Private Equity

Business and Legal Issues

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FUND*amentals*

1. Why Form a Fund as a Limited Partnership (LP) instead of as a Limited Liability Company (LLC)?

Prior to the widespread adoption of the LLC as a legal entity, private equity funds were almost universally formed as LPs due to the "flow-through" tax treatment of the limited partnership structure under the Internal Revenue Code. With the near universal adoption of the LLC as a business entity, there is generally no legal reason to prefer that a fund be structured as an LP instead of an LLC.

Some states, such as Florida and Texas, do impose franchise or entity taxes on LLCs, and California imposes an entity tax on gross receipts of LLCs according to graduated rates. Beyond this, the LP and LLC generally share the same tax advantages. The LLC combines the flow-through tax treatment of a limited partnership with the limited liability protection of a corporation. The LLC is usually as simple to create and structure as an LP, and all members of an LLC enjoy limited liability. Most clients, however, prefer the "traditional" familiarity of the LP as an investment vehicle, and the LP therefore remains the dominant vehicle for private equity funds.

2. Why are There Limitations on the Ability of a Limited Partner to Transfer Its Interest?

There are four main reasons why a fund limits the ability of limited partners to transfer their interests. The first reason is to ensure that the fund qualifies for an exemption from registration with the U.S. Securities and Exchange Commission (SEC) under the Securities Act of 1933, by limiting the offer of fund interests to only "accredited investors" (generally, institutional investors and individuals with net worth (alone or with a spouse) above $1,000,000 or with an income in excess of $200,000 for the past two years (or $300,000 together with their spouse) and a reasonable expectation of reaching the same income level in the current year).

The second reason is to ensure that the fund is exempted from the requirement of registering with the SEC under the Investment Company Act of 1940 (Investment Company Act). Private equity funds take advantage of one of two exemptions under the Investment Company Act: (i) Section 3(c)(1), for funds owned by 100 or fewer investors; and (ii) Section 3(c)(7), for funds with an unlimited number of investors, provided that all investors in the fund are "qualified purchasers" by meeting certain net worth requirements.

The third reason is to avoid being treated as a corporation for tax purposes under the "publicly traded partnership" provisions of the Internal Revenue Code. Funds can avoid being deemed publicly traded partnerships by prohibiting fund interests from being bought, sold or exchanged in a manner comparable to partnership interests trading on established securities markets.

Lastly, a fund will simply want to ensure that all investors admitted to the fund are able to cover capital calls. By providing certain restrictions on the ability of limited partners to transfer their interests, the fund can avoid the issues described above.

3. What are a Private Equity Fund's Obligations Regarding the USA Patriot Act?

The USA Patriot Act of 2001, signed into law by President Bush on October 26, 2001, imposes certain anti-money laundering requirements on financial institutions. Under the act, a broad range of "financial institutions" (as defined by the act), including private equity funds, are required to establish anti-money laundering (AML) programs and to share certain information with government agencies upon a proper request. A fund must designate a "compliance officer" and develop written policies, procedures and controls to monitor investment activity and prevent money laundering.

Due to the illiquid nature of most private equity funds (other than hedge funds), the Treasury Department has adopted rules which exclude many private equity funds from the AML provisions. For those funds to which the AML provisions do apply, adequate compliance measures might generally include a written policy statement and the designation of a compliance officer to ensure that investors are screened through a list of names kept by Treasury's Office of Foreign Asset Control.

In terms of the information sharing requirements, federal law enforcement agencies may submit requests for information regarding suspects to Treasury's Financial Crimes Enforcement Network (FinCEN), which in turn will request the fund to disclose certain information about the suspect (including identifying information regarding the suspect, as well as information regarding the nature and type of investment transaction) to FinCEN. Funds must protect the confidentiality of a FinCEN request.

4. When Must a Fund Manager/General Partner Qualify as an Investment Advisor?

The Investment Advisers Act of 1940 (Advisers Act) requires fund managers to register with the U.S. Securities and Exchange Commission (SEC) as "investment advisors"

if the manager has $25 million or more under management. However, many fund managers or general partners have managed to avoid this registration requirement under an exemption under the Advisers Act that allows investment advisors with fewer than 15 clients (each client a "qualified" high net worth client) during the previous 12-month period, so long as those advisors do not hold themselves out to the general public as investment advisors.

