

# Morgan Lewis

## **VENTURE CAPITAL & PRIVATE EQUITY FUNDS DESKBOOK SERIES**

### **Accommodating Non-U.S. Investors: Understanding ECI**

A significant source of capital for venture capital and other private equity funds is non-U.S. investors. Non-U.S. investors that are engaged in a trade or business in the United States are taxed on their income that is “effectively connected” with that business, often referred to as “effectively connected income” or ECI. At least equally as important, non-U.S. investors that are engaged in a U.S. trade or business are required to file U.S. tax returns. In connection with their investments in private investment funds, many non-U.S. investors seek to avoid ECI. As discussed below, practically speaking, a covenant to avoid ECI (regardless of whether phrased as requiring “reasonable best efforts” or some variant thereof) means that the fund cannot invest in U.S. real estate or real estate-heavy companies, and cannot invest in flow-through operating entities except through “blocker” structures.

Because the typical investment fund is organized as an entity treated as a partnership for U.S. federal income tax purposes, U.S. taxation of non-U.S. investors in an investment fund depends on whether the income of the fund is treated as being related to a trade or business in the United States. If an investment fund is engaged in a U.S. trade or business, each non-U.S. investor in the fund will be treated as being engaged in a U.S. trade or business and will be subject to U.S. income taxation at regular U.S. tax rates on any income of the fund that is effectively connected with the conduct of a U.S. trade or business. The United States currently imposes federal income tax on both individuals and corporations at graduated rates of up to 35%. If a non-U.S. investor has ECI or is a member of a partnership that is engaged in a trade or business in the United States, the investor is required to file a U.S. federal income tax return. Many non-U.S. investors seek to avoid ECI so that they are not required to file U.S. federal income tax returns.

If a fund is not engaged in a U.S. trade or business, a non-U.S. investor generally will not be subject to U.S. income tax on capital gains upon the sale of portfolio investments by the fund, other than “United States real property interests” (USRPIs) or interests in flow-through entities themselves engaged in a U.S. trade or business (“flow-through operating entities”). In addition, the non-U.S. investor generally will not be subject to U.S. income tax upon a sale or other disposition of its interest in the fund, except to the extent of any gain attributable to USRPIs or flow-through operating entities. U.S.-sourced interest (other than “portfolio interest”), dividends, and other “fixed or determinable annual or periodical income” are subject to U.S. withholding tax at a 30% rate, subject to possible reduction by an income tax treaty between the United States and the investor’s country of residence.

### **Application to Investment Funds**

Most of the income of most private equity and venture capital funds will consist of gains from the sale of portfolio companies and, to a lesser extent, dividends and interest. While dividends and interest may be subject to withholding taxes, the investment activity of the fund generally will not generate ECI. However, certain common activities of investment funds can result in ECI: investments in USRPIs, which include U.S. real estate and U.S. corporations with substantial U.S. real estate holdings; investments in U.S. operating businesses structured as partnerships or limited liability companies; and provisions that

credit certain types of fees earned by the general partner or its affiliates against the management fees paid by investors.

### ***Investments in Real Estate and Real Estate–Heavy Corporations***

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), any gain recognized by a non-U.S. investor on the disposition of a USRPI is treated as ECI, even if the investor is not otherwise engaged in a U.S. trade or business. Examples of businesses that may include significant real estate assets that therefore may constitute USRPIs include cable companies; companies with oil, gas, or other petroleum or mineral interests; and other companies with infrastructure investments such as highways, ports, or airports. USRPIs generally include stock in any U.S. corporation that, at any time during the five years preceding the disposition of the stock, was a “United States real property holding company” (USRPHC). A USRPHC generally is any U.S. corporation for which 50% or more of the value of its gross assets consists of USRPIs. There are exceptions for holders of no more than 5% of the stock of a corporation regularly traded on an established securities market, and for corporations that have fully disposed of their U.S. real estate assets in taxable transactions.

