STRUCTURING BUYOUTS FOR "RECAP" ACCOUNTING — MAXIMIZING TARGET'S POST-ACQUISITION BOOK EARNINGS AND IPO VALUE

KIRKLAND & ELLIS

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SEVERAL YEARS AFTER A PRIVATE EQUITY ("PE") FUND HAS ACQUIRED TARGET IN A BUYOUT (AN "LBO"), PE FUND WILL OFTEN TURN TO THE PUBLIC EQUITY MARKETS to sell its Target stock. Because the price of Target's shares in a public offering is often based on a multiple of Target's book earnings, the typical PE fund is paying increasing attention to the accounting implications of its initial acquisition of Target. This article explores ways to structure PE fund's LBO of Target in order to obtain the benefits of recapitalization or "recap" accounting, increasing Target's post-acquisition book earnings and, hopefully, its ultimate IPO value.

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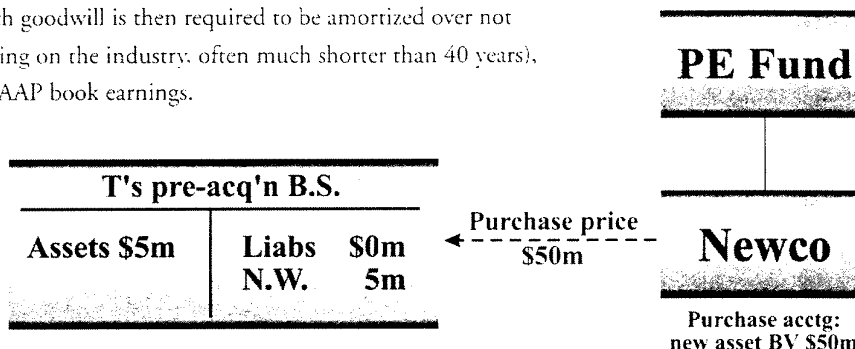
Where PE fund simply forms Newco to acquire Target in an LBO, generally accepted accounting principles ("GAAP") purchase accounting rules generally require Target's assets to take a new aggregate book value equal to the amount paid by Newco to acquire Target *plus* Target liabilities assumed *plus* expenses of the acquisition. This new aggregate book value is then allocated first to Target's current assets at fair value ("FV"), second to Target's fixed assets at FV, next to Target's specific intangibles at FV, and the residual to Target's goodwill. Such goodwill is then required to be amortized over not more than 40 years (and depending on the industry, often much shorter than 40 years), thus reducing Newco/Target's GAAP book earnings.



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These GAAP purchase accounting rules apply regardless of whether the acquisition transaction is structured as an asset purchase, stock purchase, or merger. Hence even when the acquisition has been structured for tax purposes to achieve carryover asset tax basis ("COB") (e.g., a stock purchase with no Code §338 election), so that Newco has no tax savings from a stepped-up asset tax basis ("SUB"), the GAAP purchase accounting rules require increased book depreciation/amortization.[2] If Newco/Target were subsequently to go public or be acquired by a public company which was concerned about earnings per share dilution, such GAAP purchase accounting would decrease Newco/Target's valuation.

Pooling accounting — under which Target's old asset book value simply carries over with no increase in post-acquisition GAAP depreciation and amortization — would apply only if roughly 90% or more of the consideration for the acquisition of Target common stock and common stock equivalents consists of Newco voting common stock and numerous other arbitrary pooling requirements are satisfied. In an LBO, the predominant consideration paid to Target's shareholders is almost invariably cash and hence the 90%-Newco-voting-common-stock requirement can not be met.[3]

However, where PE fund's LBO of Target is structured for recap accounting, a pooling-like result is obtained — i.e., there is no change in Target's asset book value, no additional goodwill is created, and hence Target's post-acquisition book earnings are not reduced for goodwill amortization.

Where Target's new owners plan ultimately to take Target public, qualifying for recap accounting and avoiding full or partial purchase accounting may yield substantial benefits. Because Target's assets are not written up for GAAP accounting purposes in connection with a recap LBO, Target's future GAAP depreciation and amortization charges will be lower, and hence Target's future book earnings higher, than if purchase accounting had applied. Because the price of Target's shares in a public offering often is based on a multiple of Target's per share book earnings, the use of recap accounting may allow Target's new owners to realize greater proceeds in a future public offering of Target's shares.

