Skin in the Game
Fund Managers as “Investors” in Their Private Equity Funds
Introduction

• Under most venture capital and other private equity fund structures, the individual members of the “General Partner” (the “Fund Managers”) provide a portion of the fund’s capital
  – For tax reasons, the minimum investment by the Fund Managers as a group often is equal to the lesser of (x) 1% of total fund capital or (y) $500,000
  – For business reasons, the actual amount invested by Fund Managers often is higher
Introduction (cont.)

- There are many different ways to structure the Fund Managers’ investment
- This presentation describes the most common structures, as well as the circumstances under which certain structures will be more attractive than others
Background

• Prior to release of "check-the-box" regulations in 1996, the Federal income tax classification of a fund often was dependent upon a minimum capital investment by the General Partner
  – Under a "safe harbor" rule published by the Internal Revenue Service, the minimum investment was the lesser of (x) 1% of total fund capital or (y) $500,000

• Today, the General Partner’s capital investment is not relevant to the Federal income tax classification of a fund, but it remains important for ensuring that the General Partner will be respected as a “partner” of the fund for tax purposes
  – If the General Partner were not respected as a “partner,” the Fund Managers could be taxable on their carried interest at ordinary income tax rates (rather than on a flow-through, capital gains basis)
  – Thus, many General Partners continue to satisfy the safe harbor rule
Background (cont.)

• For business reasons, many General Partners invest far more than is required by the safe harbor rule
  – Often, the General Partner’s capital commitment to a fund will be equal to 1% or more of total fund capital, even if total capital is in the hundreds of millions or billions of dollars

• Limited Partners often prefer large investments by General Partners
  – Large investments:
    ▶ Reflect serious personal commitment by the Fund Managers to the fund
    ▶ More closely align the interests of the Fund Managers and the Limited Partners
      – When the Fund Managers are heavily invested in their fund, it is more difficult for them to be indifferent to the fund’s performance, even if the fund is under water and there is little chance of significant carried interest profits
Key Issue

• If the Fund Managers are prepared to invest more than is required under the safe harbor rule ("Additional Capital"), how should the investment be structured?
  – Typically, the amount required to satisfy the safe harbor rule is committed by the Fund Managers to the General Partner which, in turn, makes an equivalent commitment to the fund
Key Issue (cont.)

• There are 5 common structures for the Fund Managers’ investment of Additional Capital
  – Invest through the General Partner
  – Invest through the “Main Fund”
  – Invest through an “Affiliates Fund”
  – Co-invest directly in each Main Fund portfolio company deal
  – Invest through a specially created “Principals Fund”

• Limited Partners typically allow Fund Managers to select the structure through which Additional Capital is invested
Structure 1: Invest Through the General Partner

• The Fund Managers invest Additional Capital in the General Partner which, in turn, invests Additional Capital in the fund
  – With respect to its entire capital investment, the General Partner shares in fund profits and losses just like a Limited Partner
Invest Through General Partner (cont.)

- **Main Fund, L.P.**
  - **Investors**
  - **Portfolio Securities**
  - **Fund Manager 1**
    - **Additional Capital**
  - **Fund Manager 2**
    - **Additional Capital**
  - **General Partner, L.L.C.**
Invest Through General Partner (cont.)

• Benefits
  – Simplicity
    › No need to involve other entities
    › No need to obtain individual Fund Managers’ consents or signatures when portfolio investments are made
Invest Through General Partner (cont.)

• Benefits (cont.)
  – Efficient use of tax basis
    ▸ When a fund makes an in-kind carried interest distribution of portfolio company stock, the stock normally takes a “carry over” basis in the hands of the General Partner
      – Example: If the stock has a basis of $100 in the hands of the fund, it will have a $100 basis in the hands of the General Partner immediately following the distribution. A subsequent sale of the stock for $100 would generate zero taxable gain.
    ▸ However:
      – Basis assigned to distributed stock reduces the General Partner’s basis in its fund interest by an equivalent amount; and
      – The basis of distributed stock cannot exceed the General Partner’s basis in its fund interest (as measured immediately prior to the distribution)
      – Example: Stock has a basis of $100 in the hands of the fund, and the General Partner’s fund interest has a basis of $60. Following distribution of the stock, the General Partner’s fund interest will have a basis of zero and the distributed stock will have a basis of $60 in the hands of the General Partner. A subsequent sale of the stock for $100 would generate $40 of taxable gain.
Invest Through General Partner (cont.)

