

New Tax Law Affects Funds

The American Jobs Creation Act of 2004 contains several provisions that affect venture capital and other private equity funds. The Act was passed by the House of Representatives on October 7, 2004 and by the Senate on October 11, 2004, and is expected to be signed into law by the President.

Summary

Several provisions of the Act directly affect funds and their management groups. These include:

- ▶ Rules requiring mandatory tax basis adjustments to partnership¹ assets in certain cases when an interest in the partnership is transferred and the partnership holds its assets at a substantial loss. Most venture capital, buyout and “funds of funds” partnerships will qualify for an “investment partnership” exception to these mandatory adjustments. However, general partner and management company entities may be subject to the mandatory adjustments.
- ▶ A related rule disallowing a portion of an acquiror’s share of losses from an electing investment partnership and imposing new information reporting burdens on sellers of fund interests and funds.
- ▶ An exception to the “unrelated business taxable income” rules (applicable to most tax-exempt limited partners) for small business investment company (“SBIC”) funds that issue debt-like partnership interests to the Small Business Administration.

- ▶ An increase in the amortization period for partnership organizational expenses to 15 years.
- ▶ Repeal of the “foreign personal holding company” and “foreign investment company” rules, which currently apply to some funds investing in foreign corporations.

The Act also contains provisions addressing nonqualified deferred compensation arrangements. These new rules may affect certain deferred compensation arrangements entered into by fund principals. In addition, one aspect of these rules may cause funds to rethink their procedures for “management fee waiver” arrangements.

Finally, the Act includes certain other rules designed to prevent “loss shifting” by partners. These rules should not affect most funds.

New Basis Adjustment Rules

Most funds have heard about the new basis adjustment rules. Fund-related groups were actively involved in the lobbying process related to these rules—which many originally referred to as the “repeal of Section 754.” This is the section of the Internal Revenue Code allowing partnerships to elect whether or not adjustments to the basis of partnership assets are made upon a transfer of interests in, or distributions of assets by, a partnership. The legislation is intended to prevent taxpayers from “shifting” or “duplicating” large tax losses on partnership assets having a tax basis less than their fair market value.

If an interest in a partnership is transferred, the new rules require the partnership to adjust the tax basis of its assets to fair market value IF:

- ▶ The partnership’s assets have a “substantial built-in loss” at the time of the transfer; and
- ▶ The partnership does not qualify for an exception.

A “substantial built-in loss” is present when the tax basis of partnership assets exceeds their fair market value by more than \$250,000. Apparently, this is tested on an aggregate basis, rather than asset-by-asset.

If the provision applies, the partnership must adjust the tax basis of all partnership assets to fair market value with respect to the new partner’s interest and keep a separate accounting of those adjustments.

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This is intended to prevent the new partner from sharing in the substantial loss built in to the partnership's assets at the time he acquires his partnership interest. The required adjustments and separate accounting are quite complex. Moreover, separate adjustments and accounting are required for each transfer of a partnership interest where a substantial built-in loss is present, exacerbating the accounting burden of the new rules.

Thanks to a successful lobbying effort by investment groups, most funds will be exempt from the new rules. The available exemption applies to "investment partnerships," defined as a partnership that meets the following criteria:

- ▶ The fund makes an election to be treated as an "investment partnership."²
- ▶ The fund would be an "investment company" under Section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under paragraph 3(c)(1) or 3(c)(7) of the 1940 Act.
- ▶ The fund has never been engaged in a trade or business.
- ▶ Substantially all of the fund's assets are held for investment.
- ▶ At least 95% of contributions to the fund consist of money.
- ▶ No assets contributed to the fund had a tax basis exceeding their fair market value at the time of contribution.
- ▶ All fund interests are issued in private offerings, with the final closing occurring not more than two years after the first capital contribution to the fund.
- ▶ The fund's partnership agreement contains substantive restrictions on each partner's ability to cause a redemption of the partner's interest.³
- ▶ The fund's term under its partnership agreement is 15 years or less.⁴

Effective Date: The new rules are effective for transfers of partnership interests occurring after the date the Act is signed. However, the redemption restrictions requirement

of the investment partnership exception will not apply to funds that were in existence on June 4, 2004.

