Five New Tax Developments Private Equity Investors Must Know in Structuring a Buyout or Venture Investment

KIRKLAND & ELLIS

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THIS ARTICLE DESCRIBES 5 TAX DEVELOPMENTS IMPORTANT TO EVERY PRIVATE EQUITY INVESTOR:

- A significant new restriction on a portfolio company's ability to issue redeemable preferred stock tax free to selected Target shareholders in a tax-free rollover,
- Recently enacted disallowance of interest on portfolio company debt where a substantial portion of the principal or interest is payable in (or by reference to the value of) the portfolio company's equity,
- Recent expansion of the rules allowing a tax-free rollover of proceeds from selling qualified small business corp stock,
- Newly enacted limitation on the ability of a private equity fund to make a tax-free distribution of publicly traded stock in kind to its partners, and
- Recent elimination of the continuity of shareholder interest (holding period) requirement when a portfolio company is sold for BuyerCo stock in a tax-free reorganization.

A. NQ Pfd Stock Treated as Taxable Boot in a Tax-Free Rollover

In an LBO, Target's management (and certain other shareholders) often wish to roll over tax free a portion of their appreciated Target stock to pay for a post-acquisition

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equity investment in Newco (where a private equity fund forms Newco to acquire Target in a traditional LBO) or in Target (where a private equity fund invests directly in Target in a leveraged recapitalization). In many cases, all or a portion of such equity investment by selected old Target shareholders takes the form of a "strip" of redeemable preferred stock and common stock (generally in the same proportions as the strip of redeemable preferred stock and common stock purchased by the private equity fund).[2] Where this rollover can be accomplished tax-free, it is significantly more tax efficient for Target shareholders than selling their appreciated Target stock, paying tax on the gain, and reinvesting after-tax proceeds.[3]

Prior to the 1997 Tax Act, it was relatively simple to issue both common and redeemable preferred stock in such a tax-free rollover. However, after the 1997 Tax Act, most redeemable preferred stock of the type traditionally issued in private equity transactions constitutes "nonqualified preferred stock" ("NQ Pfd"), treated as taxable boot in an otherwise tax-free exchange, triggering gain to the exchanging Target shareholder.

Example 1

A owns a portion of T's common stock with a tax basis of $100 and an FV of $1,000. Private equity fund forms Newco to acquire T's stock in an LBO. Private equity fund purchases 90% of Newco's common stock for cash and, as part of the LBO, A exchanges his T common stock for (e.g.) 10% of Newco's common stock (FV $200) plus Newco redeemable preferred stock (FV $800) mandatorily redeemable in 7 years. Although A's exchange of old T stock for newly issued Newco stock is part of Newco's tax-free formation under Code §351, the $800 of Newco preferred stock received by A constitutes NQ Pfd and hence taxable boot to A. Thus, A recognizes $800 of taxable gain on his T stock (the lesser of the $900 appreciation in A's old T stock or the $800 NQ Pfd boot received by A), even though A has received solely Newco stock (and no cash) in exchange for his old T stock.

Example 2

The result described in Example 1 is the same where the LBO is structured as a leveraged recapitalization, with (1) private equity fund investing directly into Target, (2) Target redeeming most of its previously outstanding stock for cash, and (3) selected Target shareholders exchanging a portion of their old Target shares for new Target common (constituting, e.g., 10% of Target's post-recap common stock) plus Target redeemable preferred stock.

Treatment of redeemable preferred stock as boot creates structuring problems for virtually every private equity transaction involving a rollover of equity by existing Target shareholders into preferred stock or into a strip of preferred and common stock. Such rollovers have become even more common in recent years, as private equity funds have structured LBOs to qualify for recapitalization accounting, since such transactions typically involve the rollover of a significant equity stake by old Target shareholders.[4]

2 Management will typically also receive additional shares of Newco or Target common equity as an incentive (in some cases in the form of stock options).

