



# Structuring with Tax Partnerships

By

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**R**ecently, there has been an increase in the use of “tax partnerships”—arrangements that constitute partnerships for U.S. federal income tax purposes, but involve no legal entities—by private equity funds. While it would be premature to describe this structuring technique as a new trend in private

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equity, it is nevertheless noteworthy, especially given the fact that private equity funds have rarely used tax partnerships historically. Although tax partnerships raise several potential issues, they can offer significant benefits to funds and their managers in certain circumstances.

This article presents a general summary of tax partnerships, discusses their use in typical private equity contexts—blocker structures and carried interest arrangements—and highlights some of the issues that may arise.

## What Is a Tax Partnership?

The assertion that tax partnerships are rare in private equity might be confusing since virtually all U.S. private equity funds are formed as Delaware limited partnerships or offshore entities that elect to be treated as partnerships for U.S. tax purposes. For purposes of this article, however, the term “tax partnership” has a very specific meaning. It is any arrangement that qualifies as a partnership for U.S. tax purposes, but is not a state or foreign law entity. In other words, a tax partnership exists only for U.S. tax purposes.<sup>1</sup>

<sup>1</sup> While not a state or foreign law entity, a tax partnership does require a partnership agreement (whether written or verbal), which may give rise to legal rights under applicable contract laws, the discussion of which is beyond the scope of this article.

Although the existence of a tax partnership without an entity may seem like a strange concept, it is a long-established principle of U.S. tax law that a partnership—which generally is not subject to entity-level taxation—can exist in the absence of a state law partnership or other entity. In fact, the Internal Revenue Code defines a tax partnership as a catch-all category that includes any joint business arrangement by two or more persons that is not a trust, estate or corporation for tax purposes.<sup>2</sup>

The Code was broadly drafted so that taxpayers cannot avoid the partnership tax rules simply by forgoing a state law entity. In fact, the IRS, for various reasons, has used this broad definition to re-characterize arrangements without entities as tax partnerships.<sup>3</sup> Nevertheless, as tax flow-through arrangements with tremendous economic flexibility, tax partnerships also can be used by taxpayers as beneficial structuring tools.

### Why Use a Tax Partnership?

As discussed below, a tax partnership may be more vulnerable than a state law partnership to re-characterization by the IRS as an arrangement other than a partnership for U.S. tax purposes. Therefore, a tax partnership should be used only in circumstances where an actual entity cannot be used or otherwise would raise significant non-tax concerns.

In situations where an entity is not feasible, however, it may be possible to use a tax partnership to accomplish the same results, from a U.S. tax perspective, as a state law partnership. In the private equity context, the intended tax goals typically would be the avoidance of an entity-level U.S. tax, the allocation of income and gains in a manner that is disproportionate to capital (*i.e.*, carried interest), and the preservation of the U.S. tax character of such income and gains.

<sup>2</sup> Code Section 7701(a)(2) defines a partnership to include “a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation.” As discussed below, however, the courts and the IRS often have taken a narrower view of a tax partnership than the statutory definition.

<sup>3</sup> See, *e.g.*, *Bergford v. Comm’r*, 12 F.3d 166 (1993); *Luckey v. Comm’r*, 334 F. Supp. 719 (1964); *Gilford v. Comm’r*, 201 F.2d 735 (1953).

### Risks of a Tax Partnership

The fundamental issue with respect to a tax partnership is whether the arrangement will in fact be respected as a partnership for U.S. tax purposes. If the IRS successfully re-characterizes a tax partnership as a mere contractual arrangement, a number of adverse U.S. tax consequences might result, depending on the situation in which the tax partnership is used. In the private equity fund context, it would mean that the allocations of the tax partnership to a carried interest recipient that is not a partner would not be respected. As a result, the carried interest would be treated as first earned by another entity or person (possibly subject to U.S. tax in their hands) and then paid over to the carried interest recipient as compensation, taxable as ordinary income. In addition, the re-characterization of a tax partnership could trigger interest and penalties.

Although the concept of a “partnership” for tax purposes has been around for many years, the law in this area is still surprisingly unsettled. In circumstances with virtually the same fact patterns, the IRS and the courts have both found and disregarded tax partnerships.<sup>4</sup>

Since 1997, Treasury Regulations have allowed business entities (other than certain entities treated as *per se* corporations) with two or more members to elect to be classified as either corporations or partnerships for U.S. federal tax purposes.<sup>5</sup> These so-called “check-the-box” regulations make it clear that whether an organization is an “entity” separate from its owners for U.S. federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.<sup>6</sup> The regulations, however, do not define “member.” Accordingly, an election to be treated as a partnership does not prevent the IRS from denying a participant’s status as a “member” if such participant does not rise to the level of a partner for tax purposes. In addition, the IRS can challenge an entity’s status as a “business” entity to deny partnership tax treatment under the check-the-box regulations.