A. Overview of Recap Accounting[4]

Even where an LBO results in a change of control for Target, recap accounting—and not purchase accounting—will generally apply to Target so long as Target survives and Target's old shareholders continue to own a "significant" stake in recapitalized Target's common equity. Generally, where Target's old shareholders as a group own more than 20% of recapitalized Target's common equity, the significant continuing stake test is satisfied. Where this group owns 5% or less, the test is not satisfied, so that purchase accounting applies. Where this group owns more than 5% but not more than 20%, the transaction is in a gray zone, so that the result turns on factors such as the number and type of old Target shareholders with a continuing interest in Target's common equity.

- In the event that the continuing interest in Target's stock held by old Target shareholders is "widely-held," accounting firms and SEC appear to be comfortable with continuing ownership as low as 5.5% to 7%.

- Where the continuing interest in Target's stock held by old Target shareholders is not "widely-held," but the continuing old Target shareholders are not part of Target's post- transaction management, at least some accounting firms appear to be comfortable with continuing ownership as low as 5.5% to 7%.

2 See Ginsburg & Levin, *Mergers, Acquisitions, and Buyouts*, §1503.3 (Aspen Law and Business, March 1998) ("Ginsburg & Levin") for a discussion of purchase accounting. See Ginsburg & Levin, §§1503.7.2, 3, and 4 for a discussion of partial purchase accounting, applicable where, for example, Newco acquires less than 100% of Target.

3 See Ginsburg & Levin, §§1503.2 and 1503.5 for a discussion of pooling accounting.

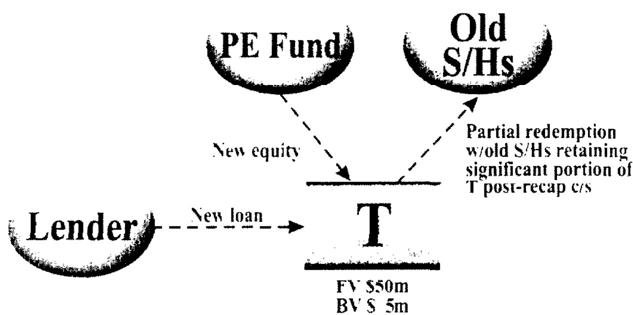
4 For a more extensive discussion of recap accounting, with examples, see Ginsburg & Levin, §1503.7.6

- However, where the only continuing old Target shareholders are part of Target's post-transaction management, 7% to 10% continuing ownership appears to be the minimum, since management is viewed as being less independent of the new investors due to their employment relationship (and in certain cases, accounting firms have sought a somewhat larger continuing stake).

See B below for a further discussion of the continuing interest in Target which must be retained by old Target shareholders.

In the typical transaction qualifying for recap accounting (a) a group of new shareholders invests new money in Target for new stock (common and/or preferred) without forming a new holding corporation for Target, (b) Target borrows additional money, (c) Target uses its new equity money and its new debt financing to redeem a portion of its outstanding stock, and (d) after the transaction Target's old shareholders continue to own a significant stake in recapitalized Target's common equity.

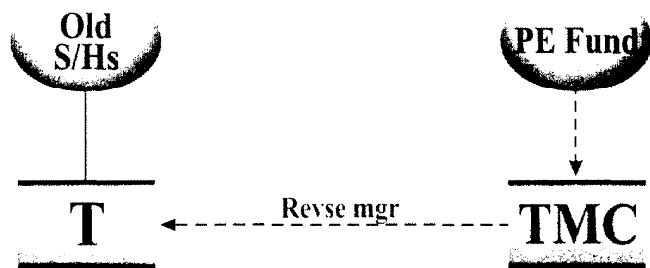
However, it is not essential that the new shareholders invest their new money in Target. The transaction can qualify for recap accounting where the new shareholders pay their new money directly to Target's old shareholders to purchase previously outstanding Target stock, so long as after the transaction Target survives and Target's old shareholders continue to own a significant stake in Target's common equity.



