax treaty) withholding tax, on certain passive type of income (FDAP) derived from sources within the United States. FDAP includes dividends, rents, royalties and certain interest. Non-US investors are generally not subject to US tax on gains realized from the sale of US stock or securities unless such gains (x) are effectively connected with the conduct of a trade or business ("ECI") (or, if a treaty applies, the gains are attributable to the investor's permanent establishment in the US) or (y) arise from the disposition of a US real property interest ("FIRPTA").[9] Non-US investors are usually not required to file US tax returns to report FDAP income, but are required to file US tax returns to report FIRPTA gains and ECI. Thus, besides minimizing withholding taxes on FDAP income,[10] non-US persons investing in US private equity funds are mainly concerned with avoiding ECI and US tax filing obligations. [11]

a. Avoiding ECI

The principal source of ECI to a non-US investor is from investments in US operating partnerships. If a fund invests in an entity treated as transparent for US tax purposes (such as a partnership or an LLC) that is engaged in a US trade or business, a foreign partner's pro rata share of the entity's income would be ECI.[12] In addition, the Internal Revenue Service takes the position that gain from the sale of the fund's interest in the entity, and a portion of any gain realized from the investor from the sale of its interest in the fund is ECI.

b. Avoiding FIRPTA gains

---

[9] A non-US individual investor would also be taxed on gains from the disposition of US stock or securities if the individual is present in the United Sates for 183 days or more during the taxable year and certain other conditions are met.

[10] It should be noted that private equity sponsors have an incentive in promptly investing the proceeds drawn down from investors. This is because, to do otherwise could adversely impact the Internal Revenue Rate ("IRR") of the fund. Thus, FDAP income is typically a small portion of the total income of the fund, the majority of which is represented by capital gains from disposition of securities.

[11] Non-US persons are taxed on ECI at the regular gradual rates applicable to US individuals or corporations. In addition, the ECI attributable to a foreign corporation maybe subject to a 30% branch profits tax. The amount subject to the branch profits tax is roughly equal to the investor's pro rata share of ECI that is not reinvested in the US business. Some foreign tax treaties provide for exemptions, or rate reductions of, the branch profits tax.

[12] A US partnership is required to withhold tax at the highest applicable marginal rates on the ECI allocable to each foreign partner.

Under the Foreign Investment in Real Property Tax Act (FIRPTA), gains realized by non-US investors from the disposition of US real property or stock of a US real property holding corporation is taxed as ECI. A US real property holding corporation is a corporation where the value of the corporation's real property interests is at least 50% of the value of the corporation's business assets at any time during the previous five years. Real property interests include leasehold interests, options and improvements (such as underground telephone and cable lines) and personal property associated with the use of the real property.[13] To avoid ECI income, non-US investors should seek to obtain "best efforts" or "reasonable efforts" covenants that the fund will structure its investments so as to minimize ECI and FIRPTA. Another strategy to avoid or minimize ECI and FIRPTA is to request opt out provisions, pursuant to which a non-US investor will be excused from participating in an investment that is likely to generate ECI and/or FIRPTA.

c. Avoiding Filing US tax Returns

If, by reason of the activities of the fund, a non-US investor is deemed as engaged in a US trade or business, the non-US investor would be required to file a US federal income tax return, whether or not the investor is allocated any net income or loss from the fund. It should be noted that a non-US investor that does not currently file US tax returns would be generally unwilling to become subject to US filing obligations (and the consequent IRS audit jurisdiction). In these cases, the non-US investor should consider investing through a 'blocker' corporation usually organized in a tax-haven jurisdiction.[14]

2. US Taxable Investors

US taxable investors are usually either high net worth individuals or corporations.

a. US Individuals

US individuals are taxed at a maximum rate of 20% on long-term capital gains (i.e., assets held for more than 1 year) and 38.6% for short-term capital gains and ordinary income. As a result, one of the main concerns of US individuals is to characterize their income as long-term capital gain, rather than ordinary income. If the fund is not engaged in a trade or business, its expenses will be investment expenses, rather than trade or business expenses. In this case, the individual investors' ability to deduct these expenses may be subject to limitations. Another sensitive issue to individual investors is to avoid the application of the "Foreign

[13] There is an exception to FIRPTA taxation for gains from the sale of stock in a publicly traded US corporation if the non-US seller has historically held less than 5% of such stock.
[14] While investing through a blocker corporation may preserve the identity of the investor from being disclosed to the IRS, it may result in tax inefficiencies, such as the denial of tax treaty benefits, US tax withholding on dividend distributions and application of the branch profits tax.