3 Where Newco is formed to acquire Target in a traditional LBO, the old Target shareholder's swap of appreciated Target stock for Newco stock is tax-free under Code §351 (as part of Newco's tax-free formation). Where Target is the subject of a leveraged recapitalization, the old Target shareholder's swap of appreciated Target stock for new Target stock is tax-free under Code §§368(a)(1)(E) and 354 (as part of a recapitalization). See Ginsburg & Levin, *Mergers, Acquisitions, and Buyouts*, Chapter 9 (Aspen/Panel Publishers 1998) for a discussion of the requirements which must be met in order for an exchange to be tax-free under Code §351 and Chapters 6-8 for a discussion of the requirements which must be met in order for an exchange to be tax-free under Code §368, as well as ¶1313 for a discussion of tax-free rollovers for management and other Target shareholders (*Mergers, Acquisitions, and Buyouts* is hereinafter cited as Ginsburg & Levin).

Technically, such a rollover merely defers tax, since the shareholder takes a low carryover basis in stock received in the exchange (equal to the basis of the stock given up in the exchange). However, if the shareholder dies before selling the new stock, he takes a stepped-up death basis and the gain is permanently exempted from tax.

4 Recapitalization accounting typically requires rollover Target shareholders to retain a significant stake in post-recapitalization Target's voting common equity. However, for economic reasons, private equity funds often insist that rollover Target shareholders in such a recapitalization transaction acquire the same "strip" of preferred and common stock being acquired by the private equity fund. For a discussion of structuring buyouts to achieve recapitalization accounting, see Levin & Welke, Structuring Buyouts for Recap Accounting, 2 Venture Capital Review 7 (1998) and Ginsburg & Levin, ¶1503.7.6.

Definition of NQ Pfd

In general, NQ Pfd is preferred stock that is likely to be retired within 20 years after its issuance. More precisely, NQ Pfd is defined by the Code as stock which (1) is limited and preferred as to dividends, (2) has no significant participation in corporate growth, *and* (3) is *either*:

- *Puttable,* i.e., the holder has the right to require the issuer (or a related person[5]) to redeem or purchase the stock within 20 years after issuance, *or*
- *Mandatorily redeemable,* i.e., the issuer (or a related person) is required to redeem or purchase the stock within 20 years after issuance, *or*
- *Callable,* i.e., the issuer (or a related person) has the right to redeem or purchase the stock and, as of issuance, it is more likely than not that the call right will be exercised within 20 years after issuance.[6]

Solutions to the NQ Pfd Problem

There are a number of methods for structuring around the new NQ Pfd rules, so that Target shareholders who roll over Target stock in whole or in part for Newco/Target preferred stock in a private equity transaction will not be taxable on the new preferred stock. No single structuring solution works in all cases. However, in the authors' experience, one or more of the structuring solutions is often preferable to recognizing gain on the exchange or changing the economics of the transaction to eliminate the preferred stock.

Solution #1 — Evergreen Preferred Stock. Preferred stock is not NQ Pfd if it is "evergreen," i.e., neither puttable, mandatorily redeemable, nor callable within 20 years after issuance. Thus, where rollover Target shareholders receive evergreen Target or evergreen Newco preferred stock, the NQ Pfd rules do not trigger gain recognition.

However, rollover Target shareholders often seek some assurance that they will be able to achieve liquidity with respect to the evergreen preferred stock at some point in the future and will not be required to hold the evergreen preferred indefinitely. Where the private equity fund is to own a controlling stake in Newco or Target after the transaction (so that the private equity fund can control whether and when Newco/Target offers to redeem its preferred stock), it is generally possible to address this concern by (1) arranging for the private equity fund to purchase evergreen preferred stock of the same class held by the rollover Target shareholders and (2) prohibiting Newco/Target from redeeming the private equity fund's preferred shares without simultaneously offering to redeem the rollover preferred shares. In such case, the rollover Target shareholders will obtain liquidity for their preferred shares when the private equity fund's preferred shares are redeemed and the private equity fund will seek redemption of its preferred shares as soon as feasible in order to liberate its capital.[7]

It is also possible to create an incentive for Newco/Target to retire the evergreen preferred after a fixed period (e.g., 7 years) or upon the occurrence of a specified event (e.g., an IPO) by providing for dividend rate increases on the evergreen preferred if Newco/Target does not offer to redeem the preferred stock after the specified period or upon occurrence of the specified event. So long as the dividend rate increase is reasonable in amount and not so large as to economically compel an offer to redeem, such term should not cause preferred that is otherwise evergreen to be treated as NQ Pfd.

