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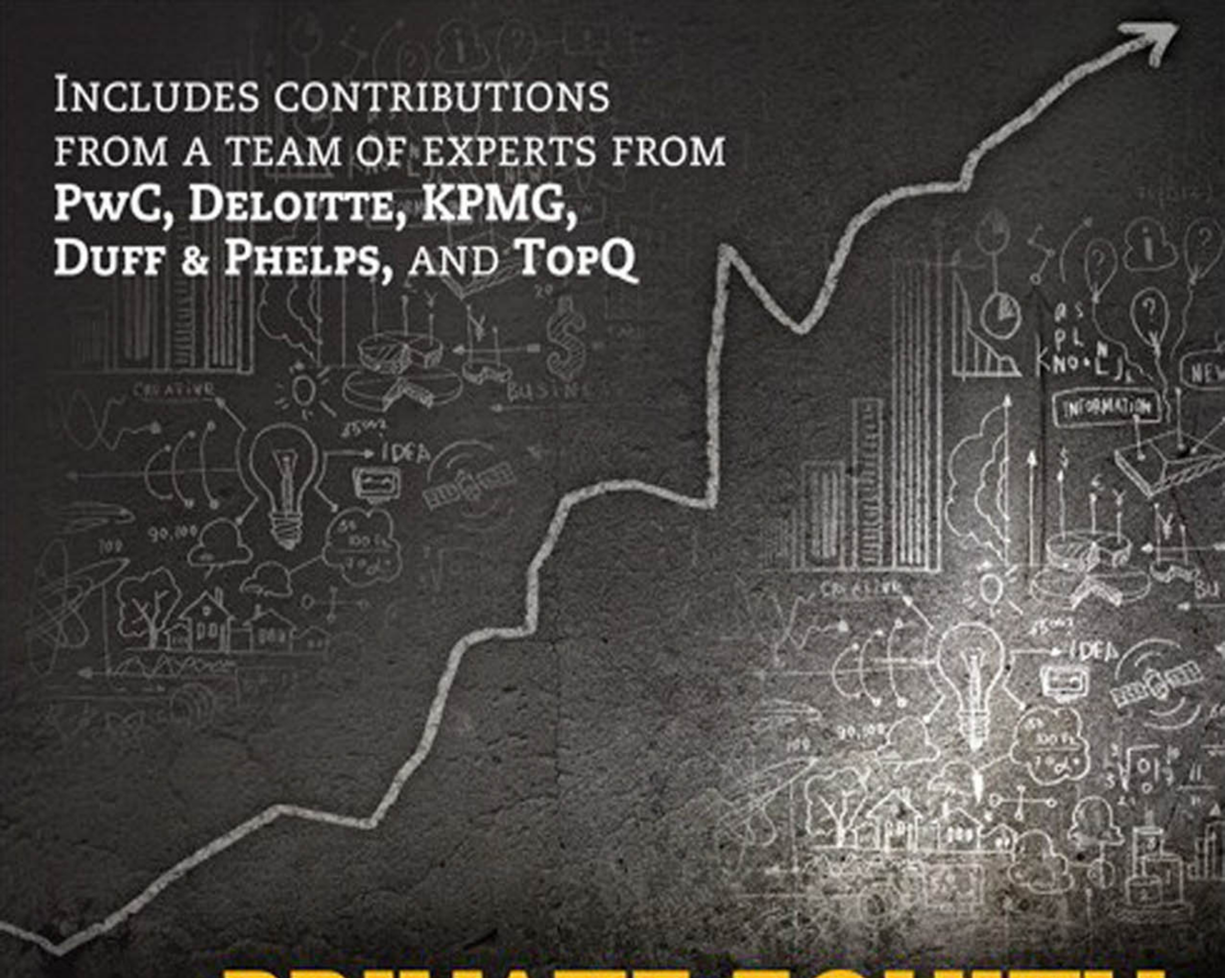

PRIVATE EQUITY ACCOUNTING, INVESTOR REPORTING, AND BEYOND

MARIYA STEFANOVA

Private Equity Accounting, Investor Reporting, and Beyond

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Mariya Stefanova

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To Lilly and Alex, who gave me a reason to do it;
and to my mom, without whose help I couldn't have done it.

