Reinhart

Private Equity Investor Alert; Real Estate Fund Investor Alert: Selected Tax Topics

POSTED:

Oct 31, 2007

RELATED PRACTICES:

[Employee Benefits](https://www.reinhartlaw.com/practices/employee-benefits)
https://www.reinhartlaw.com/practices/employee-benefits

[Institutional Investor Services](https://www.reinhartlaw.com/practices/institutional-investor-services)
https://www.reinhartlaw.com/practices/institutional-investor-services

RELATED SERVICES:

[International](https://www.reinhartlaw.com/services/international)
https://www.reinhartlaw.com/services/international

RELATED PEOPLE:

[Jussi P. Snellman](https://www.reinhartlaw.com/people/jussi-snellman)
https://www.reinhartlaw.com/people/jussi-snellman

Introduction

This Investor Alert discusses tax comments that sophisticated investors in private equity funds and real estate funds may make. The discussion begins with investor comments that are relatively standard, and continues on to the more esoteric. Tax provisions affecting non-US investors are also addressed.

Investor Comments Regarding Withholding Taxes

Private Equity Funds generally have the right to pay and/or withhold taxes on behalf of investors. In response, investors frequently request the following covenants from the fund:

1. to be notified prior to a withholding payment, in sufficient time to object to the payment and contact the taxing authorities.
2. for tax exempt investors: that the fund (a) notify taxing authorities of the investor's tax-exempt status and (b) use best / reasonable efforts to obtain an exemption from withholding with respect to such investors.
3. assistance in obtaining refund of taxes the fund has paid on investors' behalf – including, specifically, providing information necessary for completing forms; actually completing those forms; and filing those forms with appropriate taxing authorities.
4. applicability of items (1), (2) and (3) to foreign, state and local taxes, in addition to U.S. federal taxes. Assistance with respect to these taxes is especially important, as they are not within most investors' sphere of competence

Investor Comments Regarding Avoidance of Foreign Tax Filing Obligation

Non-U.S. investors frequently go to great lengths to avoid recognizing "Effectively

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.

Connected Income" in the United States, because such income would require them to file tax returns with the IRS and subject them to IRS audit. Among actions taken are (1) utilizing offshore feeder funds and parallel funds, (2) utilizing blocker corporations for portfolio investments that involve pass-through entities to avoid operating, and (3) waiving rights to receive a refund of transaction fee income upon dissolution of the fund.

Similarly, U.S. investors need to be certain that they do not inadvertently become required to file tax returns in non-U.S. jurisdictions. The analysis generally involves whether the investor would have a "permanent establishment" or whether the investor is "engaged in a trade or business" in the foreign country. Comfort on this topic can be obtained via a LPA or side letter provision requiring (a) opinion of counsel, or (b) (less favorable) consultation with counsel, in connection with foreign investments.

Caution: Funds may seek to rely on previously obtained opinions/consultation, including opinions obtained by predecessor funds. Such reliance is only appropriate if the investment structure is the same as when advice was previously given (i.e., portfolio company and holding company are same types of entities and have the same ownership percentages), and the relevant tax laws have not changed.

Investor Comments Regarding Use of Foreign Tax Credits

Some tax payments made by funds on behalf of investors to foreign entities will entitle investors to U.S. tax credits. Credits reduce U.S. taxes dollar-for-dollar by the amount paid to the foreign jurisdiction and makes the investment tax-neutral to taxable investors. Some partnership agreements even treat credits as the equivalent to distributions, on which carry is paid.

It is advisable for taxable U.S. investors to request (e.g., via side letter) GP assistance in claiming the tax credit. In addition, it is important to make sure that both the withholding and the credit are not treated as a distribution, to avoid double-counting the distributed amount.

By contrast, non-tax-paying U.S. investors (e.g., pension funds, foundations) cannot make use of foreign tax credits because they do not pay tax in the U.S. to which they could apply the credits. For these investors, it is preferable that the investment be structured in a manner that does not produce tax credits, if any tax

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.

Reinhart

savings could be realized via the alternate structure. (For example, a Luxemburg holding company structure (low tax, no tax credit) would be better than a Danish holding company (higher tax, with credit)). Additionally, these investors need to review the LPA carefully, to be certain that tax credits are not treated as distributions; otherwise they would have to pay carry on the worthless credit.

Investor Comments Regarding Tax Payments Treated as Distributions

Many LPA's provide that tax payments by the private equity fund on behalf of any limited partner will be treated as a distribution to the limited partner. Thus, the payment is included in the distribution waterfall — and (a) that the payment counts toward the preferred return and (b) the general partner receives carried interest with respect to the payment.