Where Target qualifies for recap accounting, the book value of Target's assets does not change at all (i.e., there is no purchase accounting or partial purchase accounting). Thus, Target's future depreciation and amortization *charges are not increased as a result of the buyout* (as they would have been if purchase accounting had applied) and Target's book earnings will be correspondingly higher.

Target's book net worth changes to reflect (a) an increase for any new equity investment and (b) a decrease for amounts paid out in the redemption. Hence Target's book net worth generally declines by the excess of (i) the amount Target paid out in the redemption of Target's old stock over (ii) the amount Target received for new Target stock. This may, in some cases, cause Target to have a negative book net worth.

Use of Transitory MergerCo. In some LBOs the new shareholders form a transitory new entity ("Transitory MergerCo" or "TMC") for purposes of merging Transitory MergerCo into Target and forcing Target's shareholders to accept the consideration specified in the merger agreement in exchange for their Target stock.

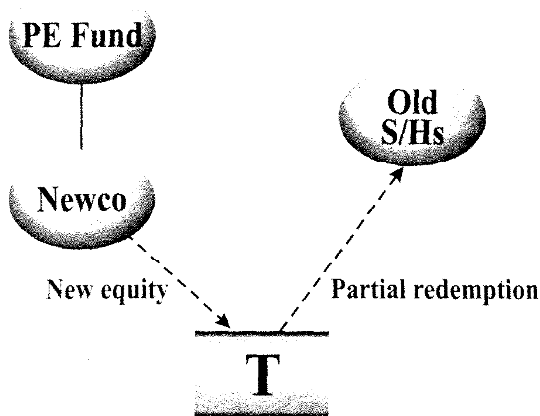


Despite the formation of Transitory MergerCo, the transaction can still qualify for recap accounting, although for extremely murky reasons accountants apparently take the position that recap accounting will not apply if the amount of money flowing through Transitory MergerCo to Target's old shareholders is more than 50% of Target's pre-merger stock FV, i.e., where, in accounting parlance, the merger transaction results in a change of Target's control.

Thus, recap accounting is apparently precluded where a substantial portion of the money flowing to Target's old shareholders (more than 50% of Target's pre-merger stock FV) is funded into Transitory MergerCo (by the new shareholders and lenders). On the other hand, recap

accounting is apparently not precluded where all or a sufficient portion of the money for Target's old shareholders is funded directly into Target (by the new shareholders and lenders), i.e., not funded through Transitory MergerCo, so that the cash they receive from Transitory MergerCo constitutes 50% or less of their pre-merger Target stock FV. In the latter situation, returning once again to accounting parlance, the merger transaction (meaning the money flowing through Transitory MergerCo) did not result in a change of Target's control, rather the money funded directly into Target (without passing through Transitory MergerCo) caused the change in Target's control.

Use of Newco. A transaction may qualify for recap accounting at the Target level even where the new shareholders form a Newco to hold their Target stock. As noted in C below, recap accounting would not, however, apply at the Newco level.



If such a Newco is formed, it will frequently be a partnership or LLC (i.e., a flow-through entity for tax purposes) so that (a) Newco can be dissolved tax free or (b) if Newco has not previously dissolved, there will be no federal income tax at the Newco level when Newco sells its Target stock (e.g.) to the public.

Newco should in most cases not be formed as a corporation because (i) Newco will be subject to corporate-level tax on its gain from selling Target stock (e.g.) to the public and (ii) a sale of Newco stock to the public (which would avoid Newco corporate-level tax on Newco's gain in its Target stock) would not benefit from recap accounting because Newco is required to use purchase accounting at the Newco level for its interest in Target.

If Newco is formed as a corporation, an upstream or downstream merger of Newco and Target would eliminate Newco corporate-level tax on Newco's gain in its Target stock. However, such a merger would also eliminate the benefits of recap accounting (even where the merger occurs after Target goes public). If Newco owns more than 50% of Target's common stock and Newco and Target subsequently merge (either upstream or downstream), the merger would result in Newco being viewed as the surviving entity for accounting purposes, regardless of the legal form of the merger (i.e., even if Target was the surviving entity). Accordingly, Newco's higher accounting basis in its percentage interest in Target would survive, effectively forcing push-down purchase accounting on Target.[5]