- Benefits (cont.)
  - Efficient use of tax basis (cont.)
    - Contributions of Additional Capital increase the General Partner’s basis in its fund interest
    - If stock distributed to the General Partner will be sold (by the General Partner or by the Fund Managers), such increased basis can reduce the Fund Managers’ tax liability
    - Thus, investing Additional Capital through the General Partner may reduce the Fund Manager’s tax liability in respect of in-kind carried interest distributions
Invest Through General Partner (cont.)

• Benefits (cont.)
  – Efficient use of tax basis (cont.)
    ‣ Example: Fund A has total committed capital of $1 billion, of which $10 million was committed by the General Partner. The General Partner holds a 20% carried interest, and carried interest distributions can be made any time the fund’s net asset value exceeds the partners’ unreturned capital contributions. At a time when 50% of committed capital has actually been contributed and the net asset value test is satisfied, Fund A distributes stock with a tax basis of $50 million and a fair market value of $100 million. The General Partner receives 20% of the total distribution. The fund makes no other distributions prior to liquidation (5 years later).
      – The General Partner takes a tax basis of $5 million in the stock it receives. This is $4.75 million greater than if the General Partner had made a capital commitment limited to the safe harbor requirement. The General Partner then promptly sells the stock it receives and recognizes a taxable gain of $15 million.
      – The General Partner effectively obtains a 5 year deferral of $4.75 million in capital gain. At a 20% Federal tax rate, and assuming a 10% simple interest discount rate, the deferral is worth approximately $475,000.
      – Under any other structure, the deferral generally would not have been available.
      – This is a highly simplified example. It can be very difficult to predict the deferral value of investing Additional Capital through the General Partner. Results will vary based upon the timing and content of distributions as well as the fund’s specific distribution procedures.
Invest Through General Partner (cont.)

• Benefits (cont.)
  – Efficient use of tax basis (cont.)
    ‣ Note: Under other structures, basis attributable to Additional Capital generally will be available to reduce tax liability, but possibly at a later time, which can be less efficient from a time-value-of-money perspective
Invest Through General Partner (cont.)

• Costs
  – Increased liability exposure
    ▶ The General Partner of a fund engages in potentially liability-creating activities
    ▶ Under most fund agreements, the General Partner’s right to indemnification is limited
      – No indemnification for material misconduct
      – Indemnification payments limited to available fund assets
    ▶ In the event of a valid, non-indemnified claim, creditors would have access to all General Partner assets
    ▶ Investing Additional Capital through the General Partner exposes such capital to potential seizure by creditors
      – If this structure is used, consider purchasing insurance to partially offset such exposure
Invest Through General Partner (cont.)

• Costs (cont.)
  – Potential limitation of qualified small business stock (“QSBS”) rollover benefits
    ▸ Fund Managers who (directly or indirectly) sell QSBS derived from other investment activities (such as direct investments or operation of a prior fund) may seek to treat fund investments as qualified “re-investments” which allow tax-free rollover of gain from such sales
    ▸ It is not clear whether re-investments made indirectly, through a partnership such as the Main Fund, are qualified reinvestments for rollover purposes
    ▸ Thus, investing through the General Partner increases the risk that the capital so invested will not be useful in generating rollover benefits
Invest Through General Partner (cont.)

- Rollover Example
  - It is uncertain whether rollover benefits are available where
    - Fund Manager A is a member of Funds F1 and F2
    - F1 distributes Original QSBS to A
    - A sells Original QSBS and realizes gain
    - Within 60 days of sale, F2 purchases Replacement QSBS
Invest Through General Partner (cont.)