Personal Holding Company"[15] ("FPHC") regime, which could give rise to phantom income to the investors.[16] A common strategy to minimize FPHC concerns is to require that US individuals invest through "parallel" or "feeder" vehicles (not treated as an individual investor for US tax purposes) that can be organized either in the United States or offshore.[17]

b. US Corporations

US corporations are generally taxed at the same graduated tax rates (up to 35%) on both ordinary income and capital gains. Thus, subject to few exceptions, a US corporation is likely to be less concerned about the characterization of its income from the fund than a US individual. In connection with investments by a fund in non-US portfolio companies, US taxable investors as a class are generally concerned with avoiding the application of the CFC [18] and "passive foreign investment company" ("PFIC") [19] regimes, which could result in certain disadvantageous tax consequences to the investors.[20] As an alternative to the PFIC regime, the US investors could choose to make a "qualified electing fund" ("QEF") election and be taxed each year on their pro-rata share of the PFIC income. It should be noted, however, that to make a QEF election, the PFIC must provide the fund investors with an annual information statement detailing, among other things, the PFIC's ordinary income and net capital gains for the taxable year.

3. US Tax-Exempt Investors

The main tax concern to US tax-exempt entities (such as pension plans, charities and universities) investing in private equity funds is to avoid Unrelated Business Taxable Income ("UBTI"). If an exempt entity is partner of a fund that generates UBTI, the entity will be taxed on its distributive share of the fund's UBTI at the regular corporate or trust rates, depending on the form in which the entity is organized. The principal areas of concern for tax-exempt investors are (a) investments in operating partnerships, (b) unrelated debt financed income, (b) fees for services and (c) certain insurance income.

---

[15] Generally, FPHC arises when 5 or fewer US individuals own (by vote or value), or are treated as owning under certain attribution rules, more than 50% of the stock of a corporation and at least 50% (60% for the first FPHC year) of the foreign corporation's gross income consists of certain passive income.

[16] If a fund portfolio company is a FPHC, all of the fund US taxable investors (not just the individuals) will be subject to current tax on their share of the FPHC's undistributed FPHC income. FPHC income includes dividends, interest, royalties and annuities, with certain exceptions.

[17] Similar considerations generally apply for personal holding companies ("PHCs") with respect to investments by private equity funds in domestic portfolio companies.

[18] See footnotes # 7 and 8 above.

[19] Generally, a non-US corporation is a PFIC if either 75% or more of its gross income is derived from passive sources or 50% or more of its assets produce passive income.

[20] If a portfolio company is a CFC, the US taxable partners of the fund could be taxed currently on certain passive income earned by the portfolio company (including interest, dividends, certain rents, and royalties) and gains from the sale of the stock of the portfolio company could be treated as a taxable dividend. If a fund invests in a PFIC, any gain on disposition of PFIC's stock and certain "excess distributions" made by the PFIC will be taxed at ordinary income rates and subject to an interest charge based on the tax that would have been owed in prior years if the gain had accrued ratably.

a. Operating Partnerships

UBTI from operating partnerships arises when the fund invests in a portfolio company (treated as a partnership or other pass-through entity for tax purposes) that carries on a trade or business unrelated to the tax-exempt entity's function. In this case, the tax-exempt partner's share of the portfolio company's income would be UBTI.