5 A person is related to the issuer if they are more than 50% related through overlapping equity ownership within the meaning of Code §§267(b) or 707(b).

6 Code §351(g)(2). This third 20-year requirement for NQ Pfd is also treated as automatically satisfied where the preferred stock's dividend rate varies based on interest rates or similar indexes (e.g., adjustable rate preferred) or is otherwise periodically reset with a similar effect (e.g., auction rate stock). This article does not discuss such indexed rate NQ Pfd.

7 The private equity fund may resist purchasing evergreen preferred stock either (1) because the fund believes it is easier to use the proceeds of an IPO to retire redeemable preferred stock (than evergreen preferred stock) or (2) because of risk the fund may lose control of Newco or Target before redeeming the preferred shares.

Solution #2 — Participating Preferred Stock. Stock is NQ Pfd stock only if it is limited and preferred as to dividends and has no significant participation in corporate growth. Thus, if Newco/Target preferred has sufficient participation features, it will not be treated as preferred stock for purposes of the NQ Pfd rules and can be received tax-free in a rollover without producing taxable boot (even though puttable or mandatorily redeemable after, e.g., 7 years). The key is to add sufficient participation to eliminate the NQ Pfd tax problem without significantly changing the parties' economic deal.

One approach is to give the preferred stock some additional dividend rights based on Newco/Target's performance. For example, if the preferred stock was to bear fixed dividends at 8% of face, the dividend could be revised so that it varies from 6% to 10% of face depending upon Newco/Target's profitability.

A second approach is to give the preferred stock some additional rights on liquidation. For example, if the preferred stock was to receive $1,000 per share on liquidation, the liquidation value could be revised so that it varies from $800 to $1,200 per share depending upon Newco/Target's profitability or value.

Obviously the preferred stock might have both a variable dividend and a variable liquidation value. Whether such variations are sufficient to defeat NQ Pfd treatment turns on whether in the particular case the holder has a "real and meaningful probability of actually participating in the earnings and growth of the corporation" or, on the other hand, "little or no likelihood of ...actually participating..."[8]

A third approach (the "mush-together approach") — where a rollover Target shareholder is to receive both redeemable preferred stock and common stock — is to combine in a single instrument the rights from all or a portion of the rollover shareholder's common stock with the rollover shareholder's rights from the redeemable preferred stock. If enough common rights are added to the redeemable preferred rights in this fashion, the resulting stock instrument should avoid classification as preferred stock for tax purposes and hence should not be NQ Pfd, even though it contains redemption rights with respect to the preferred portion of the instrument.[9]

A fourth approach is for the redeemable preferred to be convertible into other stock (e.g., common stock). In this case, the preferred's conversion feature should be taken into account in determining whether the preferred stock participates significantly in corporate growth. Thus, where the preferred is convertible into common stock at a fixed price and the conversion price is either at or in the money (or at least not substantially out of the money) at the time of issuance, the conversion feature should generally cause the convertible preferred stock to be treated as participating in corporate growth and hence not NQ Pfd. However, the parties may balk at this approach because the economic rights of convertible preferred stock are different than the economic rights of redeemable preferred plus common stock. With convertible preferred, the holder's preferred position (and right to the return of his preferred capital) must be surrendered by conversion into common stock in order to enjoy the convertible preferred's participation in corporate growth, while with redeemable preferred plus common the holder can retain his preferred position and still enjoy his common stock rights.