Action Item: Funds will need to review their partnership documents as soon as possible to confirm that they meet the criteria described above. Counsel should be contacted to confirm that the fund is an eligible section "3(c)(1)" or "3(c)(7)" fund and that the requisite transfer restrictions are contained in the partnership agreement (if required).

Note that most fund general partner and management company entities organized as partnerships or LLCs likely will not qualify for the investment partnership exemption because they are engaged in a trade or business. Accordingly, they may be subject to the new accounting burdens when interests in those entities are sold, if they hold assets (such as an interest in a fund) at a substantial loss. Although transfers of interests in such "upper-tier" entities do occur, it is somewhat atypical for interests in such entities to be sold in a transaction that would trigger the new basis adjustments. The most common "transfers" of interests in upper-tier entities occur as the result of forfeiture provisions upon a member's departure. Such transfers generally will not trigger the new basis adjustment rules.

Loss Deferral Rule Imposes Additional Information Burden

Another new rule (the "Loss Deferral Rule") designed to prevent "loss shifting" provides that the acquiror of an interest in an electing "investment partnership" will be precluded from using its distributive share of the investment partnership's gross losses from the sale or exchange of partnership property except to the extent that such losses exceed the loss (if any) recognized on the sale of the interest by the seller. Because the disallowed losses will not decrease the acquiror's basis in the acquired partnership interest, this will presumably result in an increased loss (or decreased gain) for the acquiror upon later sale or liquidation of the partnership. Hence, this rule is referred to in the Act as

a loss "deferral" rule. This rule will likely have a direct affect on acquirors of fund interests.

The Loss Deferral Rule also imposes an accounting burden—presumably on the investment partnership and the seller. The seller will apparently be required to disclose the amount of its loss recognized on the sale so that the acquiror (or the investment partnership) will be able to determine the amount of losses that will be disallowed to the acquiror. While unclear at present, it also seems likely that the investment partnership will be required to report the amount of gross losses disallowed to the acquiror in preparing the acquiror's Schedule K-1.

SBIC Debt Exception to UBTI Rules

The Small Business Administration's ("SBA") small business investment company ("SBIC") program enables qualifying funds to obtain investment dollars from the SBA. The program has long provided for both debt and equity investment by the SBA. However, funds with tax-exempt partners generally are unwilling to issue indebtedness because such indebtedness may cause income and gains of the fund to be taxable to tax-exempt partners as "unrelated debt-financed income"—one category of "unrelated business taxable income" or "UBTI." Thus, SBIC funds with tax-exempt partners have generally not made use of the debt component of the SBA's investment program.

The Act corrects this by providing that UBTI will not arise solely as a result of an SBIC fund's issuance of indebtedness to the SBA under the SBIC program rules. However, an SBIC fund will not qualify for this exception if either:

- ▶ A single tax-exempt partner owns more than 25% of the capital or profits interests of the fund; or
- ▶ Tax-exempt partners own more than 50% of the capital or profits interests of the fund in the aggregate.

Effective Date: The new exception from UBTI applies to debt issued to the SBA after the

date the Act is signed, by an SBIC fund licensed after that date.

15-Year Amortization for Organizational Costs

The Act institutes a new 15-year amortization period for partnership organizational costs, if the partnership elects to amortize such costs. (Partnerships may continue to capitalize such costs, if desired.) Under the new rule, a partnership may amortize \$5,000 of such expenses in its first year of operation, reduced by the amount by which the partnership's total organizational expenses exceed \$50,000. The remainder of the partnership's organizational expenses are amortizable over the 180-month period beginning with the month in which the partnership begins operation. For most funds, this will mean that the first-year's organizational expense deduction will simply be the pro rated portion based on the number of months remaining in the tax year after the partnership begins operation.

In addition to the obvious decrease in annual organizational expense deductions, this new rule may affect funds in at least two ways. First, many funds that admit partners after the first closing wish to treat newly admitted partners equally with respect to the allocation of organizational expenses. This is often accomplished through special allocations of either organizational or other expenses. The longer amortization period makes it more likely that such special allocations can consist exclusively of organizational expenses, as opposed to management fee expenses, which are subject to limitations on deductibility for some partners. Second, many funds will wind up and liquidate before the end of the new 15-year amortization period. In such case, any portion of the organizational expenses not yet amortized will be allowed as a deduction upon liquidation.