• Costs (cont.)
  – Potential limitation of QSBS rollover benefits (cont.)
    ‣ QSBS rollover generally is an issue for venture capital firms rather than buy-out firms
    ‣ For a detailed discussion, see Fund Services Group presentation “Tax-Free Rollovers of Qualified Small Business Stock”
Invest Through General Partner (cont.)

• Costs (cont.)
  – Possible complexity in tax reporting of management fees
    ▶ Under most fund agreements, capital committed by the General Partner generates management fees in the same manner as capital committed by a Limited Partner
    ▶ If a Fund Manager invests Additional Capital through the General Partner, the investment typically will generate such management fees
    ▶ If the Fund Managers agree among themselves, as a business matter, that their Additional Capital investments shall not be subject to management fees, the General Partner agreement typically allocates management fee income to the Fund Managers whose Additional Capital investments generated such income (so that the Fund Managers’ management fee income and expense offset one another)
Invest Through General Partner (cont.)

• Costs (cont.)
  – Possible complexity in tax reporting of management fees (cont.)
    ‣ This could create a tax mismatch
      – A Fund Manager's share of management fee expense (generated at the fund level) may not be deductible for tax purposes
      – A Fund Manager’s allocated share of management fee income (generated at the General Partner or management company level) may be taxable
      – Efforts to eliminate this mismatch may require complex tax return attachments, which may trigger Internal Revenue Service inquiries
    ‣ Mismatch problem could be avoided if the fund agreement were revised to provide that no management fees would be generated in respect of Additional Capital
      – However, for marketing/relationship reasons, many Fund Managers prefer to avoid such provisions in fund agreements
Invest Through General Partner (cont.)

• Costs (cont.)
  – Reduced flexibility in Fund Manager estate planning
    ▸ Fund Managers often wish to make gifts of carried interest to family members, trusts, etc.
    ▸ Such transfers generally must be made on a "vertical slice" basis (i.e., a proportionate share of the Fund Manager’s entire interest in the General Partner entity) to avoid special gift tax valuation rules
      – Such a “vertical slice” must also include a proportionate amount of Additional Capital
      – This may result in a larger gift than was actually intended (with correspondingly greater gift tax liability)
Invest Through General Partner: Summary

• Benefits
  – Simplicity
  – Efficient use of tax basis

• Costs
  – Increased liability exposure
  – Risk that certain tax-free rollovers will be disallowed
  – Possible complexity in tax reporting of management fees
  – Reduced estate planning flexibility
Structure 2: Invest Through the Main Fund

• The Fund Managers invest Additional Capital as Limited Partners of the Main Fund
  – The Fund Managers continue to invest sufficient capital in the General Partner to enable the General Partner to comply with safe harbor requirements
Invest Through Main Fund (cont.)

Fund Manager 1

Investors

Main Fund, L.P.

Fund Manager 2

General Partner, L.L.C.

Portfolio Securities

AC = Additional Capital
Invest Through Main Fund (cont.)

• Benefits
  – Simplicity
    ▸ No need to create additional entities
    ▸ No need to obtain individual Fund Managers’ consents or signatures when portfolio investments are made
  – Reduced liability exposure
    ▸ Capital invested directly in the Main Fund will not be available to satisfy claims of General Partner creditors (so long as the Main Fund does not indemnify the General Partner with respect to such claims)
    ▸ However, new liability risks may arise (see next slide)
Invest Through Main Fund (cont.)