As usual, I also dedicate my work to those who need it most—
the private equity accounting and investor reporting practitioners
whose task to provide adequate reporting for the Limited Partners
is very challenging, facing lack of detailed guidance and
having to make many judgment calls.

Contents-at-a-Glance

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Mariya Stefanova is a founding partner of Private Equity Accounting Insights (PEAI), a private equity training and consultancy firm, providing specialist training and technical advice to GPs, LPs, and fund administrators. She has more than eleven years of experience in private equity accounting and investor reporting and more than seven years of experience in training, during which period she has trained over a thousand fund accountants and senior executives on the GP, LP, and fund administration side. PEAI Group is also providing specialist PE publications such as the *PEAI Private Equity Technical Journal*.

Mariya is also the author of the best seller *Private Equity Accounting: The Global Guide* (https://www.privateequityinternational.com/peaccounting/), published by PEI Media in October 2011.

Previously, Mariya worked in the technical department of Augentius Fund Administration LLP, a premium provider of fund administration services specialized in private equity and real estate funds. She was in charge of the technical training of the client services accountants and keeping them up-to-date with the industry and accounting developments. Mariya also provided advice to clients and client-services accountants in resolving complex technical issues, as well as performed technical reviews of accounts, quarterly investors' reports, and complex calculations.

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1

Private Equity Structures and Their Impact on Private Equity Accounting and Reporting

Mariya Stefanova, PEAI

In this chapter, we discuss:

- Structuring considerations in private equity
- Main building blocks of a private equity structure
- Domiciliation: whether to form the fund—onshore or offshore
- Plain-vanilla private equity structure
- Combination of structures, including master-feeder structures, structures involving blockers, and parallel structures
- How to treat private equity structures for accounting and reporting purposes
- Alternative private equity structures: fund lites

Any thorough discussion on private equity accounting and reporting should start by considering the relevant structure involved—whether at the fund level or at the underlying portfolio company's level.

This chapter is by no means a comprehensive guide to private equity (PE) structures; it sets the scene for the accounting and reporting to take place. Accountants do need a reasonable understanding of the fund structure in order to account for it properly.

For some sponsors, a plain-vanilla structure works perfectly. For others, even a complex structure based on a combination of vehicles involving a number of jurisdictions might not be enough. In such cases, lawyers and tax advisers can provide tailored solutions to suit the sponsor's specific requirements.

In the context of private equity accounting and reporting, when making decisions about the reporting of the fund, structure plays a part in how the information is channeled and then sliced and diced to come up with the most appropriate reporting. For instance, if you have a parallel structure, will you be reporting each parallel entity separately, or will you be reporting everything on an aggregated basis, as if the separate entities didn't even exist and you had only one fund? Or will you use both methods?

Structuring Considerations in Private Equity

To understand how and why a private equity fund is structured in a certain way, you need to understand what drives the main participants. First, there are two main questions to be asked:

1. **What do PE fund managers/general partners (GPs) want?**

   In a nutshell, what GPs want is:

   - Good tax results
   - Simple structure—does not always work, but aim to use as simple a structure as possible with entities in as few different jurisdictions as possible
   - Ease in operating/administering
   - Moderate regulation/reporting
   - Onshore access—unless good reason to be offshore (for example, VAT issues, creaming, avoid remittance)
   - Familiar to LPs

2. **What do investors/limited partners (LPs) want?**

   In a nutshell, what LPs want is:

   - No tax at fund level
   - Familiarity with the vehicle
   - Limited liability
   - No additional regulatory or reporting issues
   - Good reputation (offshore / onshore / EU?)
   - Avoidance of U.S. issues (for example, UBTI / ERISA / ECI / FIRPTA / FATCA if possible)

   Based on the above drivers for the main participants, I think it's safe to say that most of the private equity structures are predominantly tax driven. Still, some other considerations deserve mentioning:

   - Tax transparency of the fund—Limited partnerships, the most efficient and preferred legal form for PE funds, ticks that box.
   - Limited liability for both manager and investors.
   - Tax position (location and status) of the target investor base.
   - Tax treatment of the fund's target assets.
   - Tax efficiency of the management fee and carried interest.
   - Regulatory issues (whether the manager and/or the fund need to be authorized or regulated).
   - Commercial alignment of interests between managers and investors.
   - Location of the management team.
   - Investor and tax authority attitudes toward certain jurisdictions.
   - Familiarity with and confidence in certain vehicles and jurisdictions.
   - Cost (to maintain the structure) and time and resources (to handle the complexity of the structure).