<sup>4</sup> See, *e.g.*, *Bergford v. Comm’r*, 12 F.3d 166 (1993); *Alhouse v. Comm’r*, 62 T.C.M. 1678 (1991).

<sup>5</sup> Treas. Reg. Section 301.7701-3.

<sup>6</sup> Treas. Reg. Section 301.7701-1(a).

Given the legal uncertainty with respect to partnership tax classification generally, a tax partnership presents more risk than a state law partnership of being challenged. The magnitude of the risk, however, is impossible to estimate and depends upon the facts and circumstances of the situation in which the tax partnership is used. Although the IRS has not viewed state law characterization of an arrangement as determinative of a tax partnership,<sup>7</sup> it has indicated that the existence of a state law partnership is helpful in establishing a tax partnership.<sup>8</sup> In addition, a number of courts have taken state law into account in analyzing whether a partnership exists for tax purposes.<sup>9</sup>

In determining partnership classification, several U.S. Supreme Court cases have focused on whether the parties to an arrangement intended to establish a partnership.<sup>10</sup> Although the Court made it clear that state law characterizations are not binding on this determination, the formation of a state law partnership could be viewed as one factor in establishing the intent to join together in a business enterprise. Accordingly, to establish intent, a tax partnership ideally should be contemplated as part of the initial structuring. In addition, it should be documented with a written tax partnership agreement.

Another factor in establishing the intent to join together in a business enterprise is the sharing of profits and losses.<sup>11</sup> To share in losses, at least initially, a partner must have capital at risk. Consistent with this view, the Code states that a person will be recognized as a partner if such person owns a capital interest in a partnership in which capital is a material income-producing factor.<sup>12</sup> Although the lack of a capital interest does not necessarily mean that a person

will not be respected as a partner of an investment partnership, such as a private equity fund, it is prudent to have a capital interest. As discussed below, however, contributing capital may be problematic in certain situations where tax partnerships are desirable. Accordingly, in such situations, a tax partnership may be subject to a greater risk of IRS challenge.

In addition, as a practical matter, tax partnerships are relatively rare. Therefore, an IRS agent may be unfamiliar with the fact that a tax partnership can exist in the absence of a state or foreign law entity. As a result, the learning curve for the agent could be a time-consuming and difficult process for both the agent and the taxpayer.

Finally, even if a tax partnership is respected as a partnership for U.S. tax purposes, it is unclear whether it would be treated as a domestic or foreign partnership. The Code states that a partnership is domestic if it is "created or organized in the United States or under the law of the United States or of any State."<sup>13</sup> A partnership is foreign if it is not domestic.<sup>14</sup> The status of a partnership as domestic or foreign may result in varying treatment under a number of U.S. tax rules, including tax withholding rules, "controlled foreign corporation" and "passive foreign investment company" provisions, and U.S. tax return filing requirements. In the case of a partnership that is a legal entity, its characterization as a domestic or foreign partnership is straightforward and also effectively elective, since a taxpayer can choose where to organize the entity. With respect to a tax partnership, however, it is unclear under existing authority where it is created or organized for tax purposes. Presumably, the relevant factors would include the law governing the tax partnership agreement and the place (or places) where the agreement was negotiated and executed.

If a tax partnership is characterized as domestic for tax purposes, it must obtain a taxpayer identification number, file U.S. partnership tax returns and provide

<sup>7</sup> Treas. Reg. Section 301.7701-1(a)(1).

<sup>8</sup> Rev. Rul. 2004-86, 2004-33 I.R.B. 191, 193 ("Generally, when participants in a venture form a state law entity and avail themselves of the benefits of that entity for a valid business purpose, such as investment or profit, and not for tax avoidance, the entity will be recognized for federal tax purposes.").

<sup>9</sup> See, e.g., *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part, rev'd in part*, 293 F.3d 279 (2002).

<sup>10</sup> *Comm'r v. Culbertson*, 337 U.S. 733 (1949); *Lusthaus v. Comm'r*, 327 U.S. 293 (1946); *Comm'r v. Tower*, 327 U.S. 280 (1946).

<sup>11</sup> See *Tower*, 327 U.S. at 286-87.

<sup>12</sup> Code Section 704(e)(1).

<sup>13</sup> Code Section 7701(a)(4).

<sup>14</sup> Code Section 7701(a)(5).