In contrast, if Newco is formed as a corporation and is later eliminated in a downstream "C" or "D" reorganization (not carried out under a state law merger statute),[6] Target should continue to qualify for recap accounting because accountants generally view a downstream "C" or "D" reorganization as a mere dissolution of Newco (since Newco is dissolved for state corporate law purposes after exchanging its assets (i.e., the Target stock) for new Target stock, even though for income tax purposes, a downstream "C" or "D" reorganization is treated as a tax-free combination of Target and Newco). The ability to eliminate Newco in a downstream "C" or "D" reorganization may allow the use of a corporate Newco in a recapitalization of Target (e.g., where Newco is formed as a corporation in order to make a Code §338(h)(10) election for Target —so long as Newco is not eliminated too quickly after the LBO) without (i) adverse effect on Target's recap

5 Furthermore, it is possible that the interest formerly held by Target's minority shareholders would be revalued using purchase accounting rules at the time of the merger (i.e., treated as if the minority interest were purchased by Newco).

6 See Code §368(a)(1)(C) and (D).

accounting or (ii) the imposition of corporate-level tax on Newco's gain in its Target stock. See H below for a discussion of the use of a Newco formed as a corporation to obtain Target asset SUB in certain situations.

B. Nature of Old Target Shareholder Retained Equity Interest

As described above, recap accounting may apply even if Target's old shareholders do not own (after the LBO) more than 20% of Target's common equity, but rather in some cases may apply even if they own slightly more than 5%, with qualification for recap accounting where the old Target shareholders' ownership is in the gray zone (more than 5% but not more than 20%) presenting a factual issue.

Measurement of old Target shareholders' continuing common equity in Target is generally made on a fully diluted basis, so that the test is failed where the new Target shareholders receive warrants or convertibles at the time of the transaction (or later, but prior to Target's becoming a public company — see E below), which would, if exercised, dilute Target's old shareholders below the level of a significant stake.

Target Voting Common Stock. In determining whether Target's old shareholders have retained the requisite continuing common equity in Target (i.e., in applying the more-than-5%-to-20%-continuing-common-equity test), the principal measurement is the percentage of Target's post-recapitalization voting common equity owned by Target's old shareholders on account of their ownership of Target's pre-recapitalization common equity.

Although the written rules are silent, other types of voting stock with common-like features should logically count toward the requisite retained equity interest including, for example, voting participating preferred stock with common-like participation features (particularly where preferred and common stock have been amalgamated into one instrument). Voting convertible preferred stock may also count. However, there is little indication of SEC's view on these types of stock.

Target Stock Options. The treatment of unexercised vested options held by old Target shareholders—both pre-recapitalization and post-recapitalization—is unclear, i.e., it is not clear whether unexercised vested options held by old Target shareholders before the recapitalization or held by old Target shareholders after the recapitalization or held at both times can be counted to create the more than 5% to 20% requisite continuing common equity.

However, if old Target shareholders exercise their previously held vested options before the recapitalization transaction, the stock they receive on exercise can be counted toward the requisite continuing common equity if it is retained as Target stub common stock. Accountants believe it unlikely that newly purchased Target common stock (retained as Target stub common stock) may be counted if it is purchased pursuant to unvested options that are vested in anticipation of the transaction or pursuant to new options granted in anticipation of the transaction.

Newly Purchased Target Stock. Additional Target shares purchased as part of the recapitalization transaction by an old Target shareholder may constitute a favorable factor for determining qualification for recapitalization accounting where the level of continuing common ownership is in the more than 5% but not more than 20% gray zone. Most accountants, however, recommend against relying on such purchased equity in order to reach the desired threshold of retained ownership.

Where an old Target common shareholder is paid in cash for his old Target stock but as part of the recap transaction simultaneously reinvests all or a portion of the proceeds in new Target shares, logic would suggest that such new Target shares (up to the percentage of Target's post-recap common shares such old Target shareholder would have retained if his old Target common shares had not been paid off in cash in the recapitalization) should be counted as continuing common equity. However, it is not clear whether this result will be accepted by accountants and the SEC, since the reinvestment by an old Target common shareholder may be viewed as a separate investment decision rather than as a continuing common equity interest, thereby precluding recap accounting treatment.