- Costs
  - General lack of confidentiality
    - Because Fund Managers are direct Limited Partners of the Main Fund, other Limited Partners may obtain information regarding transfers or restructurings of the Fund Managers’ investments
  - Liability risks
    - Typically, as “Limited Partners” of the Main Fund, the Fund Managers should have no personal liability for the Main Fund’s debts and obligations
    - However, Fund Managers in the private equity industry often refer to themselves as “general partners,” even when they are actually “managing members” of the LLC that serves as the true General Partner
    - Under state limited partnership law, Fund Managers who refer to themselves as “general partners” may have liability as constructive general partners of the Main Fund vis-à-vis third parties who reasonably believe that such Fund Managers are actually general partners
    - This risk can be reduced or eliminated through careful attention to proper use of titles
      - Fund Managers should be referred to as “managing directors,” “managing members,” “fund managers” or just about anything other than “partners”
Invest Through Main Fund (cont.)

• Costs (cont.)
  – No efficient use of tax basis (see above)
  – Risk that certain tax-free rollovers will be disallowed (see above)
  – Possible complexity in reporting of management fees (see above)
  – Reduced estate planning flexibility
  ▸ Under special gift tax valuation rules, a Fund Manager who makes a gift of carried interest (i.e., via transfer of an interest in the General Partner) may also be deemed to have transferred a proportionate share of the Fund Manager’s Limited Partner interest in the Main Fund
  ▸ This may result in a larger gift than was actually intended (with correspondingly greater gift tax liability)
Invest Through Main Fund: Summary

• **Benefits**
  – Simplicity
  – Reduced liability exposure

• **Costs**
  – Lack of confidentiality
  – No efficient use of tax basis
  – Risk that certain tax-free rollovers will be disallowed
  – Possible complexity in tax reporting of management fees
  – Reduced estate planning flexibility
Structure 3: Invest Through an Affiliates Fund

- The Fund Managers invest Additional Capital as Limited Partners of an Affiliates Fund
  - The Fund Managers continue to invest sufficient capital in the General Partner to enable the General Partner to comply with safe harbor requirements
  - Affiliates Fund is an industry standard fund for “friends and family” of the private equity firm, possibly with a zero or reduced carried interest and/or management fee
Invest Through Affiliates Fund (cont.)

AC = Additional Capital
Invest Through Affiliates Fund (cont.)

- In many cases, same benefits and costs as investing through the Main Fund

- Benefits
  - Simplicity
  - Reduced liability exposure
Invest Through Affiliates Fund (cont.)

- Costs
  - Lack of confidentiality
  - Risk that Fund Managers will be liable as “general partners”
  - No efficient use of tax basis
  - Risk that certain tax-free rollovers will be disallowed
  - Possible complexity in tax reporting of management fees
    - However, many Affiliates Funds do not pay management fees
  - Reduced estate planning flexibility
Structure 4: Invest Directly as Co-Investors

- The Fund Managers invest Additional Capital alongside the Main Fund as co-investors in each portfolio company deal
  - The Fund Managers continue to invest sufficient capital in the General Partner to enable the General Partner to comply with safe harbor requirements
  - Note: Under many circumstances, the Fund Managers will be contractually obligated to participate proportionately in every deal, just as if they were participating through a fund entity (e.g., a “no cherry picking” rule)
Invest Directly as Co-Investors (cont.)

AC = Additional Capital
Invest Directly as Co-Investors (cont.)

• Benefits
  – Possible reduced liability exposure
  – However, new liability risks may arise (see next slide)
  – Greater certainty of tax-free rollover treatment
    ‣ Because re-investments are made directly, rather than through a partnership, uncertainties are reduced
  – No management fees need apply, so no associated tax reporting issues
  – No loss of estate planning flexibility
Invest Directly as Co-Investors (cont.)

• Costs
  – Individual Fund Managers must execute documents and make representations with respect to each separate portfolio investment
    ▶ Possible to reduce time and effort through power-of-attorney or similar authorization
    ▶ However, each portfolio company still sees many separate investors and generally should demand separate securities law representations
    ▶ Subsequent transfers of portfolio securities may require portfolio company involvement (significantly more cumbersome than transfers of fund interests)
  – No efficient use of tax basis
  – Liability risks
    ▶ Individual Fund Managers could be personally liable for errors and omissions in connection with their direct investing activities
    ▶ Risk that individual Fund Managers may be deemed to act pursuant to an undocumented general partnership, which could make them jointly and severally liable for such errors and omissions
Structure 5: Invest Through Principals Fund

• The Fund Managers invest Additional Capital alongside the Main Fund through a specially created Principals Fund
  – The Fund Managers continue to invest sufficient capital in the General Partner to enable the General Partner to comply with safe harbor requirements
Invest Through Principals Fund (cont.)

