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Private Equity Funds

Business Structure and Operations

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[2]—Techniques for Sharing

If as an economic matter the Sponsors and the Limited Partners agree that fee income is to be effectively shared with investors, a number of techniques have been developed to achieve that goal. Direct payments of all or a portion of fee income to the Fund or to investors could raise tax concerns.[3] The income could be considered "unrelated business taxable income" and thus taxable to investors who are otherwise tax-exempt. The income could also be considered "effectively connected with a United States trade or business." In this case, offshore investors could be subject to withholding with respect to their share of the fee-related income.

One technique commonly used to address these concerns is to avoid any direct payment of fee-related income to the Fund or its investors. Rather than making direct payments, the agreed-upon portion of fee income is used to offset the future payment of Management Fees. Obviously, the designated portion of fee income may exceed the future Management Fees that would otherwise be payable. This raises the question of whether any such excess fee income should at that point be used to reimburse investors for prior Management Fees and, ultimately, for direct payments to the Fund or the investors.

In most cases, domestic taxable investors would prefer the reimbursement and direct payment approach. Some tax-exempt investors also prefer this approach, apparently considering that an incremental dollar of income, even if taxable, is better than no incremental income.

Other tax-exempt investors have a higher order of sensitivity to receiving any taxable income. In addition, some offshore investors are similarly sensitive to receiving income that requires them to file tax returns in the United States. In these cases, investors are typically given the option to elect not to receive any economic benefit, whether by offset or by payment, attributable to fee income. In some cases, investors who make an election of this kind are offered a lower Management Fee. In other cases, electing investors are provided with a right to receive a special allocation of future Carried Interest designed to match the share of fee income that would have been received but for the election. Since there is no assurance that there will be any Carried Interest, the contingent nature of any future payment to these investors is generally not regarded as presenting a significant risk of taxation arising from the fee-sharing technique.

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[3] See Chapter 5 *infra*.

is allocated solely to the Tax-Exempt Partners whose capital funded the Alternative Investment Vehicle. The net effect of this structure is that the entire gain of the Tax-Exempt Partners derived from the investment is subject to corporate level tax in the hands of the Alternative Investment Vehicle. This result may be less favorable to a Tax-Exempt Partner than if it decides to make its capital contribution directly to the Fund and suffer the consequences of debt-financed income, particularly if the Tax-Exempt Partner is making a capital contribution to fund part of the investment and, thus, not all the gain from the investment would be UBTI.

[2]—Possible Unrelated Business Taxable Income Items

The Fund may also be treated as deriving UBTI if it receives income other than gains from the disposition of interests in portfolio companies, dividends, and interest.[22] The characterization of certain fees received in the context of a private equity investment is unclear for UBTI purposes. Thus, break-up fees, closing fees, equity commitment and guarantee fees may constitute UBTI to a Tax-Exempt Partner. As a general matter, transaction fees, i.e., fees for making an equity investment that are payable only if the investment is actually made, should not be treated as UBTI or, indeed, any type of income whatsoever, as the fees are in the nature of a rebate of the purchase price for the equity investment. Accordingly, if received by the Fund, they should have no tax effect other than a reduction of the cost basis of the underlying investment.

The characterization of break-up and equity commitment fees is more difficult. Although loan commitment fees are not UBTI,[23] there is no guidance on the treatment of comparable fees payable with respect to equity investments. Arguably, equity commitment fees should be treated as the equivalent of a premium for a call option which do not give rise to UBTI. Break-up fees are somewhat similar and should be characterized accordingly. Advisory fees that are sometimes paid by a Portfolio Company for advice rendered by the General Partner or one of its affiliates would clearly be UBTI because these fees are paid for services rendered.[24]

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[22] Interest from a "controlled entity" is treated as UBTI, however. I.R.C. 512(b)(13)(A). A controlled entity includes a corporation the stock of which the Tax-Exempt Partner owns more than 50 percent (by vote or value). I.R.C. § 512(b)(13)(D).