A final approach is a convertible preferred stock that converts into redeemable preferred stock plus common stock. Such a convertible preferred is similar in economic effect to redeemable preferred stock plus common stock, but may provide the convertible preferred with enough participation features to avoid NQ Pfd status. In general, in order for the conversion feature to have substance (so that

8 The quotes are from analogous IRS regulations under Code §305, since there are no regulations under the Code's relatively new NQ Pfd provisions.

9 A later unbundling of this "mush-together" preferred into separate redeemable preferred and common components will generally cause the basis of the original "mush-together" instrument to be allocated among the redeemable preferred and the common in proportion to their relative values at that time. This allocation may be unfavorable to a taxpayer with a high basis in the "mush-together" preferred stock. However, rollover Target shareholders more typically have a low basis in their Target stock, minimizing this problem.

In addition, the receipt of redeemable preferred on the unbundling might trigger gain because the new redeemable preferred is NQ Pfd and hence boot. This should not be an impediment if the preferred is to be redeemed shortly after the unbundling.

the convertible preferred stock is not simply treated at time of issuance as constituting for tax purposes the redeemable preferred stock and the common stock into which it would convert), the convertible preferred's preference amount should be greater than the preference amount of the redeemable preferred to be received on conversion, so that there would be an incentive on the part of a holder in some circumstances not to convert.[10]

Solution #3 — Issue NQ Pfd in a Stock Dividend. The NQ Pfd rules apply to NQ Pfd issued in exchanges subject to Code §351 (tax-free formation of a new corporation) and Code §368 (tax-free corporate reorganization). However, prior to Target's LBO or leveraged recap, Target can issue preferred stock tax-free in a pro-rata stock dividend to Target's common stockholders under Code §305. In the absence of regulations to the contrary (which should, if ultimately issued by IRS, apply only to stock dividends occurring after issuance of such regulations), the receipt of redeemable preferred stock in a tax-free stock dividend should not result in taxable boot under the NQ Pfd rules.

Example 3

A, B, C, and D each own 25% of T's common stock, aggregate FV $4,000. T distributes $3,600 of redeemable preferred stock (constituting NQ Pfd) pro rata to A, B, C, and D in a stock dividend that is tax-free under Code §305. Private equity fund subsequently invests $3,000 cash in T for (a) 75% of T's common stock and (b) $2,700 face amount of T's redeemable preferred stock (of the same class issued by T in the stock dividend). T uses the $3,000 received from private equity fund to redeem all of the T common and preferred stock held by A, B, and C. D retains his T common and preferred stock. Although the T preferred stock held by D constitutes NQ Pfd,[11] it was not received in an exchange governed by Code §351 or Code §368. Thus, D does not recognize any gain on receipt of the T redeemable preferred stock.[12]

Solution #4 — Redemption is a Remote Contingency. A put, call, or mandatory redemption does not cause preferred stock to be treated as NQ Pfd if the right is subject to a contingency which renders remote the likelihood of a purchase or redemption within 20 years after issuance. Thus, if the put, call, or mandatory redemption features are appropriately conditioned, the Target/Newco preferred stock is not NQ Pfd.

Rollover Target shareholders often desire their Newco/Target preferred stock to be retired for cash in the event of Newco/Target's sale (i.e., change in control) and/or IPO, events which are generally remote in the lives of most business entities. There is some risk IRS might argue that a contingency based on a change in control or IPO is not "remote" in a typical private equity transaction where the private equity fund intends either to sell Newco/Target (a change in control) or effectuate an IPO well before 20 years pass.

However, we believe that in a situation where a sale or IPO is not being negotiated at the time of the preferred's issuance, is not expected to occur in the near term, is dependent on Newco/Target's business success, and is not in the control of the holders of Newco/Target's preferred stock, the fund's generalized future intention or goal of selling its Newco/Target stake does not require the Newco/Target preferred stock be treated as NQ Pfd.