For purposes of counting the number of "clients" to an investment advisor, the SEC rules permit many entities such as partnerships, LLCs, trusts, or corporations to be counted as a single client. Therefore, fund managers may usually consider the fund itself as a single client. Recently, the SEC proposed new rules that would be applicable to "private funds," whereby each investor in a fund would be counted as a single client. The definition of a "private fund" would exclude most private equity funds because private equity funds generally do not permit redemption of investor interest within two years of purchase. Hedge funds, however, may fall within the private fund definition.

Fund managers generally will be required to register under their states' investment advisors act unless they fall within an exemption. Managers registered with the SEC, however, need not comply with their state's investment advisors act.

5. What is a Venture Capital Operating Company, and Why Do Funds Seek to Qualify as VCOCs?

Many funds choose to accept investments from retirement or pension funds regulated by the Department of Labor under the Employee Retirement Income Security Act of 1974 (ERISA) (benefit plan investors). The problem with accepting such investments is that if these investments constitute more than an "insignificant" interest in the fund (i.e., 25% or more of the value of each class of fund interests-the "significant participation test"), then the fund manager must comply with ERISA fiduciary requirements, which are both expensive and will invariably limit the freedom of the manager or general partner to make certain investments. Additionally, some forms of carried interest will not be permitted by funds whose manager is a qualified ERISA fiduciary. If the fund manager seeks to avoid becoming an ERISA fiduciary, the fund must qualify as a VCOC.

A fund will be a VCOC if it has at least 50% of its portfolio investments in operating companies to which the fund holds "management rights." For purposes of determining whether a fund qualifies as a VCOC, the value of the investments will be measured at cost. An operating company is a company that is engaged in producing products or services (as opposed to an investment company or holding company). In order to have management rights in an operating company, the fund must have direct contractual rights to substantially influence or substantially participate in the management of at least one portfolio company each year (usually through a management agreement). Finally, the fund must qualify as a VCOC both by the date of its first portfolio investment and during every "annual valuation period." An annual valuation period is a preset annual period, which does not exceed 90 days in duration, and which starts no later than the anniversary of a fund's initial valuation date. An annual valuation period cannot be changed once established, except for good cause.

6. What is Effectively Connected Income, and Why Do Foreign Investors Prefer Offshore Partnerships Over Domestic Ones?

The United States employs two separate regimes for taxing foreign persons (non-resident aliens and foreign entities). Under one regime, a 30% tax (which may be lowered by treaty) is imposed on the gross amount of U.S. source income of specified types not effectively connected with a U.S. trade or business. The income taxed under this regime is often referred to as "passive," "non-business," or "investment-type" income. A foreign person who is not otherwise subject to U.S. income tax will generally be subject to withholding taxes on his share of partnership income from dividends, interest (other than interest that constitutes portfolio interest) and certain other income.

Under the second regime, the regular U.S. tax rates apply to the net income that is effectively connected with a U.S. trade or business (or treated as effectively connected). If a foreign person is a partner in a partnership that is engaged in a trade or business in the United States, such foreign person is considered to be engaged in a trade or business in the United States. The activities of the partnership, which is a pass-through entity, are attributed to the foreign partner. To enforce payment of taxes due by the foreign person, the partnership is required to withhold and deposit tax on the foreign person's share of the partnership's income, whether that income is actually distributed to him.

Foreign persons generally seek to avoid effectively connected income because it exposes them to the U.S. taxing system, including the obligation to file a U.S. tax return. Accordingly, foreign persons often prefer receiving passive income, which may be subject to a withholding tax but does not require them to file a U.S. tax return.

To avoid effectively connected income, a foreign person can invest in a U.S. partnership indirectly through a corporation or other non-pass-through entity. The shareholders of a corporation are not attributed with the activities of the corporation. Although the corporation, as a partner in the partnership, would have effectively connected income, it would "block" the effectively connected income from reaching the foreign person who holds stock in the corporation. There are a number of ways to create a blocking structure, but the principal objective is to prevent foreign persons from having effectively connected income. Funds that intend on attracting foreign investors will often set up a blocking structure through which the foreign persons will invest.

Some foreign persons prefer investing in offshore partnerships. The United States does not tax a foreign person, except in extremely rare circumstances, on income from sources outside the United States. Thus, it is less likely that a foreign person investing in an offshore partnership will be subject to U.S. taxes. Moreover, it is unlikely that an offshore partnership would withhold U.S. taxes from payments to foreign partners.

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