

## Does one size still fit all?

*Single, commingled limited partnerships may no longer be the best option for US funds of funds*

By Scott Jones and John Harvey of Proskauer Rose

Historically, US private investment funds that invest in other private investment funds (so called “funds of funds”) have been structured as single limited partnerships or other “flow-through” vehicles for US tax purposes, commingling investors with different US tax profiles. As a result of this structure, a US fund of funds typically has US taxable, US tax-exempt and non-US investors all participating in the same vehicle.

Generally, the only additional structuring offered by a US fund of funds is to protect US tax-exempt and non-US investors from US tax filing requirements. This is accomplished by allowing those investors to participate in the fund of funds through a “blocker feeder” – a non-US entity treated as a corporation for US tax purposes that itself is a limited partner of the fund of funds. (See figure 1) Although beyond the scope of this article, in certain circumstances a blocker feeder also may reduce the overall tax liability of a US tax-exempt investor in a fund of funds.

Although this basic, commingled structure generally has been tax efficient for funds of funds investors, recent changes in the investment structures of direct private investment funds may require funds of funds to consider more complex structures that segregate investors based upon US tax characteristics.

### THE BASIC FUND OF FUNDS STRUCTURE

For years, US funds of funds have been able to use a relatively simple structure, grouping together all of their investors into a single vehicle, either directly or through an offshore blocker feeder, regardless of their US tax profiles. This simple paradigm – which is relatively cost effective both from an organisational and operational perspective – generally has also been tax efficient for investors.

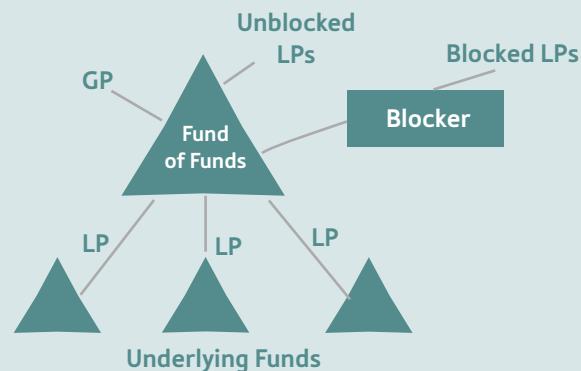


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This efficiency is the result of both the types of investments made, and the investment structures used, by direct fund managers. Given that investors in most US funds of funds (as a group) are subject to at least three distinct US federal taxing regimes, this efficiency is both surprising and an important reason why the US private equity industry has been relatively successful in raising capital from disparate groups.

By way of background, US taxable investors generally have two fundamental US tax preferences: (1) avoidance of an entity-level tax, and (2) realisation of long-term capital gains. US tax-exempt investors, on the other hand, generally seek to avoid unrelated business taxable income (UBTI). Non-US investors, however, seek to minimise income that is (1) effectively connected with the conduct of a US trade or business (ECI), or (2) considered US-source income that is subject to US withholding tax, such as interest, dividends and royalties. In the private

FIGURE 1: BASIC COMMINGLED FUND OF FUNDS STRUCTURE



equity context, UBTI and ECI have significant overlap, but also some fundamental differences, which are discussed later in this article.

Historically, direct fund investments – at least with respect to most venture capital, growth equity and buyout funds – have been tax efficient for all investors, because the income generated largely has consisted of non-UBTI, non-ECI, long-term capital gains. Direct funds have accomplished this by investing in corporate stock rather than LLCs (or other tax “flow-through” vehicles) with business operations in the US, referred to in this article simply as “operating LLCs”.

Furthermore, if a direct fund did invest in an operating LLC (e.g., because the direct fund managers could not force the entity to convert to a corporation), the direct fund typically would hold its entire investment through a blocker corporation. As a result of this simple blocker structure, the tax interests of the direct fund managers and all of the investors are aligned. Specifically, the fund manager would attempt to structure the exit as a sale of the blocker corporation’s stock, thereby avoiding a corporate-level tax that would reduce the economic returns of all investors, while generating non-UBTI, non-ECI, long-term capital gains.

Since direct funds have mostly generated non-UBTI, non-ECI, long-term capital gains by investing in corporate stock, or have used blocker structures that impact all investors (and offer no option for limited partners in any event), the basic, commingled fund of funds structure has worked quite well.