Main Building Blocks and Vehicles of a PE Structure

Lawyers use three broad categories of vehicles as building blocks to create private equity structures:

1. **Limited partnerships** (and their equivalents in the relevant jurisdiction under consideration) and funds for joint account. Some of the most popular ones are listed here:
   - Delaware Limited Partnerships—Although it is most often preferred by U.S. managers, this vehicle is also a vehicle of choice for non-U.S. sponsors. This is due to the jurisdiction's well-developed case law and lack of obligation to disclose publicly the terms of the LPA, the identity of the LPs, and the partnership's accounts, among other important characteristics.
   - Cayman Exempted Limited Partnerships—Cayman Limited Partnerships are one of the most common vehicles if you want to go offshore. They represent quite a flexible alternative along the English model whereby the LPs have to be registered and gazetted with the Cayman Exempt Limited Partnership, which does not have many of the original limited partnership features and is more aligned with the Delaware model, also including a number of innovative features.
   - English Limited Partnerships—Tax transparent for UK-tax purposes (for capital gains distributed to LP, as well as carried interest distributed to carried interest holders), it is one of the most commonly used vehicles in Europe, even by non-UK sponsors, and is also used by non-EU sponsors. Additional benefit for carried interest holders is that, on top of the beneficial treatment of carried interest (taxed with capital gains tax instead of income tax), they also "inherit" part of the base cost of the LPs (called "base-cost shift"), thus further reducing the capital gains tax liability of these carried interest holders.
   - Scottish Limited Partnerships—While still tax transparent, unlike the English Limited Partnership, this vehicle has a separate legal personality, discussed in more detail in Chapter 11. That distinction makes it more suitable for fund of funds (FoFs) and carried interest vehicles.
   - Jersey & Guernsey Limited Partnerships—These vehicles are the offshore equivalent of the UK limited partnerships with flexibility around the separate legal personality mentioned above.

- Luxembourg FCP *(fond commun de placements)*—As one of the few Luxembourg private equity regulatory regimes, this vehicle is a popular European fund vehicle, particularly for property funds. With no legal personality, represented by its management company, this vehicle is not a distinct corporate entity but a co-ownership of assets established by a contract.
- Dutch CV *(commanditaire vennootschap)* Dutch Limited Partnership—This vehicle is often used alongside English Limited Partners or Luxembourg FCP, rather than as a primary fund vehicle. They can be used to accommodate Dutch LPs that sometimes require a separate parallel fund vehicle structured so as to avoid classification as a "corporation" for Dutch tax purposes, which would potentially lead to adverse tax effect.
- Dutch FGR *(fonds voor gemene rekening)* Dutch mutual fund—An alternative way of structuring a fund (usually used for parallel or feeder vehicles), this vehicle is a set of agreements between the investors, the fund manager, and a depository.
- French FCPR *(fonds commun de placement à risques)*—Co-ownership of securities without a separate legal personality that is transparent for French tax purposes.
- German KG *(Kommanditgesellschaft)*—A vehicle often used, among others, by German institutional investors (such as pension funds and insurance companies) restricted from investing in non-OECD (Organization for Economic Co-operation and Development) partnerships.
- Spanish FCRs *(Fondos de Capital-Riesgo)*—Separate pools of assets that are legally and beneficially owned by investors but managed by a management company. The main characteristics of this vehicle are the lack of legal personality, limited liability, no tax transparency, and regulated status.