Schedules K-1 to its partners, just like any domestic, state law partnership.

Accordingly, given the additional tax risks associated with tax partnerships, they should be used only after careful consideration and in situations where a state or foreign law entity either cannot or should not be used. The remainder of this article discusses two contexts in which tax partnerships might be used by private equity funds.

## Blocker Structures

Private equity funds that invest in operating companies formed as LLCs (or other tax-transparent entities) often invest through an intermediary entity that is a corporation for U.S. tax purposes to “block” unrelated business taxable income (UBTI) and effectively connected income (ECI) from tax-exempt and non-U.S. partners, respectively. Rather than having the main fund invest through a blocker—which creates U.S. tax inefficiencies for the taxable U.S. members of the general partner and taxable U.S. limited partners of the fund—funds increasingly have begun to use parallel blockers.<sup>15</sup> In this structure, the blocker is established to invest alongside the main fund in the operating LLC. The blocker is not owned by the fund itself, but rather by the general partner and the fund’s non-U.S. and tax-exempt limited partners, who “opt out” of the LLC investment through the main fund, and instead invest in the LLC through the parallel blocker.

Alternatively, some private equity groups will establish a parallel fund—which typically invests *pro rata* in all main fund investments—for tax-exempt and non-U.S. investors. Rather than the parallel fund itself being a blocker, which causes U.S. tax inefficiencies, the parallel fund is a partnership for U.S. tax purposes that uses blockers only for operating LLC investments. For groups that anticipate several operating LLC investments (or more), creating a parallel fund may be cheaper and easier than establishing parallel blockers and using “opt outs” in the main fund.

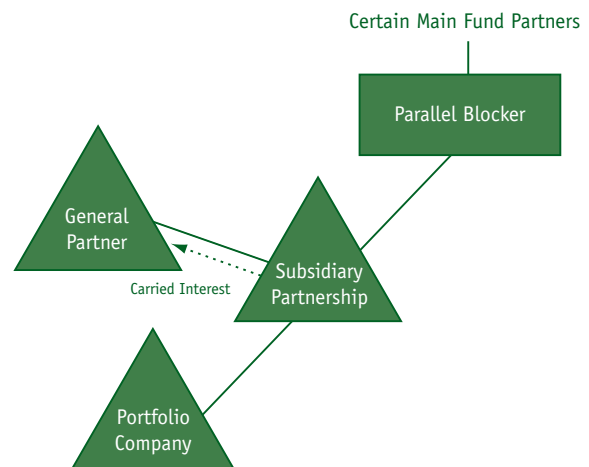
<sup>15</sup> See our article, *The Rise of Parallel AIVs*, in the spring 2006 edition of *Venture Capital Review*.

In either structure, the blocker (whether domestic or offshore) is subject to regular U.S. federal income tax on income allocated to it by the operating LLC (currently, at a maximum rate of 35%), and its owners may be subject to an additional withholding or “branch profits” tax. As a result, any carried interest earned by the general partner through the blocker may be subject to a much higher rate of U.S. tax than through the main fund. To avoid this tax inefficiency, a subsidiary partnership may be used. In this structure, the blocker invests into the operating LLC through a newly created subsidiary partnership, in which the general partner is also a partner, but the general partner does not invest through the blocker itself. **See Figure 1.**

The general partner receives its carried interest attributable to the blocker’s gains through the subsidiary partnership, rather than directly from the blocker. As a result, the general partner receives its carried interest without bearing any entity-level tax.

The subsidiary partnership structure, however, might not be viable if the parallel blocker (or the parallel fund) must qualify as a venture capital operating company (VCOC) under ERISA. In the parallel blocker structure, the blocker likely cannot disregard its investment in the subsidiary partnership and “look through” to the underlying operating company, because the subsidiary partnership is not wholly owned by the

**Figure 1**



blocker.<sup>16</sup> Therefore, the blocker can qualify as a VCOC only if the subsidiary partnership itself qualifies as an “operating company” under ERISA. If the subsidiary partnership does not have a majority interest in the underlying portfolio company, it will not qualify as an “operating company.”<sup>17</sup>

Similarly, in the parallel fund structure, if the parallel fund has to qualify as a VCOC, its investment in the blocker would not qualify as a “venture capital investment” unless the subsidiary partnership were an operating company (by having at least a majority interest in the portfolio company). Although the parallel fund is only required to have at least 50% of its assets in “venture capital investments” on certain testing dates to qualify as a VCOC, the subsidiary partnership structure may become problematic if the parallel fund makes significant investments using such a structure.