Restrictions on Retained Equity Interest. If the old Target shareholders' continuing equity interest in Target is

subject to significant restrictions (e.g., imposed under a shareholders' agreement, call option, etc.) which tend to eliminate the old Target shareholders' ability either to control their continuing stake or to realize the economic benefits and burdens of its ownership, it is possible that the old Target shareholders' retained equity will not count toward the common ownership threshold needed for recap accounting.

Value of Retained Equity Interest. If the value of recapitalized Target's common stock is reduced by leverage (i.e., where Target issues Target debt or Target debt-like preferred stock to fund redemptions of Target stock), old Target shareholders who retain a stub percentage of common equity in Target do not have to leave behind a similar percentage of their consideration. Thus, for example, a 1% or 2% stake in pre-recap Target could be worth 10% - 15% of post-recap Target.

As an economic matter, however, new investors may insist that old Target shareholders retain a strip of Target securities, including both less desirable (i.e., lower potential return) subordinated debt or debt-like preferred stock and more desirable (i.e., higher potential return) "cheap" common stock. See H below for a discussion of the possibility that the receipt of Target preferred stock in exchange for Target common stock will be taxable boot.

C. Effect of Recap Accounting on Newco's Financial Statements

Where a change in Target's stock ownership qualifies for recap accounting but one of Target's new shareholders is an entity (e.g., Newco formed by PE fund to acquire its interest in Target) owning sufficient Target stock so that Newco must account for its Target stock investment on the equity method of accounting (generally where Newco owns 20% or more of Target's voting power) or on the consolidated method of accounting (generally where Newco owns more than 50% of Target's voting power), Newco must use purchase accounting principles in preparing its financial statements, even though Target can use recap accounting in preparing its own separate financial statements. Thus, even where Target qualifies for recap accounting and hence no goodwill is created on Target's financial statements, Newco (which owns 20% or more of Target's voting power) in calculating Newco's net income must amortize goodwill arising out of Newco's purchase of Target stock.

D. Uncertainty in Recap Accounting Rules

The guidelines used to determine whether Target qualifies for recap accounting are based on the rules prescribed by the SEC staff in determining whether Target must apply push down purchase accounting, i.e., where a recapitalization of Target results in such a substantial change in Target's ownership that push down purchase accounting would apply to Target, recap accounting will not apply to Target.

Determining whether a transaction qualifies for recap accounting is not without complexities. Recap accounting rules are not extensively—in truth are only minimally—spelled out in SEC staff rules. Thus, application to varying circumstances is necessarily subject to substantial judgment and accounting firms at times disagree on the rules' application to specific circumstances. The SEC staff generally dislikes recap accounting. Hence, the SEC staff will generally examine Target's recap accounting when Target goes public and may challenge Target's previous use of recap accounting for its earlier LBO.

Moreover, there is risk SEC might in the future limit or eliminate recap accounting altogether. Such a change could be effective for a Target that was not public at the time of the change, even though a previous acquisition of Target (completed before the change) was structured to obtain recap accounting.

Although not entirely clear, it is likely that Target's public offering of debt will "lock-in" Target's recap accounting so that a later change in SEC policy should not require Target to use purchase accounting for its earlier LBO, even if Target has not yet had a public stock offering.

E. Effect of Post-LBO Events on Recap Accounting

If, after an LBO of Target structured to achieve recap accounting but before Target becomes public, Target or the new investors purchase all or part of the old Target shareholders' continuing equity stake, so that the old

Target shareholders cease to have a significant continuing equity stake in Target, Target will be required to use purchase accounting, i.e., Target's earlier recap will be disqualified. This is true even if the purchase from old Target shareholders occurs a number of years after the LBO and is not part of a plan in existence at the time of the LBO.

In contrast, purchase accounting should not be required if the old Target shareholders sell all or a portion of their continuing equity stake in Target to buyers other than Target or the new investors who led the LBO (or certain persons considered to be closely associated with Target or the new investors).

If, after the LBO but before Target becomes public, Target issues additional stock or options that dilute the old Target shareholders' continuing equity stake so that it is no longer significant, Target may be required to use purchase accounting if the additional stock or options are issued to the new investors that led the LBO (or to certain persons closely associated with Target or the new investors).

Once Target becomes public (with either publicly traded equity or publicly traded debt), subsequent events should not eliminate Target's ability to use recap accounting for the LBO.