2. **Taxable corporate fund vehicles.** The most popular ones in Europe follow:
   - Luxembourg taxable corporates—There are a number of Luxembourg corporate fund vehicles that qualify for the Lux 'Soparfi' investment regime:
     - SA *(société anonyme)*—Joint stock company or public limited company.
     - Luxembourg SarL *(société à responsabilité limitée)*—A private limited company that is not generally used as a fund vehicle, but more often used at the SPV level.
     - SCA *(société en commandite par actions)*—The closest Luxembourg corporate equivalent to the limited partnership.

- SICAR *(société d'investissement en capital à risque)*—An investment regime rather than a legal form (unlike the aforementioned SA, SarL, and SCA, which are legal forms). SICARs may be set up in various legal forms.

■ Dutch taxable entities:

- BV (*besloten vennootschap met beperkte aansprakelijkheid*)—The BV is required by law to have a "blocking close" in their articles of association to restrict the transfer of shares; therefore, it is not suitable for listed funds.
- NV *(naamloze vennootschap)*—The Dutch NV is very similar to the BV, except for the "blocking clause" that makes them more suitable for listed fund vehicles. The BV and the NV are treated in the same way for Dutch tax purposes.
- Dutch cooperative *(coöperatie)*—This vehicle could be used for fund vehicles, holding companies, and structured finance vehicles. It is popular due to its favorable tax treatment.

■ German GmbH—A limited liability company.

3. **Tax-exempt corporate fund vehicles.** Some are listed here:

■ Luxembourg SICAV (*société d'investissement à* capital variable, or "investment company with variable capital") and SICAF (*société d'investissement à capital fixe, or "investment company with fixed capital"*).

■ Dutch VBI *(vrijgestelde beleggingsinstelling)*—Exempt investment institution regime. These also may be set up in different legal forms (Dutch open mutual fund/open FGR, NV, or other similar European EU entity or entity from a Dutch tax treaty jurisdiction).

I will not elaborate on each of these vehicles. The purpose of this chapter is to put the private equity structures in the context of their accounting implication, not to explain the legal and tax implications. Some legal and tax aspects are mentioned, however, where relevant to the topic discussed.

This chapter focuses on the limited partnership as the preferred legal form for private equity funds, whether an English, Delaware, or Cayman limited partnership, or one set up in another jurisdiction. Therefore, unless stated otherwise, the discussions on accounting and reporting deal with a limited partnership structure in mind.

Domiciliation: Where to Form the Fund—Onshore or Offshore?

In addition to the legal form, the sponsor, with the help of legal and tax advisers, needs to decide on the jurisdiction where the fund will be domiciled. Of particular consideration is whether it will be in an onshore or offshore jurisdiction.

Simple or Complex?

Some lawyers say that it's best to keep it simple, with as few jurisdictions as possible, but that rarely works. Tailored solutions can be provided according to the specific circumstances of each sponsor, their investor base, and underlying assets.

A Plain-Vanilla Private Equity Structure

Starting with the basic private equity structure in its simplest form is the plain-vanilla private equity structure in Figure 1.1 and Figure 1.2. These structures form the basis for understanding private equity structures in general. Even if your structure is complex because of your specific circumstances and structuring considerations, as long as you understand these structures, you should be able to follow along with more complex structures covered later in the chapter that use a combination of vehicles.