10 The NQ Pfd rules may apply to trigger gain on the conversion of such an instrument (in an amount up to the value of the redeemable preferred issued upon conversion). However, absent regulations to the contrary (which should, if ultimately issued by IRS, apply only to conversions occurring after issuance of such regulations), there appears to be a good argument that a conversion is not subject to the NQ Pfd rules because a tax-free conversion does not depend on the Code §351 tax-free incorporation or the Code §368 tax-free reorganization rules.

11 D's T preferred stock will generally constitute Code §306 stock, if T has earnings and profits at the time of the stock dividend, which may create some complexities if the preferred is later redeemed from D while he continues to hold his T common stock. Code §306 creates no issues for A, B, and C since their entire interest in T (both common and preferred) is redeemed in the transaction.

12 The result would *not* be the same if the transaction were structured as a traditional LBO (rather than as a leveraged recap), with (1) T issuing a dividend of redeemable preferred stock to A, B, C, and D, (2) Newco then buying A's, B's, and C's T common and preferred stock, and (3) D then swapping his old T common and redeemable preferred stock for newly issued Newco common and redeemable preferred stock, because in a swap of old T NQ Pfd for newly issued Newco NQ Pfd, the Newco NQ Pfd would constitute boot.

Preferred stock subject to such a contingency bears little economic resemblance from the holder's perspective to debt and hence does not resemble the type of preferred stock that should be treated as NQ Pfd. Unfortunately IRS has not yet issued any clarification as to the meaning of "remote" in this situation.

Solution #5—Redeemable only on Death & Disability. Preferred stock is not NQ Pfd if (1) the right or obligation to redeem or purchase may be exercised only upon the holder's death or disability and (2) all of the following are true with respect to Newco/Target:

- Newco/Target is not a public company (i.e., no class of stock readily tradable on an established securities market or otherwise),
- No person related to Newco/Target is a public company, *and*
- The transaction is not one in which Newco/Target or a related corp is to become a public company.

This exception is particularly useful where an elderly Target shareholder does not want to recognize capital gain with respect to his Target stock (because he hopes to eliminate such capital gain by holding stock until death and receiving a stepped-up death basis) yet would like to limit his exposure to the risks of Target's business as much as possible by holding Newco/Target preferred stock redeemable upon his death (rather than Newco common stock).

Example 4

A owns a portion of T's common shares with a tax basis of $100 and an FV of $1,000. Private equity fund forms Newco to acquire T's stock in an LBO. A exchanges T common stock for (e.g.) 10% of Newco's common stock (FV $200) plus Newco redeemable preferred stock (FV $800) mandatorily redeemable solely on A's death (i.e., A has no separate right to put the preferred stock or require its redemption prior to A's death). Neither Newco nor T has any publicly traded stock (and neither company is related to a publicly traded corporation nor is Newco or a related company slated to go public).

The Newco preferred stock received by A does not constitute NQ Pfd because it is redeemable only on A's death. Thus, A recognizes no gain on the exchange and takes a carryover basis in the Newco common and preferred stock. When A dies, A's estate will receive a stepped-up death basis in the Newco common and preferred and, as a result, A's estate should recognize no gain on redemption of the preferred.

Solution #6—Stock held by Service Provider with Redemption only on Separation from Service. Preferred stock is not NQ Pfd if the preferred stock is "transferred [to a service provider] in connection with the performance of services for [Newco/Target] ... and ... represents reasonable compensation" and is redeemable only on the service provider's separation from service.

While this exception could be narrowly read as requiring that the service provider receive the preferred stock as "reasonable compensation" (rather than in exchange for a rollover of old Target stock), such a narrow reading would make no sense: stock received by a service provider as compensation is always taxable ordinary income and is never tax-free, hence the NQ Pfd rules (which change an otherwise tax-free swap into a taxable swap) would never be relevant.