Instead of using a subsidiary partnership, one alternative is simply to “gross up” the general partner’s carried interest to account for the additional tax cost of the blocker. Such a solution, however, simply shifts the tax

burden to the limited partners and does not solve the overall tax inefficiency of the structure.

Another approach is to use a tax partnership instead of an actual subsidiary partnership. As in the subsidiary partnership structure, the general partner and the blocker would be partners of the tax partnership. **See Figure 2.** Each of the blocker and the general partner would acquire direct interests in the operating LLC on a *pro rata* basis, based upon their respective capital commitments. In addition, they would enter into a written partnership agreement that, among other things, would provide for the 20% carried interest allocation of income and gains to the general partner.

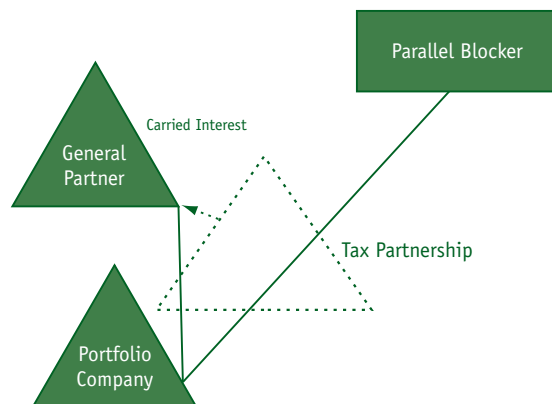
Although the DOL has not issued guidance directly addressing this structure, a reasonable argument can be made that the blocker should be treated, for purposes of applying the VCOC rules, as investing directly into the operating LLC, since the blocker and the general partner will hold interests directly in the operating LLC and the tax partnership exists merely for U.S. tax purposes and not as an entity under state or foreign law. Accordingly, if the other VCOC requirements are satisfied (*i.e.*, adequate management rights are obtained), the parallel blocker should qualify as a VCOC, or in the case of the parallel fund, the operating LLC investment should count as a “venture capital investment.”

If the tax partnership were not respected for tax purposes, the general partner’s carried interest likely would be treated as having been received by the blocker (and therefore subject to U.S. tax at the blocker level), and then paid to the general partner as compensation (taxed at ordinary income rates and subject to employment taxes). In addition, the IRS could impose interest and penalties on both the general partner and the blocker.

### Carry Arrangements—Foreign Funds

In a typical private equity fund structure, the fund and the general partner are limited partnerships (or LLCs), and the carry recipients are limited partners (or members) of the general partner. Accordingly, so long as the general partner entity and the carry recipients are respected as partners of the fund and the general partner

**Figure 2**



<sup>16</sup> Although DOL Advisory Opinion 95-04A states that for purposes of determining whether a VCOC holds 100% of an entity’s equity, the DOL will disregard any *de minimis* holdings by a general partner to comply with the minimum safe harbor requirements established by the IRS for classification as a partnership for tax purposes, the general partner’s carried interest in the subsidiary partnership would likely be considered to exceed such a *de minimis* holding.

<sup>17</sup> The term “operating company” is generally defined to mean “an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital.” 29 C.F.R. Section 2510.3-101(c).

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entity, respectively, for tax purposes, the carried interest retains its fund-level tax character—primarily long-term capital gains or qualified dividend income.

There may be situations, however, where the carried interest cannot preserve its fund-level tax character. For example, some non-U.S. funds must be organized as entities that cannot elect to be classified as partnerships for U.S. federal income tax purposes. Further, in order for such funds to qualify for certain non-U.S. tax benefits, the carried interest is paid to the principals under a contract as employment income. If, however, the non-U.S. fund has any U.S. principals, such a contractual arrangement would cause the carried interest to be treated as compensation income, taxed at ordinary income rates (and also subject to employment taxes).

In this situation, it may be possible to create a tax partnership between the non-U.S. fund and the U.S. principals. **See Figure 3.** Through the tax partnership, the U.S. principals would be allocated their carried interest. To increase the likelihood that the U.S. principals would be respected as partners for U.S. tax purposes, they should invest their share of capital in each portfolio company directly, on a pro-rata basis.

If, however, the IRS were to disregard the tax partnership, the U.S. principals likely would be subject to tax at ordinary income rates on their carried interest as

compensation income, and also subject to employment taxes and possibly interest and penalties.