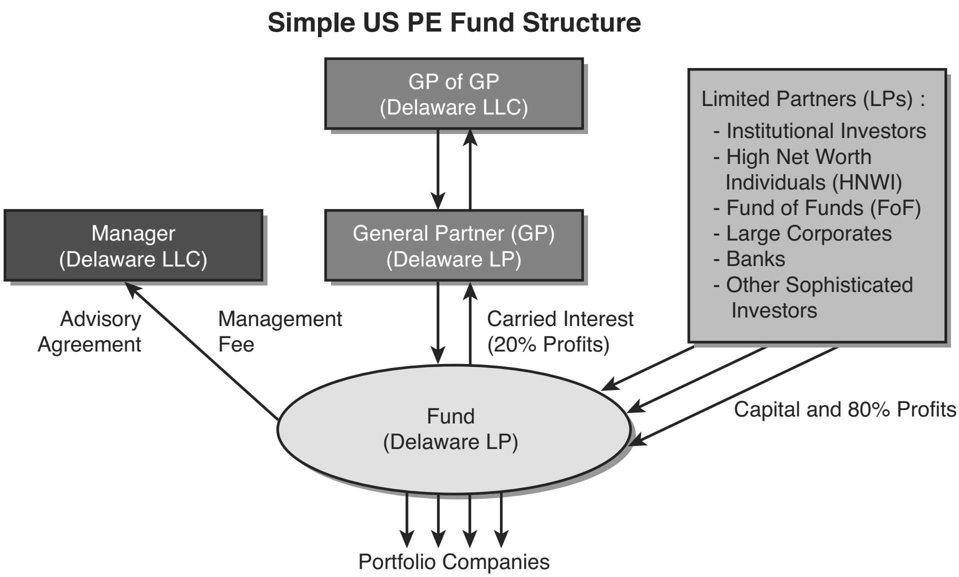

Figure 1.1 Simple U.S. PE fund structure

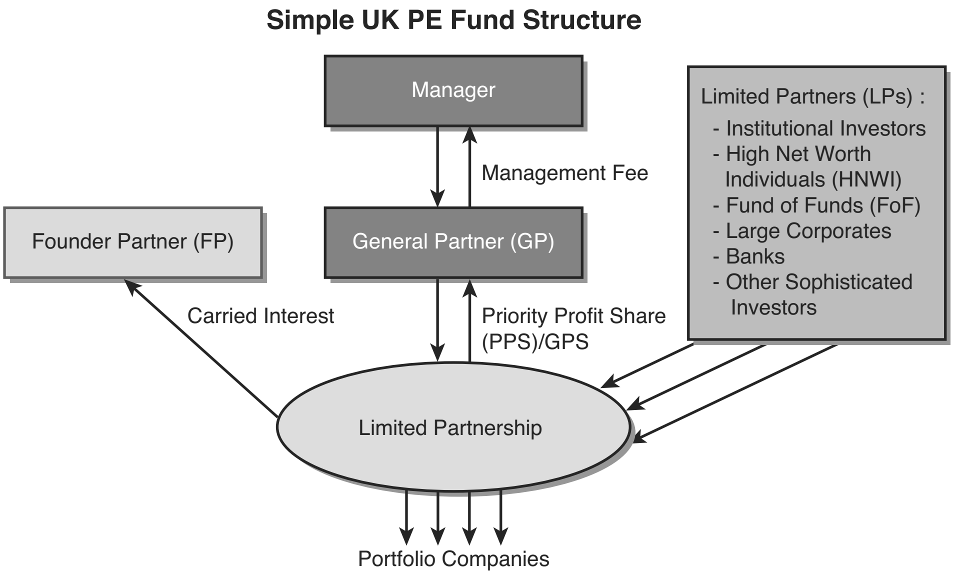

Figure 1.2 Simple UK PE fund structure

Using a Combination of Vehicles

Why would you want to use a complicated structure instead of having just one fund vehicle?

The reason for using a combination of vehicles is to cater to particular investor groups with specific tax and/or regulatory requirements that cannot be accommodated through the main fund.

For instance, assume that for the majority of your investors a common low partnership (e.g., English Limited Partnership) would work perfectly—it is tax efficient, and the investors are familiar and comfortable with this vehicle. However, there are, for example, two groups of investors, each one facing similar (within the group, but different to the other group) challenges, for which the main fund—the English Limited Partnership—is not an efficient (for tax, regulatory, or other reasons) vehicle. What do we do?

In this case, in order to attract these investors, the sponsor will have to come up with a more desirable vehicle—in fact, two additional vehicles to deal with each group of investor needs, basically creating a combination of vehicles.

To summarize, using a combination of vehicles offers the following advantage:

- Allows the sponsor to cater for different investor requirements

However, it also represents the following challenges:

- Increased complexity, which would require additional resources and skills to understand and administer the structure
- Need to rebalance among the fund entities upon subsequent closings (valid for parallel funds)
- Need to divide costs between the fund entities (also valid for parallel funds)
- Additional cost—each legal entity would involve additional cost to set up and maintain the structure

There are basically two main ways to go about the more complex structure:

- Using a master-feeder structure; or
- Using a parallel structure

Master-Feeder Funds

A master-feeder structure is a subordinated structure in which investors invest through a feeder fund(s), which then invests in the master fund. (Often direct investors invest directly in the master fund as well, as in Figure 1.3). The master fund performs all the investment-related activities; the original drawdown and distribution activities take place at the feeder level and then are passed on to the master fund, except for any direct investors who invest directly in the master fund (see Figure 1.3).