F. Structuring to Obtain Recap Accounting Where Target's Shareholders are Numerous or Recalcitrant

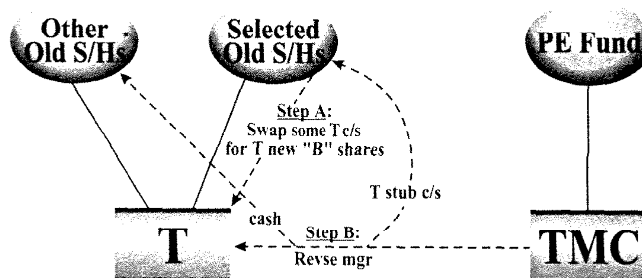
Where Target's shareholders are numerous or recalcitrant so that a redemption of Target shares can not be accomplished consensually, a transaction qualifying for recap accounting can nevertheless be structured as outlined below.

Pro-Rata Recap with Forced Merger. Where Target's shareholders are numerous or recalcitrant and all of Target's shareholders are to be treated identically, a recap can be accomplished through a merger of Transitory MergerCo into Target in which the merger consideration to Target's shareholders is cash and stub shares in recapitalized Target.

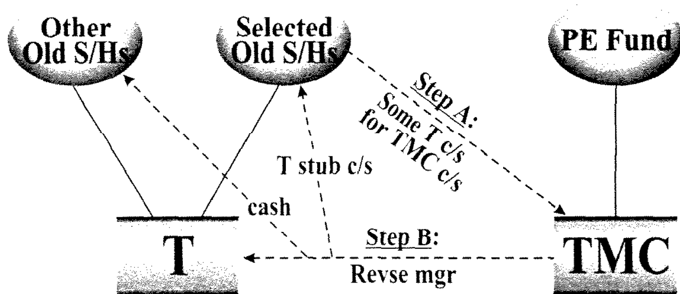
As an alternative, the old Target shareholders can be given the option to elect to take stub shares in recapitalized Target or to take cash. However, if an insufficient number of old Target shareholders elect to take stub shares, other Target shareholders must take stub shares in recapitalized Target in the amount necessary to qualify for recap accounting treatment. And if too many old Target shareholders elect to take Target stub shares, a proration mechanism must be in place to apportion the Target stub shares among the old Target shareholders electing continuing Target stock.

Non-Pro-Rata Recap. In many circumstances, the new investors desire only certain of Target's old shareholders to continue as shareholders in recapitalized Target (e.g., Target management). In the event that this cannot be accomplished by a consensual non-pro-rata redemption, there are alternative methods to accomplish this objective.

- **Alternative #1 — The front-end Target recapitalization.** Target's shareholders vote to authorize a new class of equity securities (the "New Class") which are issued in a voluntary stock swap to those old Target shareholders (in exchange for a portion of their old Target common stock) who are to retain Target stub common shares. Immediately thereafter, Transitory MergerCo merges into Target, with the holders of the New Class receiving Target stub common stock and the remaining old Target shareholders receiving cash. An old Target shareholder who is to receive part cash and part Target stub common stock exchanges only a portion of his or her old Target common stock for the New Class (i.e., makes such exchange only to the extent he or she is to receive Target stub common stock).



Alternative #2 — The front-end TMC swap. An old Target shareholder who is to retain Target stub common shares contributes Target common shares to Transitory MergerCo in exchange for stock in Transitory MergerCo. Transitory MergerCo then merges into Target, with Transitory MergerCo stock being exchanged for Target stub common stock and the remaining Target stock not held by Transitory MergerCo being redeemed for cash. An old Target shareholder who is to receive part cash and part Target stub common stock exchanges only a portion of his old Target common stock for Transitory MergerCo stock (i.e., makes such exchange only to the extent he is to receive Target stub common stock).



Some accounting firms are more comfortable with Alternative #1 and others are more comfortable with Alternative #2.

Where only large shareholders of Target are to retain equity in recapitalized Target, two additional alternatives are available.

Alternative #3 — Front-end reverse stock split. Target does a reverse stock split (e.g., each 1,000 old Target shares are transformed into 1 new share), transforming smaller shareholder's stock into a fractional share which is cashed out, eliminating smaller shareholders immediately before the recapitalization.

