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Risk of Possible Classification of Funds as Publicly Traded Partnerships

Due to the increasing incidence of fund investors who want to transfer their investment fund interests ("fund interests"), for liquidity concerns or other reasons, and the emergence of parties willing to acquire these interests, investment funds ("funds") now face a greater risk of being classified as publicly traded partnerships ("PTP") that are taxable as corporations. General partners and managers of most funds have generally assured fund investors, either explicitly or implicitly, that the fund will be treated as a partnership and will not incur any entity-level tax. Therefore, we think it is important for general partners and fund managers to be aware of the rules under which a fund may be treated as a PTP (and therefore potentially taxable as a corporation), and the techniques available to avoid such classification. **This memorandum is intended only as a summary of such rules and techniques and should not be relied upon independent of tax advice with respect to their application to specific circumstances.**

I. PTP Classification

A fund will generally be classified as a PTP if (a) the fund interests are either traded on an established securities market or are readily tradable on a secondary market or its substantial equivalent and (b) the fund is involved in the trading activity. Determining whether fund interests are traded on an established securities market is relatively simple; generally, this includes trading on national securities exchanges, foreign exchanges, regional or local exchanges, or interdealer quotation systems. On the other hand, determining whether fund interests are readily tradable on a secondary market or its substantial equivalent is more difficult, because it is based on a facts and circumstances analysis of whether the partners can readily buy, sell or exchange their interests in a

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manner that is economically comparable to trading on an established securities market, with no clear rules regarding comparability.

The second requirement (fund involvement) provides only limited protection, because the mere "recognition" (another ill-defined key term, but it might, include, for example, sending a K-1 to the transferee) by the fund of transfers of fund interests made on a market is treated as involvement by the fund in making the market.

As discussed below, there are certain safe harbors that prevent classification as a PTP. Moreover, PTP classification does not automatically turn a fund into a corporation for tax purposes as there are also safe harbors based on the type of income generated that could apply to many funds. However, in our view, relying solely on the income safe harbors will be risky.

II. Safeharbor Rules to Avoid Taxation as Corporation

Several safeharbor rules make the determination of whether fund interests are readily tradable on a secondary market or its substantial equivalent unnecessary in many instances. If the fund interests are not in fact traded on an established securities market, the fund can prevent PTP classification by qualifying under either the private placement safeharbor or the de minimis trading safeharbor. In addition, even if a fund is otherwise classified as a PTP, the passive income safeharbor may apply to prevent entity-level taxation as a corporation.

A. Private Placement Safeharbor

For a transfer of fund interests to constitute a private placement, the fund must have no more than 100 partners during the fund's taxable year, and all fund interests must be issued in a transaction that is exempt from the registration requirements under the Securities Act of 1933. Most funds other than those avowedly intending to be publicly traded satisfy the requirement that they be offered on an exempt basis.

The 100 partner limit is a bit more challenging than it appears to be. First, it is important to note that the 100-partner calculation must be computed annually and that look-through rules may apply. Particularly, a person owning an interest in a partnership, grantor trust, S corporation or other flow-through entity, which entity owns an interest in the fund (either directly or through another flow-through entity), will be treated as owning an interest in the fund if (a) substantially all the value of the person's interest in the flow-through entity is attributable to the flow-through entity's interest in the fund, and (b) the principal purpose for using the tiered arrangement is to allow the fund to satisfy the 100-partner limitation. Because "substantially all" and "principal purpose" are undefined, a fund risks falling outside of this exception, even if it believes it has only 100 partners during its tax year. Therefore, we recommend that, on an annual basis, fund managers and general partners carefully analyze each partner that is a flow-through entity to determine whether such partner is actually several partners due to the look-through rules. (In order to accomplish this annual review, it will be necessary to obtain agreement from flow-through entities to update certain information and representations provided as part of the subscription documentation.) In many cases it will be relatively easy to conclude that there are 100 or fewer partners. Qualification for this exemption will obviate the more complex analyses required by the other exemptions, as described below.