• Structure:
  – The Principals Fund is created as a separate entity to co-invest alongside the Main Fund in the same manner as a traditional Affiliates Fund
  – Structured as a Delaware “series limited liability company”
    ‣ Each Fund Manager holds a separate series of LLC equity interest
    ‣ Each series is completely separate from the overall LLC and all other series with respect to profit and loss
      – This creates the economic equivalent of a direct investment by the Fund Managers in underlying portfolio securities, with the benefits of a coordinating entity and LLC-style liability protection
    ‣ Both the Principals Fund and each series should be disregarded for Federal income and gift tax purposes
      – Each Fund Manager should be treated as a direct investor in portfolio securities
Invest Through Principals Fund (cont.)

• Structure (cont.):
  – The General Partner could serve as “Manager” of the Principals Fund to execute stock purchase agreements, etc.
  – Note: This structure is not available where Principals Fund profits would be subject to a carried interest
  – Note: If neither carried interest nor management fees apply, the Principals Fund generally should not be counted as a “client” of the General Partner for purposes of the 14-client limit under the Investment Advisers Act
    ▶ For a detailed discussion, see Fund Services Group memorandum “Investment Advisers Act of 1940”
Invest Through Principals Fund (cont.)

AC = Additional Capital
Invest Through Principals Fund (cont.)

• Benefits
  – Simplicity
    ▶ No need for each individual Fund Manager to execute every stock purchase agreement, etc.
      – However, in some cases, portfolio company counsel may request confirmation from individual Fund Managers as to certain securities law matters, such as whether the Fund Managers are “accredited investors”
  – Reduced liability exposure
    ▶ Additional Capital invested through the Principals Fund should not be subject to claims of General Partner creditors
    ▶ Existence of LLC should protect against personal liability from undocumented general partnership
    ▶ Because Fund Managers are not actual limited partners, reduced risk of personal liability due to inaccurate use of titles
Invest Through Principals Fund (cont.)

• Benefits (cont.)
  – Greater certainty of tax-free rollover treatment
    ‣ Re-investments should be treated as if made directly, rather than through a partnership
    ‣ Modest increase in risk compared to direct co-investment, but much safer than investing through General Partner, Main Fund or Affiliates Fund
      – In light of recent Internal Revenue Service guidance, also safer than investing through a partnership or LLC that merely seeks to “elect out of subchapter K”
  – No management fees need apply, so no associated tax reporting issues
  – Greater estate planning flexibility
    ‣ Should be treated in same manner as direct co-investment (modest risk of same treatment as investment in the Main Fund or Affiliates Fund)
  – Excellent protection of Fund Manager confidentiality
Invest Through Principals Fund (cont.)

• Costs
  – No efficient use of tax basis
  – Administrative/legal expense of creating and maintaining an additional entity
  – California taxes/fees
    ‣ $800/year franchise tax
    ‣ Income-based fee of up to $11,790/year
      – Fee is zero for years in which income is less than $250,000
      – Increases by steps to a maximum of $11,790 for years in which income is at least $5 million
Conclusions

• If no QSBS or estate planning goals exist, consider investment of Additional Capital through the General Partner to maximize efficient use of tax basis
  – Balance tax benefits against risk that Additional Capital will be subject to unindemnified claims by General Partner creditors

• If QSBS or estate planning goals exist, consider investment of Additional Capital through Principals Fund to maximize QSBS and estate planning benefits
  – Balance such benefits against inability to maximize efficient use of tax basis

• Consider other structures as appropriate
This presentation is intended only as a general discussion and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.

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