Alternative #4 — Fractional merger exchange ratio. Transitory MergerCo merges into Target with consideration to old Target stockholders being cash and a fractional share of Target stub stock (e.g., 1/1,000 of a Target stub share), so that small Target stockholders receive a fractional stub share and are cashed out, again eliminating smaller shareholders.

In any non-pro-rata transaction, Target's board of directors must ensure that the transaction is fair to all shareholders. This may require the creation of a special independent committee of the board to negotiate and approve the transaction on behalf of minority shareholders and may require the retention of a financial advisor to advise the board or the special committee on the economic fairness of the transaction to all shareholders.

G. Recap Accounting Where Target is a Partnership or an LLC

Recap accounting may be obtained, under the rules outlined above, where Target is a partnership or LLC, if T's pre-recap equity owners (i.e., its partners or members) retain a significant continuing equity stake in T (generally by owning voting common partnership or LLC interests) after the recapitalization.

H. Tax Issues Involved in Recap Accounting

A recap structure raises several tax issues for old Target shareholders, Target, and the new investors.

Taxation of continuing old Target shareholders. Where an old Target shareholder retains a portion of his or her Target stock and has the balance redeemed by Target, he or she is entitled to capital gain ("CG") treatment on the redemption only to the extent that the redemption qualifies as an exchange under Code §302. This will generally be the case where the shareholder's percentage interest in Target declines (by both vote and value) after the recapitalization. However, if an old Target shareholder's percentage interest in Target stays the same or increases (e.g., because the shareholder receives new equity in the recapitalized Target as part of its management group), such shareholder's redemption will generally not qualify under

Code §302 for CG treatment and will instead be treated as a dividend to the extent of Target's tax earnings and profits.

In contrast, Code §302 does not apply to stock sold to a person other than Target. Thus, if the recapitalization can be structured so that the continuing shareholder sells Target stock to the new investors, such old Target shareholder should be entitled to CG treatment, even where his or her continuing percentage interest in Target stays the same or increases. So long as old Target shareholders retain the requisite amount of Target stock, the sale of stock from old Target shareholders to the new investors should not have an adverse impact on Target's ability to use recap accounting. See A above.

Where the new investors wish to hold a strip of securities different than those purchased from old Target investors, it may in some cases be necessary for the new investors to swap all or a portion of the Target stock they purchase from old Target shareholders with Target for a different class or classes of Target stock. If such swap results in Code §306 stock for the new investors, they may recognize ordinary income on redemption or sale of the Code §306 stock in some circumstances. Such a swap may also create risk IRS could recharacterize the old Target shareholders' sale to the new investors as a redemption.

Where a continuing old Target shareholder has a portion of his or her old Target stock redeemed for cash and exchanges the balance of his or her shares for shares of one or more new classes of Target stock, there is risk IRS could treat the cash redemption and the stock-for-stock exchange as one transaction, in which case the old Target shareholder would recognize (under Code §356) all of the inherent gain in his or her stock (both the stock redeemed and the stock exchanged) up to the amount of the cash received, generally resulting in the recognition of more gain than if the redemption and exchange were treated as separate transactions. This Code §356 risk is minimized where the recapitalization is structured so that the old Target shareholders merely retain a portion of their old Target stock without exchanging it for a new class of Target stock. Alternatively, if the recapitalization can be structured so that the old Target shareholder sells his or her stock to the new investors, as described above, the Code §356 risk should generally be eliminated.

The 1997 Tax Act treats "nonqualified preferred stock" ("NQ Pfd") (i.e., most redeemable debt-like preferred stock) as taxable boot in an otherwise tax-free exchange. Where new investors want old Target shareholders to roll their continuing equity stake into a "strip" of Target common stock and debt-like preferred stock which constitutes NQ Pfd, the Target NQ Pfd would be taxable boot, triggering gain on the exchange.[7] This adverse tax result can be avoided in three ways[9]:

- The Target preferred stock may be redesigned so that it has a significant stake in corporate growth (e.g., by amalgamating the Target preferred stock and Target common stock together into a single instrument) and hence will not be NQ Pfd. As noted in B above, this type of stock, if voting, should count toward a significant retained equity stake for recap accounting purposes, although the GAAP rules are not wholly clear.

