

To: Private Equity Fund Clients
From: Fund Services Group
Date: December 27, 2002
Re: **Borrowing to Bridge Capital Calls**

This memorandum briefly addresses the risk that a private equity fund ("PEF") will generate unrelated business taxable income ("UBTI") as a result of borrowing to bridge a capital call, and describes how a PEF can structure such borrowing to avoid UBTI.

Background

Many PEFs maintain minimal cash reserves, preferring instead to draw down capital from their partners immediately prior to making an investment. This approach has several benefits, such as allowing the PEF's partners free use of their capital for as long as possible, and avoiding dilution of the PEF's rate of return which may result from significant holdings of idle cash in money market and similar low-yield investments. One negative consequence of this approach, however, is the possibility that the PEF will have an investment opportunity that must close during the period between issuance of a capital call and the due date of capital contributions thereunder. In such circumstances, the PEF must either borrow the funds necessary to "bridge" the capital call ("Bridge Borrowing") or decline the investment opportunity.

For PEFs with tax-exempt limited partners, Bridge Borrowing may raise concerns that such borrowing represents "acquisition indebtedness" which, in turn, may cause income or gain recognized in respect of the underlying investment to be UBTI.

The Internal Revenue Code (the "Code") generally defines "acquisition indebtedness" as indebtedness incurred to acquire or improve property ("Debt Financed Property") or which would not have been incurred but for the acquisition or improvement of such property. UBTI generally includes any income or gain recognized in respect of Debt Financed Property while related acquisition indebtedness is outstanding or during the one year period following repayment.

UBTI from Debt Financed Property generally is taxable to otherwise tax-exempt entities. UBTI attributable to Bridge Borrowing may be particularly objectionable to tax-exempt limited partners, because income or gain on the underlying investment typically would have been exempt from tax if the borrowing had not occurred.

Under the organizational documents of many PEFs, fund managers are required to avoid borrowing which gives rise to UBTI.

Structuring to Avoid UBTI

In general, a Bridge Borrowing should not give rise to UBTI so long as:

1. The Borrowing is made solely to fund an investment pending receipt of capital contributions pursuant to an industry standard capital call (generally, subject to a notice period of 30 days or less);
2. The Borrowing is repaid promptly (*i.e.*, within several days) after the receipt of the called capital;
3. The term of the Borrowing is brief, relative to the expected holding period of the underlying investment;
4. The PEF undertakes Bridge Borrowings in order to reduce the need for large idle cash reserves;
5. The aggregate period during which all Bridge Borrowings are outstanding is brief, relative to the PEF's active investment period; and
6. Viewed as a whole, the PEF's Bridge Borrowings are more appropriately characterized as a portfolio administration tool than an attempt to benefit from net leverage.

These criteria are based upon a series of private letter rulings by the Internal Revenue Service (the "Service") that indebtedness incurred solely for administrative convenience in managing an investment portfolio is not acquisition indebtedness giving rise to UBTI. In particular, these rulings hold that UBTI does not arise when transitory borrowings are the result of ordinary and routine investment activities and are undertaken to avoid the cost and inefficiencies of making substantial investments in cash equivalents rather than more productive long-term investments.¹

The foregoing criteria do not address all possible facts and circumstances. Certain Bridge Borrowings which fail to satisfy one or more of such criteria may nevertheless avoid creating UBTI. Moreover, where a limited partner is particularly sensitive to any risk of UBTI, additional techniques may be employed.²

¹ PLRs 8721104 (Feb. 27, 1987); 8721107 (Feb. 27, 1987); 9644063 (Aug. 5, 1996); 200010061 (Mar. 13, 2000). For a case in which borrowing was held to create UBTI because the taxpayer intended to benefit from the use of net leverage, *see Ocean Cove Corp. Retirement Plan and Trust v. U.S.*, 657 F. Supp. 776 (1987).

² For example, a PEF might offer tax-exempt limited partners the ability to "pre-fund" their capital contributions prior to a Bridge Borrowing so that, arguably, no borrowing is attributable to the tax-exempt limited partners. In an analogous non-partnership context, the Service ruled that a similar structure precluded the creation of UBTI. Rev. Rul. 76-95, 1976-1 C.B. 172. Additionally, to reduce the risk that a Bridge Borrowing could be attributed to PEF assets beyond the investment directly funded with proceeds of the Borrowing, the lender's recourse might be limited solely to identified portfolio securities. Code Section 514(c)(2).

Finally, please note that credit facility agreements and other Bridge Borrowing documentation should be carefully reviewed to ensure that they do not violate the terms of a PEF's limited partnership agreement or otherwise inappropriately restrict the PEF's operations.³

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This memorandum is intended only as a general discussion of the information presented and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.

³ Of particular concern are credit facility provisions that: (x) prevent the PEF from making in-kind distributions of portfolio securities on a timely basis; or (y) assign to the lender a right to issue capital calls on behalf of the PEF.