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VENTURE CAPITAL & PRIVATE EQUITY FUNDS DESKBOOK SERIES

Avoiding “Publicly Traded Partnership” Status for U.S. Federal Income Tax Purposes

Venture capital funds and private equity funds typically contain significant limitations on the ability of investors to transfer their partnership interests. One reason for such restrictions is a fund’s need to avoid being treated as an association taxable as a corporation for United States federal income tax purposes. The intended tax treatment of most venture capital or private equity funds, including funds organized as limited partnerships or limited liability companies, is as a partnership. If a partnership is a “publicly traded partnership,” or “PTP,” for U.S. federal income tax purposes, and doesn’t meet a “qualifying income” test, however, the partnership will be treated as an association taxable as a corporation for U.S. federal income tax purposes, with various adverse tax consequences for the partnership and its investors, including (i) the imposition of U.S. corporate income tax filing and payment obligations on the partnership with respect to the partnership’s worldwide taxable income (in the case of a partnership organized under U.S. law); (ii) possible treatment of the partnership as a passive foreign investment company, or PFIC, or as a controlled foreign corporation, or CFC (in the case of a partnership organized under non-U.S. law), resulting in additional tax filing and payment obligations for U.S. taxable investors; and (iii) the inability of investors to benefit from the pass-through treatment of the partnership’s items of income and loss.

Because of the negative consequences that would ensue if a fund is deemed to be a PTP, most investment partnerships are careful to avoid PTP status. A partnership is treated as a PTP if either (i) interests in the partnership are traded on an established securities market, or (ii) interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof). While these concepts are not well defined, United States Treasury Regulations provide for a number of “safe harbors” that a partnership can rely on to avoid PTP status. If a partnership falls within a safe harbor, interests in the partnership will not be deemed to be readily tradable on a secondary market or the substantial equivalent thereof. In approving secondary transfers of partnership interests (i.e., transfers of interests by existing partners), many partnerships will not approve a transfer if it would cause the partnership no longer to satisfy any of the safe harbors.

There are three principal safe harbors most relevant to private equity and similar partnerships: (i) “private placements,” (ii) “lack of actual trading,” and (iii) “qualified matching services,” all as set forth in Treasury Regulations section 1.7704-1.¹ Each of these is discussed below.

Private Placements Safe Harbor

A partnership is not treated as a PTP if (i) all interests in the partnership were issued in a transaction (or transactions) that was not required to be registered under the Securities Act of 1933, and (ii) the partnership does not have more than 100 partners at any time during the taxable year of the partnership. For partnerships that are offered and sold outside the United States, this safe harbor does not apply

1. There are additional rules that apply to partnerships, such as hedge funds, that provide liquidity by redeeming partnership interests, which are not discussed here.

unless the offering and sale would not have been required to be registered under the Securities Act of 1933 if the interests had been offered and sold within the United States. For purposes of the 100-partner limitation, a partner in the partnership that is itself a partnership, S corporation, or grantor trust is “looked through” to its owners if (i) substantially all of the value of the owner’s interest in the partnership or other flow-through entity is attributable to the flow-through entity’s interest (direct or indirect) in the partnership, and (ii) a principal purpose of the use of the tiered arrangement is to permit the partnership to satisfy the 100-partner limitation. This “look-through” rule is similar, but not identical, to the look-through rule under the Investment Company Act of 1940.

Lack of Actual Trading Safe Harbor

The “lack of actual trading” safe harbor, often referred to as the 2% safe harbor, applies if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in certain excluded transfers) does not exceed 2% of the total interests in partnership capital or profits.

A number of rules apply for purposes of computing the 2% limit. Some of the more significant ones are set forth below.

Computation of Outstanding Interests

The total interests in partnership capital or profits generally are determined by reference to all outstanding interests; however, if the general partner (and certain related persons) owns, in the aggregate, more than 10% of the outstanding interests in partnership capital or profits at any one time during the taxable year of the partnership, the total interests in partnership capital or profits are determined without reference to interests owned by such persons.

Monthly Determinations

The percentage interest represented by a transfer is generally determined by reference to the interests outstanding in the month that the transfer occurs. A reasonable, consistently applied convention (e.g., use of interests outstanding at beginning, 15th day, or end of month) can be used for this purpose. However, for purposes of the “block transfer” rule (described immediately below), the interests outstanding immediately prior to the transfer must be taken into account.

Block Transfers

Any transfer by a partner and related persons during a 30-day period that represents, in the aggregate, more than 2% of the total interests in partnership capital or profits is disregarded.