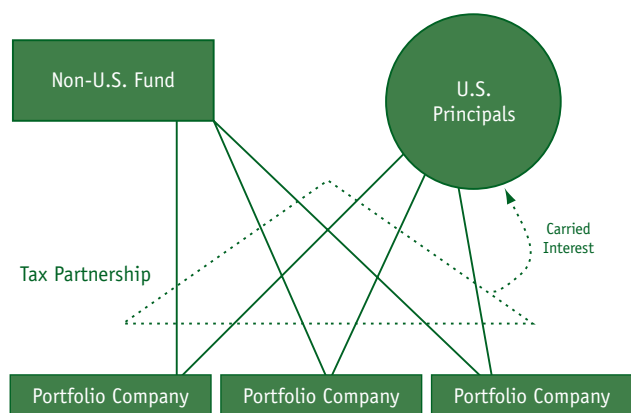
## Carry Arrangements—Institutional Funds

Some institutional private equity funds (such as bank funds) may have a strong business preference for prohibiting their investment professionals—who are viewed only as employees of the institution—from holding equity interests in the general partner entity or the fund itself.

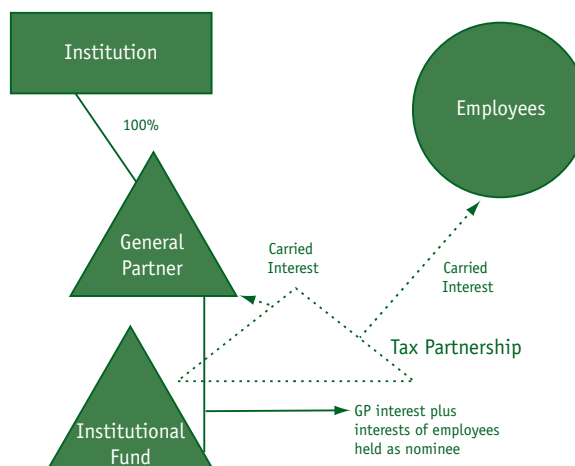
Traditionally in such structures, the carried interest is paid out as compensation income, taxable as ordinary income to the employee recipients. Nevertheless, it may be possible to achieve flow-through tax characterization of the carried interest by creating a tax partnership between the general partner (which is owned by the institution) and the employees. **See Figure 4.**

Characterizing this arrangement as a tax partnership, however, likely presents at least two additional risks. First, the employment arrangement between the institution and the investment professionals creates an additional hurdle in establishing the relationship as one of partners rather than service recipient and provider. To minimize this risk, the employees should be employed by an entity different from the one that owns the general partner (just as principals in a traditional private equity fund are employed by a related management company, not the general partner). In addition, the employees

**Figure 3**



**Figure 4**



should contribute capital to establish their status as partners rather than employees.

As mentioned, however, the institution might not want its employees to participate in the fund as partners. In such a case, the employees could instead write checks to the general partner to contribute to the fund on their behalf as a “nominee.” For tax purposes, a nominee holds legal title to property but is not treated as the beneficial owner. In other words, the nominee serves as an agent for the true owner and therefore does not include income, gains, losses or other tax items relating to the property in determining its own tax liability.<sup>18</sup>

Accordingly, the general partner and the employees would enter into a written nominee and sharing agreement, pursuant to which the general partner would hold interests in the fund as a nominee for the employees. That agreement would also establish a tax partnership between the general partner and the employees (and contain the necessary allocation, distribution and other partnership agreement provisions).

This nominee and sharing arrangement, however, is likely more vulnerable to an IRS challenge than a tax partnership in which each partner directly invests its own capital into the underlying fund (or other investment). The IRS has successfully re-characterized tax partnerships as mere nominee relationships.<sup>19</sup> Not surprisingly, it is unclear how the IRS or the courts would view an arrangement that concedes to being a nominee relationship but also claims to be a tax partnership.

As is the case with respect to the non-U.S. fund, if the IRS were to disregard the tax partnership, the employees would be subject to tax on their carried interest as compensation income (including employment taxes and possibly interest and penalties). Further, the institution also might have U.S. tax liabilities for failing to withhold on such income.

## Conclusion

In situations where entities cannot (or should not) be used, private equity funds might be able to obtain the U.S. tax benefits of a partnership without creating a state or foreign law entity. Nevertheless, tax partnerships face a greater risk of IRS challenge with respect to partnership status than those formed as legal entities, depending in part upon the particular facts and circumstances. Accordingly, careful consideration should be given before establishing a tax partnership. If a tax partnership is used, it should be part of the initial structuring and should be documented with a detailed, written tax partnership agreement. In addition, a tax partnership should have capital at risk from all of its partners. ☺

<sup>18</sup> See, e.g., *National Carbide Corp. v. Comm'r*, 336 U.S. 422 (1949).

<sup>19</sup> See, e.g., *Luna v. Comm'r*, 42 T.C. 1067 (1964).