Private Equity Investments Through Partnerships & LLCs

Presented to
London Business School

May 26, 2011

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I. Introduction
Today We Will Consider

- Why PE funds are formed as partnerships/LLCs
- Advantages / disadvantages of funds investing into partnerships/LLCs
- Limitations on investments into partnerships/LLCs
- Treatment of carry
- Legislative attacks on carry
Corporation vs. Partnership vs. LLC – Non-Tax Considerations

**Corporation**
- No Member has unlimited liability for corporate debts
- SH’s appoint BOD. BOD appoint officers
- Perpetual existence
- File certificate of incorporation to form. By laws and SH agt. deal with governance

**Partnership**
- GP has unlimited liability for partnership debts
- GP must manage
- Terminates if GP withdraws
- General partnership only needs verbal or written agreement. LP formed by filing certificate of formation. Governed by LP agreement

**LLC**
- No member has unlimited liability for LLC debts
- Either member or manager managed
- Can be perpetual
- Form by filing certificate of formation. Governed by LLC operating Agreement
Some Basics on Investors

• US individuals taxed at rates up to 35% on ordinary income and short-term capital gain
• US individuals taxed at 15% on long-term capital gain and qualified dividends until January 1, 2013
  • Think about the carry partners!
• US corporations taxed at 35% on all income
• Tax-exempt organizations not taxed except on UBTI
• Foreign investors generally not subject to tax in US except:
  • Withholding tax on US source income (e.g., dividends and interest, but usually not capital gains); and
  • Net basis tax on income effectively connected to US trade or business (including capital gain)
Partnerships vs. Corporations

**Partnerships/LLCs**
- Single level of tax (partners) taxed when partnership earns income
- Capital gain on sale except for certain “hot assets”
- Flow-through income character
- Distributions first tax-free return of capital
- Can transfer assets to partnership tax free (investments company exception)
- UBTI & ECI flow through

**Corporations**
- Double (or more) tax (corporation and shareholder)
- Generally no shareholders tax until income distributed
- Capital gain on sale
- Character of distributions determined under distribution rules
- Distributions-taxable dividends to extent of earnings and profits, then return of basis, then as capital gain
- Can transfer assets to corporation tax free and transferors control (investment company exception)
- Blocks UBTI and ECI
II. Fund Formation
Fund Formation LP or LLC

- **LP**
  - GP - unlimited liability
  - LPs may be treated as GP if hold themselves out as GP (unlimited liability)
  - Most developed countries treat as flow through for tax purposes

- **LLC**
  - No GP
  - May be member or manager managed - no unlimited liability issue
  - No uniform treatment o/s US
PE Funds Formed as Partnership or LLC

- Single Level of tax – partner level
- Flow through of capital gain and qualified dividends
- Flexible governing documents
PE Funds Formed as Partnership or LLCs

- Flow through of UBTI
- Flow through of ECI
- Flow though of Commercial Income
UBTI – What’s the Big Deal?

• Tax on income from “Unrelated” trade or business (including debt-financed income)
• Filing Requirements
  − Form 990T
  − Estimated Tax Payments
Primary UBTI Concerns in Private Equity Transactions

- Investments in flow-through vehicles
- Leveraging investments
- Guaranteeing portfolio company debt – Who is the true borrower?
- Fee Income
  - Route to manager
  - Route to corporate vehicle
• Income of a partnership that would be UBTI to an exempt partner is UBTI in hands of exempt partners
• Applied to unrelated debt financed income even though partners have no personal liability for debt
  • Gain on the sale of a partnership interest is UBTI if partnership has indebtedness
ECI – Who Cares?

• Nonresident alien individuals
• Foreign corporate investors
• Foreign governmental entities (special rules)
• Foreign pension funds and charities
• Adverse tax consequences (let’s discuss)

• U.S. filing obligation
• FDAP – Fixed or determinable annual or periodic income (e.g., interest & dividends)
• Flat 30% tax on U.S. source FDAP
• Rate subject to reduction or elimination by treaty
• Tax collected by withholding
• No tax return requirement if taxes withheld
Foreign Investors – Key Withholding Exceptions

- Capital gains generally exempt
- Portfolio interest generally exempt
- Treaties may reduce or eliminate tax
• ECI = Income effectively connected to a trade or business in the U.S.
Foreign Investors – Taxed Like U.S. Residents

- Graduated rates up to 35%, plus state and local taxes
- Effectively connected interest and capital gains taxes
- 30% Branch profits tax
- Tax return filing requirement
ECI Through Partnerships

• If a partnership is engaged in a trade or business in the U.S., so are each of its partners
• U.S. partnership required to withhold at highest rate on ECI allowable to foreign partners
• Each partner has to file U.S. tax returns
• If partnership is engaged in a trade or business, sale of partnership is treated as a sale of underlying assets which generates ECI (and withholding obligation on fund).

Rev. Rul. 91-32
Exempt from tax on income from:
- Stocks, bonds or other domestic securities
- Financial instruments held in execution of governmental financial or monetary policy
- Interest on deposits in U.S. banks
• No exemption for income:
  • from conduct of commercial activities (even outside of U.S.)
  • by 50% controlled commercial entity
  • from (directly or indirectly) 50% controlled commercial entity
  • from disposition of 50% controlled commercial entity

Note – all or nothing in last 3 bullets
Covenants Regarding ECI and UBTI

• Level of commitment varies depending on investors
  − Best efforts to avoid
  − Reasonable efforts to avoid
  − Reasonable efforts to avoid/minimize UBTI/ECI consistent with obligation to maximize return to investors

• Not typical for fund of funds
• Greater acceptance of UBTI
III. Investments in Partnerships/LLCs
Investments in LP/LLC

- Single level of tax
- Basis step up on sale
- UBTI/ECI Concerns
  - UBTI and ECI flow through to partners
  - Sale at exit may be ECI
• Founders - Individuals – prefer to continue partnership
• Funds may have ECI/UBTI restrictions
• Fund may have to form “blockers”
• Buyer takes cost basis in partnership interest
• 754 – basis step up in assets of partnership for Buyer
• No tax to B
• A gets capital gain (except for “hot” assets)
The Big Deal About Step Up In Basis

• Reduced gain on sale of assets
• Increased depreciation/amortization on acquired assets
  − Goodwill, going concern value and similar intangibles amortizable over 15 years
• Buyer likely to pay more for company with higher asset basis
Use of Partnership to Acquire Corporate Target

• SHs can rollover shares tax free and sell other shares – full use of basis

• Management of profits interests tax free

• Possible 338 election
IV. Carry
• Typically a “profits interest” in fund partnership/LLC
• Often a special purpose partnership/LLC holds all carry and managers share through flow through partnership
Carry vs. Incentive Fee

Fee

- Taxed @ 35%
- FICA/SECA (15.3%)
- Subject to anti-deferral rules
- Subject to 4% NY UBT

Carry

- Flow through of income – LTCG & qualified dividends taxed at 15%
- No FICA /SECA
- Only taxed as fund earns income
- No New York UBT
Attack on Carry

- Multiple attempts by House to pass legislation
- Would treat all income flowing through partnership to investment manager as ordinary services income (taxed at rates up to 35% plus SECA)
- Tax sales of partnership interest by investor service provider as ordinary services income
- Exception for interests acquired with manager’s capital don’t apply if fund makes or guarantees loan to acquire interest
- Treat income from options, derivatives & convertible interest in entity for which investment manager services provided as ordinary service income
- Trigger gain on distribution of property to investment services provider
- Substantial penalties (40%) for avoidance of rules
Pepper has expanded from its Philadelphia origins to 11 locations.