Funds can make tax payments on behalf of investors for multiple reasons; it is appropriate to treat some, but not all, of these as distributions. For ease of analysis, we group tax payments made on behalf of investors into three basic categories:

1. Tax payments made by the fund because of the unique tax situation of an individual limited partner (e.g., a partner that is subject to backup withholding or FIRPTA, or foreign partner withholding). It is generally appropriate to allocate these taxes to the specific limited partner who causes them to arise; rather than have them be borne by the fund (and thus by all partners).

2. Tax paid by the fund on behalf of all investors (such as transfer taxes related to ownership of securities, or foreign withholding taxes). These taxes should be treated as a portfolio company expense, and not go through the fund's distribution formula (and not entitle the general partner to carried interest). Tax exempt partners sometimes request that no taxes paid with respect to them be treated as distributions, unless it is a type of tax that they would themselves be responsible for, if they made the investment directly. As an alternative (or back-up position), tax-exempt investors sometimes seek assurances from the fund that the GP will seek to minimize the amount of taxes deemed distributed. Negotiating changes with respect to these types of taxes can be complicated.

3. (Infrequently seen) Taxes paid by flow-through entities owned by the fund

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.

(including portfolio companies and portfolio company holding companies). This is a very broad category, and could include taxes incurred by operating companies, such as property taxes, employment taxes, unemployment taxes, and sales and use taxes. It would be inappropriate for a fund to treat these taxes as distributions, and changes are generally easy to negotiate. (However, it is important for investors to be alert, as we have witnessed these provisions in the partnership agreement of a $1.9 billion fund (fund IV of the series) at the third close – at which time our client requested changes.)

Investor Comments Regarding Tax Reporting by Fund

It is important for limited partners to be able to understand the extent to which a fund actually treats taxes as distributions. Accordingly, it will be desirable for limited partners to receive clear reports of taxes paid on their behalf. This can be requested either pursuant to LPA "information" provisions, or specifically pursuant to a side letter. Among items that are sometimes requested to be itemized are:

- Amount of taxes paid by fund and by holding (non-operating) companies, broken down by jurisdiction, and whether or not treated as a distribution
- Tax credits
- Holding company tax payment

Investor Comments Regarding Tax-Efficient Structuring of Foreign Investments

Structuring of foreign investments is especially important, as sometimes not all categories of investors (e.g., governmental entities; non-profits; taxable investors) will benefit from the same structure. This is because tax treaties and foreign laws will frequently favor one type of investor over another. (For example, some jurisdictions: (1) provide tax credits; (2) favor direct investment over indirect/fund investments; or (3) provide tax exemptions to governmental investors). Moreover, an inherent conflict of interest exists between the tax-paying general partner and tax-exempt investors. Thus, the GP that only uses a single investment structure

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.

may be motivated to structure foreign investments to maximize tax efficiency for tax-paying investors.

For these reasons, sophisticated investors will request that the fund commit to take the investor's unique needs into account when structuring foreign investments. In the negotiation process, we frequently encounter the following claims / objections from the general partners:

- "We already structure in a tax-efficient manner." This approach leaves unanswered whether the fund takes into account tax credits, or ignores them, when undertaking its tax-efficient structuring. As discussed under "Use of Foreign Tax Credits" above, the answer can have significant economic consequences. As a result, investors can seek a commitment that tax credits will be treated favorably to them; alternatively, investors can seek broader assurances that their tax benefits under treaties will be taken into account.
- "We will not structure for an individual investor." Acknowledging that it is difficult for most individual investors (even the very largest) to obtain individual treatment, we generally frame the request as one of general applicability to the category of investor that we represent (e.g., governmental investors). Funds are more sympathetic to this approach, since there is ample precedent to protecting certain investor classes, including: tax exempt non-governmental investors (UBTI), foreign investors (ECI), foreign governmental investors (commercial activity), bank holding companies (control), and foundations (control).

Sample structuring representations are available upon request from Jussi Snellman.

These materials provide general information which does not constitute legal or tax advice and should not be relied upon as such. Particular facts or future developments in the law may affect the topic(s) addressed within these materials. Always consult with a lawyer about your particular circumstances before acting on any information presented in these materials because it may not be applicable to you or your situation. Providing these materials to you does not create an attorney/client relationship. You should not provide confidential information to us until Reinhart agrees to represent you.

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.