Therefore, we believe this exception should simply be read as applying where the service provider receives preferred stock in connection with his performance of services (whether as an employee or an independent contractor), even though he is exchanging Target common stock for Newco/Target preferred stock.[13]

13 This conclusion is supported by analogy to Code §83, which deals with other aspects of stock acquired by a service provider and clearly applies to stock purchased by a service provider (for cash or upon the surrender of other stock) in connection with the performance of services, even when the service provider pays full value for the stock so that there is no explicit compensation element in the transfer.

Example 5

A (who is T's CEO) owns T common stock with a tax basis of $100 and an FV of $1,000. Private equity fund forms Newco to acquire T's stock in an LBO. A exchanges his T common stock for (e.g.) 10% of Newco's common stock (FV $200) plus Newco redeemable preferred stock (FV $800). A will lead Newco's management team after the transaction and the Newco preferred A receives is mandatorily redeemable if A's employment with Newco terminates (and there are no other put, call, or redemption features). The Newco preferred stock received by A should not constitute NQ Pfd and hence should not be taxable boot to A in the exchange.

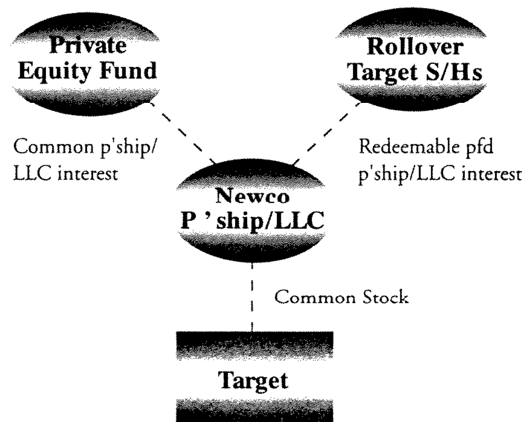
Solution #7 — Preferred Stock Redeemable for Common Stock on IPO. Rollover Target shareholders may desire preferred stock that becomes liquid upon an IPO. Where the chance of an IPO is more than remote, so that Solution #4 does not work, Newco/Target could issue preferred stock to rollover Target shareholders convertible in the event of an IPO into a number of common shares, valued at the IPO price, equal to the preferred stock face amount plus accrued dividends.[14] Such preferred stock should not be treated as NQ Pfd because it is not redeemable (i.e., the issuer is not delivering cash or other property to the holder upon an IPO). It does, however, give the rollover Target shareholders a means of achieving liquidity (in the form of tradeable common stock) for their preferred stock upon an IPO.[15]

Solution #8 — Preferred Stock that is Not More-Than-50%-Likely to be Called. Newco/Target can issue preferred stock callable by the company in circumstances where, viewed at the time of issuance, there is no reason to believe a call is more likely than not (i.e., there is no reason to believe a call is more than 50% likely). For example, Newco/Target could issue preferred stock callable at the company's option in the event of an IPO. The preferred stock would not be NQ Pfd so long as a call is not more than 50% likely (taking into account the likelihood of an IPO and the likelihood, in the event of an IPO, that the company would choose to call the stock).

This more-likely-call-than-not provision was inserted into the NQ Pfd statute to deal with cases where there was such a substantial penalty on the company for not calling the preferred, upon the passage of a specified period or the occurrence of a specified event, as to force the company to call the preferred. Hence this provision should not apply where there is no such penalty.

While this solution does not give the rollover Target shareholders a guarantee of liquidity, it does assure that Newco/Target can eliminate the preferred stock in connection with an IPO if desirable. Solution #8 can be coupled with Solution #7 to give the rollover Target shareholders a means of achieving liquidity in the event of an IPO.

Solution #9 — Use of Partnership or LLC Holding Company. The NQ Pfd rules apply only to preferred stock issued by a corporation. Thus, if a private equity fund acquires an interest in Newco/Target through a partnership or LLC, such partnership or LLC can issue a preferred partnership/LLC interest to the rollover Target shareholders, who could generally receive it tax-free under Code §721 without recognizing taxable boot under the NQ Pfd rules.



14 Such preferred stock would not be treated as participating in corporate growth, since the conversion price is based on the value of the common stock at the time of the IPO.