Management fees typically are charged at the master fund level. At the feeder fund level, usually only a symbolic fixed absolute amount (e.g., US$1,000) is charged. The main expense for the management fee charged to the master fund is passed on to the feeder fund through the net asset value (NAV) allocated to the relevant feeder by the master fund.

For many investors, investing directly in a fund that is a common law partnership (such as an English Limited Partnership) might be tax-efficient (and regulatory-efficient). Let's call these investors "direct investors." However, for another group of investors, that might not be the most efficient way. To address the tax/regulatory issues specific to that group of investors (for example, Dutch investors), the sponsor might need to set up a feeder vehicle/fund (such as a Dutch CV). Doing so would make investing in the master fund through a feeder more attractive to that particular group of investors—in this case, Dutch investors who need to avoid classification as a "corporation" for Dutch tax purposes, which would lead to adverse tax consequences.

Some sponsors and lawyers organize funds with multiple partnerships for reasons other than tax. For instance, they might want to keep all U.S. investors or all Employee Retirement Income Security Act (ERISA) investors in a separate partnership, to insulate non-U.S. investors from perceived adverse U.S. taxation, ERISA, or litigation risks.

Bottom line: Reasons differ, and lawyers can come up with different solutions depending on your specific circumstances.

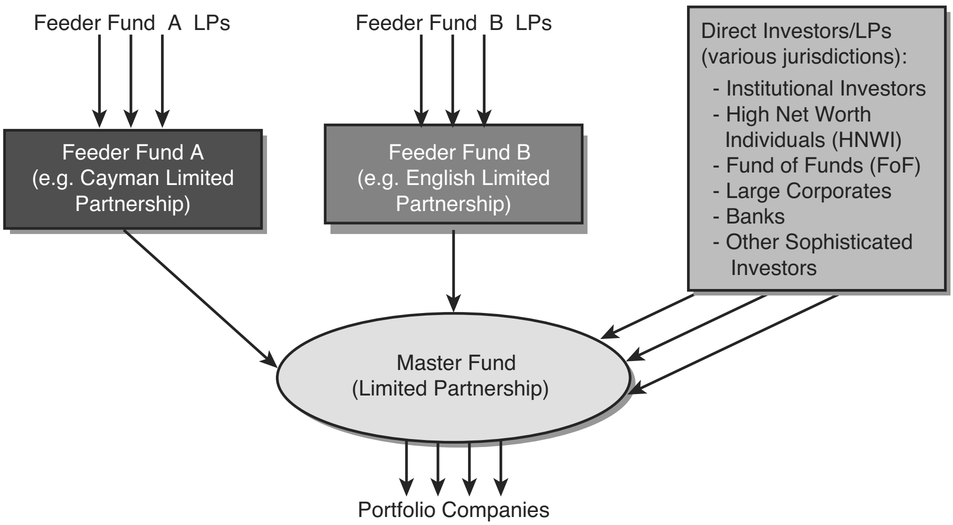

Figure 1.3 Master-feeder structure

Another alternative (see Figure 1.3) is to organize a fund with a main fund vehicle being a common law partnership, for flexibility and familiarity to investors (and sponsors), and to form feeders (as many as you need) or parallel vehicles to cater to major investor groups with specific tax or regulatory (or any other) requirements that investment in the common law partnership cannot accommodate.

You also might have one onshore feeder (such as a Delaware Limited Partnership or an English Limited Partnership) and another offshore feeder (such as a Cayman Exempt Limited Partnership or a Guernsey/Jersey Limited Partnership, respectively).