[23] See I.R.C. § 512(b)(1), which specifically excludes from UBTI "amounts received or accrued for entering into agreements to make loans."

[24] Rendering such services would presumably be a trade or business that is, by definition, unrelated to the exempt purpose of the Tax-Exempt Partner. See I.R.C. §§ 512(a)(1) and 513.

The question of whether fee income should, for U.S. federal income tax purposes, be treated as income of the Fund remains unsettled.[25] When the business terms contemplate a sharing of fee income, the absence of guidance regarding the characterization of these fees (for both UBTI and other purposes)[26] often leads a Fund to adopt the following approach. The Fund's organizational documents will provide that all fees of a certain nature[27] earned with respect to the Fund's capital be earned by the Management Company and not the Fund. The Management Company, in turn, agrees to reduce its Management Fees by all or some portion of such other fees earned by it. Typically, the Management Fees is not reduced below zero for any year, such that any transaction or other similar fees earned by the Management Company in excess of Management Fees payable are retained by the Management Company. As a result of this arrangement, the Tax-Exempt Partner is not in receipt of fees that could be characterized as UBTI but, instead, receives some or all of the benefit of such fees through an offset to Management Fees otherwise payable by it.

The U.S. federal income tax consequences of this type of arrangement with respect to transaction fees is unclear.[28] The offset mechanism (i.e., the reduction of the amount of Management Fees payable by all or some portion of transaction fees received) could be considered to some extent to be subject to the assignment of income doctrine and the Tax-Exempt Partner could therefore be treated as having received the prohibited income and assigned it to the Management Company in payment of the Management Fees owed by it. If so, the Tax-Exempt Partner would have recognized UBTI on the deemed receipt of the transaction fees. This analysis would definitely be apt if the Tax-Exempt Partner always received the full benefit of the transaction fees. Typically, the assignment of income doctrine applies to require a taxpayer to include in income an amount that was derived from, for example, his services

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[25] See generally, § 2.05 and § 2.06 *supra*, for discussion of management fees and transaction fees.

[26] A Foreign Partner investing in the Fund has similar concerns related to the receipt of these fees which could cause it to be considered to be engaged in a trade or business with the United States and, therefore, subject to U.S. federal income tax and related tax filing obligations.

[27] This would generally include transaction fees, break-up fees, commitment fees and advisory fees.

[28] This analysis is equally applicable to a non-corporate U.S. Partner who, assuming the application of the assignment of income doctrine, would be treated as receiving the transactions fees and paying a greater amount of management fees. Because the deductibility of Management Fees is limited to amounts in excess of two percent of adjusted gross income, the non-corporate U.S. partner would ultimately be liable for a greater amount of U.S. federal income tax on its income.

or his property when the right to receive such amount is transferred to another as a gift or for the taxpayer's benefit.[29]

The offset provisions with respect to Management Fees are often structured to avoid the obvious application of the assignment of income doctrine. Thus, for example, the Tax-Exempt Partner generally is not entitled to receive any transaction fees in excess of Management Fees payable by it. In addition, some Funds limit the offset against Management Fees payable for any year to transaction fees received in such year or even a percentage thereof or, at the least, permit only a carryforward (but no carryback) of any excess transaction fees to offset future years' Management Fees. Even under this carryforward arrangement, the Tax-Exempt Partner is not assured that it will receive the full benefit of the transaction fees earned with respect to its share of the capital of the Fund. Unlike cases involving the traditional application of the assignment of income doctrine, the Tax-Exempt Partner does not receive the full benefit of the amounts assigned. It is unclear whether this failure of the Tax-Exempt Partner to receive the full benefit of the transaction and other fees under the terms of typical organizational documents renders the assignment of income doctrine inapplicable.

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[29] Helvering v. Horst, 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75 (1940); Lucas v. Earl, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930).