#### FUNDAMENTAL CHANGE IN DIRECT FUND INVESTMENTS

Within the last few years, however, the investment structures of many direct buyout, growth equity and venture capital funds have changed significantly. In particular, investments in operating LLCs have increased dramatically, and direct fund managers are no longer using simple blocker structures that impact all investors.

This fundamental change is being driven by tax and



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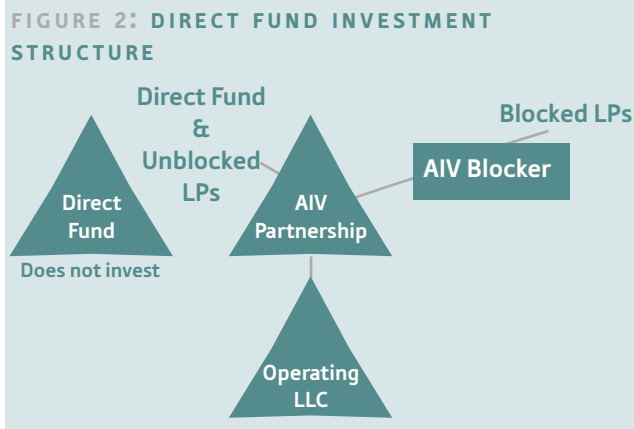
related economic benefits of operating LLCs versus corporations. From the perspective of a direct fund manager, founders, management and other US taxable investors, an operating LLC offers several benefits. First, any losses and expenses of an operating LLC flow through to investors and can offset taxable income from other sources (subject to various restrictions). In contrast, losses of a corporation generally are trapped for tax purposes and cannot be used until the corporation has income.

Second, when an operating LLC becomes profitable, there is only taxation at the investor level, while a corporation results in both an entity- and a shareholder-level tax. Third, a buyer of an operating LLC will receive tax basis for the purchase price, which can be amortised for tax purposes. Accordingly, a buyer should be willing to pay a premium for this tax benefit, as compared to an investment in a corporation.

In order to take advantage of these benefits, however, direct fund managers cannot hold their capital or carried interest through a blocker corporation. Therefore, many direct fund managers have begun to use more complex investment structures. In these structures, non-US and US tax-exempt investors are given the opportunity to participate in an operating LLC investment through a blocker corporation, while the direct fund managers, other US taxable investors and non-electing US tax-exempt and non-US investors participate in the operating LLC through a partnership or other tax flow-through vehicle. (See figure 2)

Given this choice, funds of funds managers generally will decline to participate in a blocker, because of the adverse US tax consequences to themselves, other US taxable investors and potentially US tax-exempt investors. This decision, however, likely is not the best choice for non-US investors. Depending on the circumstances, it may not be the best choice for US tax-exempt investors, either. In other words, the basic, commingled fund of funds structure may no longer be optimal from a US tax perspective for all investors.

These divergent outcomes for funds of funds investors are the result of a fairly complex tax analysis arising from



the different tax regimes applicable to different types of investors. Assuming that US tax return filing is not an issue – either because the US tax-exempt and non-US investors are already filers or they have participated in the fund of funds through a blocker feeder – the decision turns on tax efficiency.

With certain exceptions, US tax-exempts generally should prefer to avoid the blocker corporation and participate in the operating LLC investment in the same manner as US taxable investors. The reasons are two-fold. First, while current income from an operating LLC generally is UBTI (and therefore taxable), gain on the sale of operating LLC interests generally is not UBTI, unless the operating LLC has indebtedness. This is a key difference between UBTI and ECI. In the view of the IRS, gain from the sale of operating LLC interests is ECI. So, absent significant operating LLC indebtedness, a blocker corporation will pay more tax on exit than a US tax-exempt investor, because all of the gains will be subject to a corporate-level tax (currently 35 percent).

Nevertheless, participating in a blocker corporation may make sense for a US tax-exempt investor if most of the income will be generated on exit (rather than from current income), the operating LLC has significant indebtedness, and the direct fund manager is able to structure the exit as a sale of blocker stock, so that no corporate-level tax is imposed. (A US tax-exempt investor may also prefer a non-US blocker

corporation if the operating LLC generates primarily non-US source income.)