A master-feeder structure, as described by the International Accounting Standards Board (IASB), is often a common way for both foreign and domestic investors to invest in one central portfolio of underlying investments with different tax benefits, depending on whether an investor is invested in an onshore or offshore feeder fund. As IASB continues, from an accounting perspective, *the master fund and the feeder funds together could be viewed economically as one investment company.*

From an accounting perspective, the feeders are just another LP investing in the main/master fund. Therefore, the accounting for the feeder should be similar to an FoF—that is, taking an allocation of the NAV of the main/master fund.

From the master fund's perspective, the feeder is just another LP. Therefore, they should be treated like the other direct investors/LP by providing them with a quarterly report and capital account that includes their relevant allocation of the master fund's NAV. However, depending on the accounting framework/GAAP (Generally Accepted Accounting Principles), some specific requirements might apply.

For instance, under U.S. GAAP, a feeder fund is required to separately present its allocated share of the master fund's net investment income and realized and unrealized gains and losses in its financial statements. In addition, for investment companies regulated by the 1940 Act, each feeder fund is required to present a complete set of the master's financial statements along with its financial statements. This requirement is optional for unregulated investment companies.

Under International Financial Reporting Standards (IRFS), IASB has taken a slightly different view on that.

Structures Involving Blockers

Another type of structure that can also be viewed as an FoF structure for accounting purposes. In this case, an investment company invests in a blocker entity.

Some sponsors insert a "blocker" or "stopper" fund to change the character of the underlying income or asset (or both), primarily to address entity qualification criteria under tax, regulatory, or legal guidelines. Inserting a blocker fund converts "bad" assets and income into "good" assets and income (a dividend instead of a distribution from a limited partnership), allowing the investment company to maintain its status or to achieve a more beneficial tax outcome.

Parallel Structures

A number of different situations might give rise to the need to use parallel structures. One of the most common situations, for example, is where taxpaying and tax-exempt U.S. investors require the partnership through which they invest to make different elections for U.S. tax purposes. U.S. tax-exempt investors who do not want to have unrelated business taxable income (UBTI)—as they might be liable for tax on its UBTI and required to file certain tax returns—would typically require that their partnership elects to be treated as a corporation or hold investments through a corporation, and U.S. taxpaying investors would typically want their partnership to be treated as a tax transparent entity/partnership.

Although parallel structures are used most often for tax reasons, sometimes sponsors also use them to place different categories of investors into different vehicles for other than tax reasons. For instance, large investors paying reduced management fee/priority profit share (PPS) might be placed in one partnership while all the other investors who pay headline management fee rates are placed in a separate one.

Many examples (and as many reasons) prompt a sponsor to use a different parallel structure, and the aforementioned ones are just a few of them.

For reporting purposes, all parallel partnerships can be viewed as one partnership/entity because, if these reasons did not apply, the sponsor would have simply set up just one fund or vehicle. The reporting for parallel funds often reflects that by presenting a set of aggregated accounts in addition to the individual sets of accounts for each parallel vehicle. Under U.S. GAAP that is acceptable, but bear in mind that some auditors may challenge this concept under IFRS.

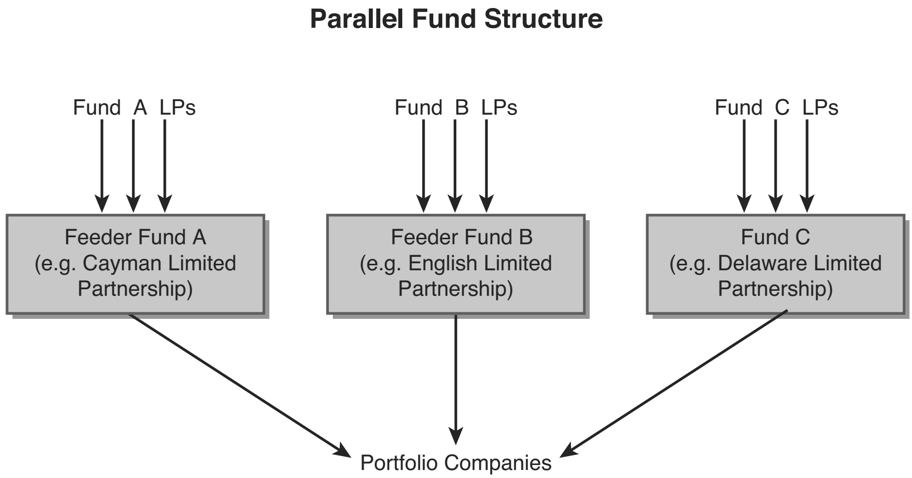

Figure 1.4 Parallel structure

Master-Feeder or Parallel Structure?