15 While such a conversion right does not give rollover Target shareholders any liquidity in the event of a change of control, the rollover Target shareholders could obtain protection against a sale of Newco/Target's control stock through tag-along rights so that they could sell their preferred stock if the common shareholders sell their common stock.

In order for the form of this transaction to be respected, it is desirable for there to be a business purpose for the use of an intermediate partnership or LLC. In addition, it is desirable for the partnership or LLC to hold only common stock of Newco/Target (rather than common stock and preferred stock mirroring the terms of the common and preferred partnership/ LLC interests held by the private equity fund and the rollover Target shareholders), so that if the partnership is treated by IRS as an aggregate of its partners rather than a separate entity, the rollover Target shareholders should still not be viewed as holding Newco/Target preferred stock.

Solution #10 — Installment Method Reporting of Gain Triggered by NQ Pfd Boot. Where boot in the form of a debt instrument is received in a tax-free exchange under Code §351 or Code §368, a taxpayer is generally entitled to report gain triggered by such boot on the installment method, so that gain is recognized only as the taxpayer receives payments on the underlying debt instrument.[16] The legislative history of the NQ Pfd rules states that IRS has authority to adopt regulations applying installment method reporting to the receipt of boot in the form of NQ Pfd stock. So far no such regulations have been adopted. The authors believe IRS should adopt regulations applying the installment method to receipt of NQ Pfd stock and that such regulations can and should be retroactive to the 6/8/97 effective date of the 1997 Act's NQ Pfd rules.

Application of installment method reporting to the receipt of NQ Pfd would eliminate a number, although not all, of the problems created by the NQ Pfd rules in private equity transactions. Installment method reporting for NQ Pfd would, however, likely involve the same or similar restrictions applicable to the use of the installment method with respect to the receipt of debt instruments. Thus, for example, (1) installment method reporting would likely be subject to an interest charge where a taxpayer held more than $5 million of NQ Pfd, (2) there would be no death step-up in tax basis with respect to NQ Pfd held by a decedent to eliminate gain previously deferred under the installment method, (3) the installment method would not apply to gain with respect to certain property(e.g., depreciation recapture, publicly traded Target stock, etc.), and (4) installment reporting would be disqualified by a gift or pledge of the NQ Pfd.

Example 6

Same as Example 1, except that IRS adopts regulations allowing installment method reporting for gain triggered by receipt of NQ Pfd. Subject to the general limitations on the use of the installment method, A would be entitled to defer tax on the $800 gain triggered by the receipt of the Newco preferred stock under the installment method until the Newco preferred stock was redeemed (or otherwise disposed of).

B. Nondeductibility of Interest on Equity-Linked Debt

Code §163*(l)*, enacted in 8/97, disallows interest deductions on equity-linked debt, i.e., debt issued by a corporation where a substantial portion of the principal or interest is payable in (or by reference to the value of) equity. The statutory language is extremely broad and in many cases ambiguous, creating numerous uncertainties as to whether this disallowance rule applies to a number of financial structures typically used in private equity transactions.

Definition of Equity-Linked Debt. More specifically, debt is equity-linked if a substantial amount of either interest or principal on the debt is:

- Required to be paid in or converted into (or at the option of the issuer or a related party is payable in) equity of the issuer or a related party,[17]
- Required to be determined (or at the option of the issuer or a related party is determined) by reference to the value of such equity, *or*

16 See Ginsburg & Levin, ¶203.4 for a discussion of the installment method and limitations on its use.

17 A related party for this purpose is a person more than 50% related by overlapping equity ownership within the meaning of Code §§267 or 707.

- Part of an arrangement "reasonably expected to result in a transaction" described above.

In addition, an option on the part of the holder of the debt to cause a substantial amount of either principal or interest to be paid in (or determined by reference to the value of) such equity will cause the debt to be treated as equity-linked but only if there is a "substantial certainty the [holder's] option will be exercised."