b. Unrelated Debt Financed Income

Investment income and capital gains are treated as UBTI to the extent the investments from which they arise are debt-financed investments. In this case, the tax-exempt investor would be taxed on (i) a portion of any investment income from debt-financed property and (ii) a portion of any gain from the sale of the debt-financed property if such sale occurred within 12 months from the repayment of the acquisition debt.[21]

c. Fees for Services

It is not unusual for the general partner or manager of a fund to render management, consulting and similar services to the fund's portfolio companies in exchange for a fee. If the fund were to receive such fees, the fund would likely be treated as engaged in a trade or business and the fees would probably result in UBTI. That is why some private equity fund agreements provide for the manager of the fund, rather than the fund itself, to receive such fees. These fees are then deducted from the management fees owed by the fund to its manager and any excess is carried forward and credited against subsequent management fees. It should be noted that there is a risk that the IRS could attempt to recast such fees as having been earned by the fund, as opposed to its manager (in which case the tax-exempt partners of the fund could be subject to UBTI). This risk is increased for funds providing that any credits for fees remaining unused at the end of the life of the fund are refunded to the investors.

d. Insurance Income

This type of UBTI could arise if a fund were to invest in a foreign company that is a CFC for US tax purposes. As a result, certain types of insurance income earned by the CFC would flow through as UBTI to the Fund's tax-exempt investors.[22]

4. Foreign Governments

---

[21] If the funds used to acquire the property come from the tax-exempt partner, then such partner should not be subject to UBTI on the theory that the exempt partner is merely lending to itself.

[22] For these purposes, a CFC is generally a foreign corporation in which more than 25% of either the total voting power or stock value is owned by one or more US persons, each of whom owns 10% of the total voting power (taking into account certain ownership attribution rules).

Foreign governments benefit from a general exemption from income and withholding taxes under US domestic laws. A foreign government could, however, lose this exemption in whole or in part if it is engaged (or deemed to be engaged) in commercial activities.[23] Foreign governments generally operate in the United States either directly (through an "integral part" of such foreign government) or through a controlled entity. If an integral part of a foreign government derives income from commercial activities, it loses its exemption with respect to such income (i.e., investment income remains exempted). However, if a controlled entity is engaged (or deemed engaged) in a commercial activity, it becomes a "controlled commercial entity" and the tax exemption is lost in its entirety.

III. Tax Shelter Regulations

The US Treasury Department has recently issued final regulations on tax shelters. The new regulations generally mandate the disclosure by taxpayers of "reportable transactions" and impose record keeping obligations on all "material advisors" with respect to the transactions. A reportable transaction is, among others, any transaction offered under "conditions of confidentiality" as to its tax treatment or tax structure. Most private equity funds' formation documents contain pervasive confidentiality provisions. Thus, it appears that an investment in a private equity fund would be a reportable transaction. As a result, any investor required to file US tax returns would be required to disclose information relating to the fund and its transactions to the IRS and retain an extensive list of documents relating to the tax structure and treatment of the fund. In addition, the manager of the fund, its legal counsel and other "material advisors" would be required to prepare certain lists and materials (which include the identity and amount invested by the investors and expected tax structure and treatment of the fund) concerning the fund, which must be submitted to the IRS upon request. An exemption could, however, be available if the Sponsor provides the fund investors with a certain written statement authorizing the disclosure of the tax structure and treatment of the fund and its investments.

IV. Conclusion

There are many business and tax considerations that drive the structuring of private equity funds and the willingness of a potential investor to participate in them. Considerations include the residency and tax status of the investors and the general partner, the jurisdictions where the fund will make investments and the nature of the investments. To accommodate these different, sometimes conflicting, interests fund documents should give the general partner the authority to create parallel funds to accommodate foreign and tax-exempt investors, alternative funds (located offshore) for non-US investments by the fund likely to generate CFC income and feeder funds to reduce FPHC income in connection with admitting US taxable individuals to the fund. In addition, in the wake of the recently finalized tax shelter regulations, private equity fund sponsors should consider revising the confidentiality provisions of their funds'

---

[23] Income from commercial activities generally includes any item of income from activities other than investment income.

documents so as to reduce the risk of being subject to the onerous tax reporting obligations mandated by the regulations.