Although sometimes the same goals may be achieved by using either master-feeder or parallel structure—for example, to resolve the issue with the different tax elections mentioned earlier—sometimes there may be advantages to a master-feeder structure compared with a parallel structure.

For instance, a master-feeder structure can be used if an investor in the master fund cannot, due to internal rules or otherwise, make up more than a certain percentage (e.g., 5%) of the vehicle he is participating in due to the fact that all the investors participate (directly or indirectly) in the master fund. If you are to use a parallel fund instead, the percentage of that investor who participates through a feeder fund may go over the restricted percentage.

Another example is when you have U.S. ERISA investors and the sponsor is relying on the so-called “25% limit exemption” from the master fund constituting “plan assets,” which requires that the aggregate amount of investment in the master fund subject to ERISA is less than 25%. Under a master-feeder structure, all the investors in the feeders count as investors in the master fund, which would not be the case with a parallel structure. In addition, if the business of the feeder fund is limited to investing in the master fund, you can claim that there is no investment discretion exercised by the manager/GP with respect to the feeder fund.

Alternative Private Equity Structures

Although they are still the norm, the traditional blind-pool/committed-capital fund structure has been challenged by the harsh fundraising climate. New alternative solutions and new fund terms are appearing. Some of these structures, such as the managed accounts and pledged funds, are not really new—they just haven't been traditionally used by private equity. Some lawyers refer to some new structures with significantly modified fund terms as fund-lite structures because they are significantly simpler/lighter than the typical traditional blind-pool fund. Investors who want more flexibility, more liquidity, shorter fund life, transparency, or a more hands-on approach to PE investments like these structures. Some of these fund-lite structures are briefly outlined here, in case you are having difficulties raising a traditional PE fund or if your LPs are challenging the traditional blind-pool fund structure:

- **Deal-by-deal structure—**The vehicle is set up for one or more specific deals, and a "sponsorless GP" raises money for each deal.
- **Pledged funds—**Investors have not contractually committed to invest but have "pledged" (through a participation agreement) certain money to invest in specific deals as they choose from time to time. A formal fund structure – separate limited partnership is set up for each investment, and every time a new investment is found, the manager offers to the investors the opportunity to invest in that deal.
- **Managed accounts—**This is not a formal fund structure, but rather a segregated portfolio of assets owned directly by the investor. It offers the investors greater liquidity, and the scope of the account could be tailored to meet individual investor requirements.
- **Combined ("combo") funds—**A combination of vehicles (for example, a traditional committed-capital fund and a pledged fund), i.e., partly committed and partly pledged.
- **Annual programs—**Investors commit capital on an annual basis, and they are free to recommit at the end of the term or pull their commitment.
- **Investment clubs—**They are more informal than structured funds, and the fees are for the "membership" of the club and on closing a transaction. It's more common in angel investing but is moving into other markets.
- **Co-investments—**They are becoming increasingly popular and are usually provided to special investors to sweeten their investment in the main fund by providing more beneficial conditions and/or allow investments on a deal-by-deal basis to boost investors' returns.

- **Fund lites—**It is usually a single-investment fund that retains the hallmark structure of a blind-pull fund, but with typically shorter term (5 to 7 years) and reduced fees; they usually have one or only a few limited investments held in them. They help first-time GPs gain a track record and help established managers bridge between fundraises or invest outside of their funds' policies.

Other key differences, compared to a traditional PE fund, are shorter life, reduced scope of investment objective, reduced fees (on committed capital only), deal-by-deal carry, and more transparency, among other solutions lawyers are trying to bring to PE clients.

Summary

The private equity world, as we know it, is changing as a result of the post-financial crisis. But regardless of the structure, fund accountants need to be able to understand it and see behind it so that they can provide accurate accounting and adequate reporting to suit the needs of the main users of the financial statements: the LPs.

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