Effective Date: The new amortization rule applies to organizational expenses paid or incurred after the date the Act becomes effective. Costs already paid or incurred by funds will continue to be subject to existing amortization rules.

Repeal of Foreign Personal Holding Company and Foreign Investment Company Rules

The Act will repeal the foreign personal holding company ("FPHC") and foreign investment company ("FIC") regimes, which now result in current taxation of U.S. investors on certain undistributed income of foreign corporations. Most often, these rules apply to tax fund investors on interest income earned by a foreign portfolio company from the temporary investment of investment dollars received from the fund. While the repeal of these rules is welcome, other "anti-deferral" regimes remain in place and will continue to affect funds investing in foreign corporations (and will continue, in some cases, to result in current taxation of fund investors on the foreign portfolio company's undistributed interest income). In particular, the "passive foreign investment company" (or "PFIC") rules and the "subpart F" rules applicable to controlled foreign corporations (or "CFCs") are retained by the Act.

Rethinking "Management Fee Waiver" Procedures and Nonqualified Deferred Compensation Arrangements

Many funds have in place procedures whereby the general partner is entitled to waive scheduled management fee payments in return for distributions (or loans) from the fund and corresponding profit allocations in the future. These arrangements typically permit the general partner to elect the fee waiver on a quarterly basis, before the first day of the relevant quarter.

The Act contains a sweeping reform of the rules on nonqualified deferred compensation. Among the new provisions is a rule requiring that employees wishing to defer compensation for a particular year must elect to defer that compensation before the beginning of the taxable year in which the corresponding services are performed. This rule was enacted in response to several cases that permitted deferrals much closer to the date the compensation was paid. See our *Cooley Alert* on the new nonqualified

deferred compensation rules generally at <http://www.cooley.com/news/alerts.aspx?ID=38715520>.

Action Item: Management fee waivers generally should not be classified as nonqualified deferred compensation that is subject to the Act's new rules. However, in light of the Act's new rule on the timing of elective deferrals of compensation, we recommend that funds consider making fee waiver elections on an annual basis only, before the beginning of the taxable year in which the fees are to be paid.

Action Item: Some fund management companies may have in place arrangements that constitute nonqualified deferred compensation plans subject to the Act. It is important that these arrangements be reviewed with counsel and possibly revised in light of the new rules. Failure to do so may result in immediate taxation on amounts that are deferred under such an arrangement.

Other Rules Aimed at "Loss Shifting"

The Act also contains a provision requiring a downward basis adjustment to partnership property if assets are distributed in kind to a partner and the distributee partner's basis in the distributed assets would be substantially lower (i.e., by \$250,000 or more) as the result of a Section 754 election. The "investment partnership" exception does not apply for purposes of this rule. The adjustments required by this rule would generally be triggered only when an in-kind asset distribution is made in complete liquidation of a particular partner's interest and the partnership continues in existence⁵—a relatively rare occurrence for most venture capital, buyout and funds of funds (though not rare for hedge funds).

Another rule is designed to prevent the shifting among partners of losses attributable to contributed property. Under the Act, if property is contributed to a partnership with a built-in loss (i.e., the tax basis of the property exceeds its fair market value at the time of contribution), that built-in loss may

only be allocated to the contributing partner. If the contributor is not a partner at the time the loss is recognized, the built-in loss amount will be disallowed. Because most funds do not accept property contributions in kind, this rule will not affect most funds.

For more information on any of the foregoing topics or other aspects of the new tax legislation, please contact any of the Cooley tax partners listed at the beginning of this Alert, or your regular Cooley contact. ■

Notes

- 1** All references in this Alert to “partnerships” are equally applicable to limited liability companies that are treated as partnerships for tax purposes.
- 2** As yet, there is no guidance as to how the election is made.
- 3** This rule does not apply to funds in existence on or before June 4, 2004.
- 4** The term may be 20 years or less for funds in existence on or before June 4, 2004.
- 5** In addition, in order for adjustments to be required, the distributee partner’s “outside” tax basis in its partnership interest would need to exceed the partnership’s basis in the distributed property by at least \$250,000.