- The Target preferred stock may be redesigned to be evergreen (i.e., not mandatorily redeemable, puttable, or callable) and hence will not be NQ Pfd.

- The redemption, put, or call features with respect to the Target preferred stock may be limited to ones which qualify for Code §351(g)(2)(C)(i)(I)'s death-or-disability exception or Code §351(g)(2)(C)(i)(II)'s issued-in-connection-with-services exception, so that in either case the Target preferred stock is not NQ Pfd.[8]

7 For an extensive discussion of the rules relating to NQ Pfd, see Ginsburg & Levin, §604.3.

8 See Ginsburg & Levin, §604.3.1.2 and §1313 for a discussion of these exceptions.

9 See Ginsburg & Levin, §604.3.2.

IRS regulations, when ultimately promulgated, may permit old Target shareholders to defer reporting gain attributable to the receipt of Target NQ Pfd by using the installment method, even for transactions effectuated before such regulations are promulgated.[9]

Tax SUB for Target's Assets. Recap accounting requires Target to survive with Target's old shareholders retaining a significant stake in recapitalized Target's common equity, thereby precluding an asset purchase as a means to achieve SUB for Target's assets. Such asset SUB for tax purposes can be achieved where a single corporate entity (here Newco formed by PE fund) purchases 80% or more of Target's stock by vote and by value (i.e., a qualified stock purchase or "QSP" under Code §338) so that Newco can make a Code §338 or Code §338(h)(10) election for Target electing to treat the stock purchase as an asset purchase for income tax purposes,[10] while still leaving Target's old shareholders with a sufficiently significant retained stake in Target to qualify for recap accounting.

In most cases, structuring for asset SUB will be tax-efficient only if Target is an S corporation or a Bigco subsidiary so that a Code §338(h)(10) election can be made with a single level of tax. However, a Code §338(h)(10) election triggers gain in all of Target's assets, so that (1) where Target is an S corporation, old Target shareholders who retain Target stock will nonetheless be taxed on their full share of the gain in Target's assets and (2) where Target is a Bigco subsidiary, Bigco will be taxed on all of the gain in Target's assets although Bigco retains some Target stock.

Use of a corporate Newco to purchase Target's stock — so that a Code §338(h)(10) election can be made to step up the tax basis of Target's assets in a transaction structured for recap accounting — is attractive only if there is a way subsequently to eliminate Newco in a tax-free manner without forcing purchase accounting on Target. As discussed in A above, if Newco corporation were to remain a Target shareholder (i) an unwanted corporate-level tax would be imposed on Newco when Newco sells its Target stock to the public (resulting in double tax) and (ii) should PE fund take Newco public (owning Target's stock), Newco is not entitled to utilize recap accounting. A properly timed elimination of Newco corporation (i.e., occurring after a sufficient wait so that Newco corporation's elimination does not disqualify the Code §338(h)(10) election by causing Newco to be disregarded as the QSP purchaser of Target stock) in a non-merger downstream "C" or "D" reorganization should accomplish the desired goal.

While eliminating Newco corporation by an upstream or downstream merger of Newco and Target would accomplish this tax goal (eliminating Newco corporation without corporate-level tax), such a merger would have the adverse result of eliminating the benefits of recap accounting (even when such merger occurs after Target goes public). If Newco owns more than 50% of Target's common stock and Newco and Target subsequently merge (either upstream or downstream), after the merger Newco would be viewed for accounting purposes as the surviving entity so that Newco/Target would generally be required to use purchase or partial purchase accounting.

Where Target is a partnership or LLC, it should be possible to obtain asset SUB without double tax and without forming a corporate Newco (i) for the new investors' share of Target's assets, where the new investors purchase partnership or LLC interests from Target's equity owners (see Code §§754 and 743) and (ii) for gain recognized by old Target equity owners on redemption of their partnership or LLC interests (see Code §§754 and 734).

Taxation of New Investors. New investors in Target will generally not qualify for Code §1202's 14% long-term capital gain rate because of the substantial redemptions that take place in the LBO-recapitalization transaction.

10 See Ginsburg & Levin, §§205 and 206 for a discussion of the effect of a Code §338 election and a Code §338(h)(10) election.