Transfers Not Involving Trading (Private Transfers)

Various transfers between related parties, and similar transactions, are disregarded in determining whether transfers exceed the 2% limit. These include transfers at death, transfers involving distributions from a qualified retirement plan, issuances of new interests by the partnership, transfers between family members, and transfers in which the tax basis of the interest in the hands of the transferee is determined, in whole or in part, by reference to its basis in the hands of the transferor or under section 732 of the Internal Revenue Code. This last group of transfers generally will include contributions to a partnership and distributions from a partnership. It also will include many transfers to corporations, including wholly owned corporations. It does not include distributions from corporations.

Qualified Matching Service (QMS) Safe Harbor

If transfers are made through a "qualified matching service," up to 10% of the interests in a partnership can be transferred during the partnership's taxable year without resulting in the partnership being a PTP. A recent development has been that fund sponsors set up their own QMSs, with the intent of allowing greater liquidity in interests in their partnerships than permitted by the 2% safe harbor. Note that this discussion of QMSs is focused solely on the requirements under U.S. federal tax laws, but significant issues must also be addressed under U.S. federal securities laws if a QMS is to be implemented. Such U.S. federal securities laws issues are beyond the scope of this article; please consult your Morgan Lewis attorney to discuss these issues further. The following paragraphs closely track the applicable Treasury Regulations in defining the parameters of a QMS.

A matching service is a qualified matching service only if the following criteria are met:

- (i) The matching service consists of a computerized or printed listing system that lists customers' bid and/or ask quotes in order to match partners who want to sell their interests in a partnership (the selling partner) with persons who want to buy those interests
- (ii) Matching occurs either by matching the list of interested buyers with the list of interested sellers or through a bid-and-ask process that allows interested buyers to bid on the listed interest
- (iii) The selling partner cannot enter into a binding agreement to sell the interest until the 15th calendar day after the date information regarding the offering of the interest for sale is made available to potential buyers and such time period is evidenced by contemporaneous records ordinarily maintained by the operator at a central location
- (iv) The closing of the sale effected by virtue of the matching service does not occur prior to the 45th calendar day after the date information regarding the offering of the interest for sale is made available to potential buyers and such time period is evidenced by contemporaneous records ordinarily maintained by the operator at a central location
- (v) The matching service displays only quotes that do not commit any person to buy or sell a partnership interest at the quoted price (nonfirm price quotes) or quotes that express interest in a partnership interest without an accompanying price (nonbinding indications of interest), and does not display quotes at which any person is committed to buy or sell a partnership interest at the quoted price (firm quotes)
- (vi) The selling partner's information is removed from the matching service within 120 calendar days after the date information regarding the offering of the interest for sale is made available to potential buyers and, following any removal (other than removal by reason of a sale of any part of such interest) of the selling partner's information from the matching service, no offer to sell an interest in the partnership is entered into the matching service by the selling partner for at least 60 calendar days
- (vii) The sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in private transfers and block transfers) does not exceed 10% of the total interests in partnership capital or profits

For purposes of paragraph (iv) above, the closing of a sale occurs no later than the earlier of:

- a) The passage of title to the partnership interest;
- b) The payment of the purchase price (which does not include the delivery of funds to the operator of the matching service or other closing agent to hold on behalf of the seller pending closing); or

- c) The date, if any, that the operator of the matching service (or any person related to the operator) loans, advances, or otherwise arranges for funds to be available to the seller in anticipation of the payment of the purchase price.

A qualified matching service may be sponsored or operated by a partner of the partnership (either formally or informally), the underwriter that handled the issuance of the partnership interests, or an unrelated third party. In addition, a qualified matching service may offer the following features:

- (i) The matching service may provide prior pricing information, including information regarding resales of interests and actual prices paid for interests; a description of the business of the partnership; financial and reporting information from the partnership's financial statements and reports; and information regarding material events involving the partnership, including special distributions, capital distributions, and refinancings or sales of significant portions of partnership assets
- (ii) The operator may assist with the transfer documentation necessary to transfer the partnership interest
- (iii) The operator may receive and deliver funds for completed transactions
- (iv) The operator's fee may consist of a flat fee for use of the service, a fee or commission based on completed transactions, or any combination thereof

PTP Qualifying Income

Even if a partnership is a PTP, unless the partnership is registered under the Investment Company Act of 1940 it will not be treated as a corporation if it satisfies a gross income test for each year beginning with the first year it is a PTP. The gross income test is satisfied if 90% or more of the gross income of the partnership for the taxable year consists of "qualifying income." Qualifying income includes, *inter alia*, interest, dividends, real property rents, gains from the sale of real property, gains from the sale of stock, securities, or foreign currencies, and other income derived with respect to the business of investing in stock, securities, or currencies. Because it is difficult to be certain that the qualifying income test will be met for each taxable year, most private equity funds prefer to fall within one of the "safe harbors" in order to be certain that the fund will not be treated as an association taxable as a corporation.

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

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