B. De Minimis Trading Safeharbor

A fund can also avoid PTP classification if only a de minimis level of trading occurs each tax year. Generally, a fund that is not traded on an established securities market is not a PTP if the sum of all percentage interests in the fund's capital and profits transferred during the tax year in question (excluding disregarded transfers discussed below) does not exceed 2% of all the interests in the fund's capital and profits.[*] In determining whether this de minimis exception applies, the following transfers are disregarded:

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[*] There are a number of complexities and ambiguities involved in determining the percentage interest represented by a particular transfer – for example, the treatment for this purpose of the general partner's

(a) transfers of fund interests by a partner or related party within 30 days which represent greater than 2% of the total interests in the fund's capital or profits (so-called "block-transfers");

(b) intrafamily transfers;

(c) transfers at death;

(d) transfers in which interests are issued by the fund in exchange for cash, property or services;

(e) transfers related to distributions from a qualified retirement plan or IRA;

(f) transfers by a partner or partners of interests that represent 50% or more of the total interests in the fund's capital and profits either in one transaction or several related transactions;

(g) transfers in which the transferee's basis in the fund interest is determined, in whole or in part, by reference to the transferor's basis or is determined under Section 732 of the Internal Revenue Code, as amended in 1986;

(h) transfers pursuant to a right under a redemption or repurchase agreement that is exercisable only upon a partner's death, disability or mental incompetence or upon the retirement or termination of services of someone who worked full-time for or actively participated in the management of the fund;

(i) transfers pursuant to a closed-end redemption plan;

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carried interest, and the inclusion or exclusion in the calculation of interests in parallel funds or alternative investment vehicles. In order to be comfortable that a fund satisfies the safeharbor test, it may be necessary to assume the least favorable resolution of each of these uncertainties.

(j) transfers pursuant to a redemption and repurchase agreement that meets detailed and specific requirements; and

(k) transfers through a qualified matching service.

C. Passive-Type Income Safeharbor

If a fund is determined to be a PTP, it will nonetheless not be taxed as a corporation if, each year, 90% or more of the fund's gross income is passive-type income. Passive-type income generally includes dividends, real property rents, certain types of interest, gains from the sale of real property, income from mining and oil and gas properties, gains from the sale of capital assets held to produce income, and gains from commodities (not held primarily for sale in the ordinary course of business), futures, forwards, or options with respect to commodities.

While the passive-type income exception may apply generally to funds, we advise you not to rely solely on this exception, because the passive-type income test must be met annually, and non-passive income may be generated by the fund either through allocation to the fund of business gross income of a flow-through entity in which the fund invests, or as a result of attribution to the fund of transaction fees paid to the fund manager which are offset against management fees payable by the fund to the manager. Thus, a fund risks falling outside the passive-type income exception if 10% or more of its gross income constitutes non-passive income. The risk is particularly acute when the fund has no passive-type gross income in the relevant tax year, which may often be the case.

III. Conclusion

We recommend that funds attempt to stay within one of the safeharbors described above whenever possible, in order to avoid the more difficult and subjective determination of whether a secondary market in fund interests has developed. If a fund that does not come within the 100-partner safeharbor is presented with a proposed transfer that in combination with other transfers would take the fund outside the de minimis safeharbor, the fund manager can choose either not to approve the transfer and stay within the de minimis safeharbor or to approve the transfer after determining that the circumstances of the transfer or transfers do not indicate that a secondary market exists. We have prepared and can make available to you a questionnaire and related worksheet intended to elicit information to assist funds, in consultation with their advisors, in determining whether certain transfers may be disregarded for purposes of the de minimis safeharbor and whether a secondary market or its substantial equivalent exists. While the latter determination is not precise and is based on a facts and circumstances analysis, we believe that it would be reasonable for a fund manager to approve a transfer that exceeds the de minimis safeharbor unless it appears (after examining the circumstances of such transfer and prior transfers) that a true secondary market exists or is developing.

If you have any questions, please feel free to contact us.