### ***Flow-Through Operating Entities***

Investment funds may invest in portfolio companies that are structured as partnerships or limited liability companies that are taxed as partnerships, thereby avoiding corporate-level income taxes. Some startup companies are formed as limited liability companies to avoid corporate-level taxes, with respect to both operating income and gain upon ultimate sale. Upon sale, an entity taxed as a partnership, unlike a corporation, can permit the buyer to step up its tax basis in the acquired assets to their market values without the seller’s incurring corporate-level tax. Because the income of the portfolio company typically will consist of active business income, such income flows through to the investors as ECI. Furthermore, the U.S. Internal Revenue Service takes the position that gain attributable to the sale of assets that give rise to ECI (e.g., an interest in a partnership or limited liability company that is engaged in business in the United States) is treated as ECI.

### ***Fee-Crediting Mechanisms***

Many investment funds provide that certain fees, such as commitment, transaction, break-up, or consulting fees, earned by the general partner or its affiliates are wholly or partially applied to reduce the management fee. Because such fees are part of the benefits received by the general partner from investing the investors’ capital, and any such fees diminish the assets of the portfolio companies and thereby reduce the returns to investors, limited partners often successfully argue that they should receive the benefit of a substantial portion or all of such fees. However, if the fees were earned by the fund, the fee income generally would be treated as unrelated business taxable income. Instead, the earned fees are received by the general partner or its affiliates, but some or all of the fee amounts are applied to reduce the management fees payable by investors. If the fees were earned by the fund in the United States, the fee income generally would be treated as ECI. It is not clear whether a mechanism by which some or all of such fees are credited against the management fee should be viewed as the equivalent of the fund’s earning such fees, in which case ECI would likely result. Provisions in fund documents that require the general partner to avoid generating ECI often carve out such fee-crediting mechanisms from the ECI prohibition.

### **Branch Profits Tax**

The ECI of non-U.S. corporations may be subject to “branch profits tax” (BPT) in addition to regular taxation. BPT is intended to be a substitute for the withholding tax on dividends that would apply if a non-U.S. corporation conducted its U.S. activities through a U.S. corporation rather than through a branch of the non-U.S. corporation. BPT is imposed at the rate of 30% on the corporation’s “effectively

connected earnings and profits," increased (or decreased) by decreases (or increases) in the corporation's net investment in the United States. The BPT rate can generally be reduced to the same rate applicable to dividends under U.S. income tax treaties. However, for investors who do not benefit from any income tax treaty, the combination of the 35% regular federal corporate income tax rate plus the 30% BPT is taxation at a 54.5% rate.

### **State and Local Taxes**

U.S. states, and a few localities, also have concepts similar to ECI and may tax business income derived within the state or gains from real property transactions. In addition to bearing the actual cost of such taxes, investors may be required to file tax returns in the state or locality.

### **Blocker Structures**

Many non-U.S. investors do not wish to file U.S. federal income tax returns and prefer that investments that will generate ECI be held through entities taxed as corporations, which will "block" receipt of ECI by the investor. In addition, the terms of many investment fund agreements relieve the fund of its obligation to avoid investments resulting in ECI if non-U.S. investors are offered the opportunity to invest through a "blocker." This blocker typically will be a U.S. corporation (or other U.S. entity that elects to be treated as a corporation), although a non-U.S. corporation (or a non-U.S. partnership that elects to be treated as a corporation) may be preferable where the potential ECI is attributable solely to an investment in a USRPHC. A blocker structure prevents the flow-through of ECI to the investor. However, the blocker corporation will be fully subject to U.S. taxation, and any dividends may be subject to U.S. withholding taxes. Thus, while the blocker avoids the requirement for the investor to file U.S. income tax returns, the U.S. taxation faced by the blocker may be substantially the same as, or greater than, the taxation that would be faced by the investor if no blocker were used.

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For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice](#) attorney.

### **About Morgan Lewis's Private Investment Funds Practice**

Morgan Lewis has one of the nation's largest private investment fund practices and is consistently ranked as the "#1 Most Active Law Firm" globally based on the number of funds worked on for limited partners by *Dow Jones Private Equity Analyst*.

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