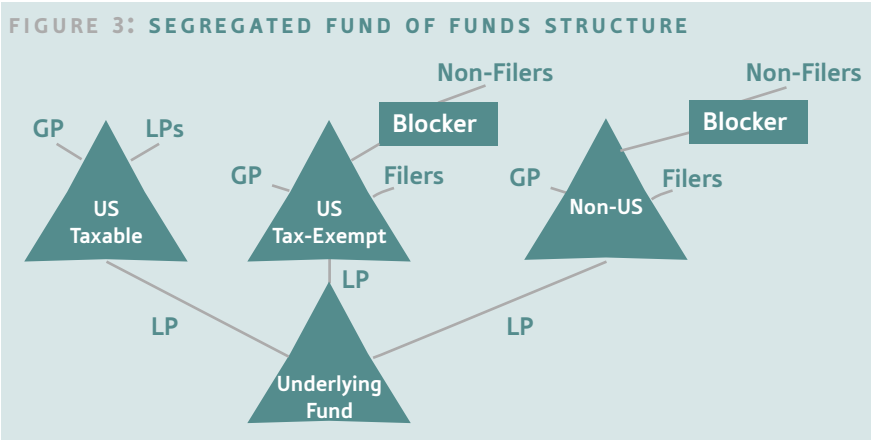
From the perspective of tax efficiency, a non-US investor will often prefer to participate through a blocker corporation established by a direct fund manager. First, if the direct fund manager is able to sell the blocker corporation's stock, the non-US investor will avoid US tax on exit altogether (although current income from the operating LLC will be taxed at the blocker level).

Second, even if the direct fund manager sells operating LLC interests, the non-US investor may be able to realise significant tax savings by participating in the blocker corporation. The reason is that if the non-US investor is a corporation (or it participates in a fund of funds through a blocker feeder to avoid US tax filings), it is subject to double taxation on ECI – the “regular” tax (currently 35 percent) and the “branch profits” tax (currently, an additional 19.5 percent tax, resulting in a combined 54.5 percent tax). By establishing a blocker corporation for a specific deal, the direct fund manager generally is able to avoid the second level of tax by liquidating the blocker corporation after the exit transaction. This creates a tax savings to the non-US investor of nearly 36 percent.

#### ALTERNATIVE STRUCTURES FOR FUNDS OF FUNDS

As a result of investors' differing tax interests with respect to direct fund blocker corporations, funds of funds managers have begun to consider, and in some limited cases implement, more complex structures. The solution is to segregate investors based upon their US tax profiles. This segregation allows funds of funds managers to make separate investment choices for each group of investors in respect of blocker corporations (or in some cases parallel funds) being offered by direct fund managers, often on a deal-by-deal basis.

Unfortunately, unlike direct funds – which generally can use a single commingled vehicle and create alternative investment vehicles (AIVs) if and when a particular investment requires – the AIV approach usually does not work for funds of funds. Direct fund managers are unwilling to split a limited partner's interest into different components



and perform the associated economic and accounting adjustments. In other words, direct fund managers want a limited partner (in this case, the fund of funds) to invest its entire interest in a particular investment either completely blocked or unblocked.

Accordingly, funds of funds must structurally segregate their investors at inception (or do partial transfers of existing fund interests, which can be a lengthy and expensive process). This can be accomplished by using parallel vehicles or series vehicles, in which a separate series is created for each class of investor. The parallel vehicle (or series) for US tax-exempt and non-US investors may also include blocker feeders for those investors that do not wish to file. (See figure 3)

For larger investors, a fund of funds manager may even consider creating a separate vehicle just for that investor (akin to a separate account), with a tax-structuring mandate specifically tailored to that particular investor. This may be useful because even within the categories of US tax-exempt and non-US investors, each investor may have specific issues, depending upon whether it is a private foundation, public charity, educational institution, non-US individual, corporation, trust or sovereign governmental entity.

In addition to extra costs and complexity, however, certain issues with using a segregated structure must be weighed against the tax efficiencies. While beyond the scope this

article, such issues include ERISA (for funds trying to stay below 2.5 percent plan assets) and US securities laws. Furthermore, if the funds of funds managers receive carried interest, then placing a parallel vehicle in a blocker corporation may adversely impact their carried interest. This issue can be resolved by requiring the parallel vehicle to adjust the carried interest so that the fund managers are in the same after-tax position as if the parallel vehicle had not invested through a blocker corporation. Although this

represents an additional cost to the parallel vehicle investors, the tax efficiencies are likely to outweigh such additional expense. ■

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