Application of Code §163*(l)* to Private Equity Transactions. Code §163*(l)* creates a potentially significant new hurdle to the deductibility of interest in LBOs and leveraged recapitalizations where debt issued by Newco (in a traditional LBO) or by Target (in a leveraged recapitalization) has equity-related features.[18] Where debt is equity-linked so that Code §163*(l)* applies, all interest deductions (including OID) on the equity-linked debt instrument are permanently disallowed, even where the particular interest is actually paid in cash. The disallowance applies even where there is no tax avoidance motive in issuing the debt, the issuer is not highly leveraged, and the debt does not actually contain significant equity-like participation features.[19]

Example 1

Newco corp issues a 10-year $1,000 note bearing interest at 8%. Half the annual interest ($40) is payable in cash and half ($40) in Newco stock with a $40 FV (measured at the time of payment). Principal is payable in cash at maturity (10 years). The Newco note is equity-linked debt (because a substantial portion (50%) of the interest is payable in stock) and Code §163*(l)* disallows 100% of Newco's interest deduction on the note, even though the note has no participation in corporate growth (since the stock issued in payment of half the interest on the note is valued at the time of payment).

The result is the same if Newco has the option to , up to 50% of the annual interest in stock, even if Newco never invokes this option and pays 100% of the interest in cash.

There is no guidance on how much interest or principal must be payable in equity in order to be deemed "substantial." For other purposes of the Code, IRS has defined "substantial" to mean as much as one-third and as little as 5%. The authors believe that, given the harsh effect of Code §163*(l)*, a one-third standard is more appropriate for "substantial"in this context. However, in the absence of IRS guidance, there is risk IRS will seek to treat amounts significantly less than one-third as "substantial" for this purpose.

Code §163*(l)* applies to convertible debt where conversion is at the option of the issuer rather than the holder, regardless of the likelihood of conversion. In addition, Code §163*(l)* may also apply to convertible debt where conversion is at the option of the holder, depending on factors such as the conversion price and whether the holder is related to the issuer.

Example 2

Newco corp issues a 10-year note bearing interest at 8%. All interest and principal on the note is payable in cash. The note is convertible into 100 Newco common shares at the option of the holder (i.e., a $10 per share conversion price). Newco common stock has an FV of $14 per share at the time the convertible debt is issued, so that the debt is convertible into Newco common stock with a $1,400 FV. The debt is equity-linked (and interest deductions are disallowed) if there is a "substantial certainty" the holder will convert the debt. Because the conversion price is substantially in the money at issuance, it appears that the conversion feature is substantially certain to be exercised and the interest deductions on the debt are disallowed.

18 The new Code §163*(l)* hurdle to a corp's interest deduction is in addition to 6 other complex hurdles previously contained in the Code. See generally Ginsburg & Levin, Chapter 13.

19 Code §163*(l)* does not change the holder's tax treatment. Thus, the holder continues to recognize taxable interest income with respect to equity-linked debt, even though the issuer's interest deduction is disallowed. And, a corporate holder of equity-linked debt is not entitled to claim a dividends-received deduction for interest received, even though the tax treatment for the corporate issuer (i.e., no interest deduction for the interest payments) is similar to the corporate issuer's treatment for dividends paid on its on stock.

Example 3

Same as Example 2, except that Newco common stock has an FV of $7 per share at the time the convertible debt is issued, so that the debt is convertible into Newco common stock with a $700 FV. Assuming that the likelihood of conversion is tested only at issuance, it is not "substantially certain" that the holder will convert the note and therefore the note should not be equity-linked. The authors believe that the same conclusion should obtain where the conversion price is at the money at issuance, i.e., where Newco common stock has an FV of $10 per share at the time the convertible debt is issued.

Example 4

Same as Example 3, except that the convertible note is purchased by a private equity fund that also owns 51% of Newco's stock. The private equity fund is related to the issuer (Newco) because it owns more than 50% of Newco's stock. Since the conversion right is exercisable by a party related to the issuer, the note appears to be equity-linked, regardless of whether the private equity fund is "substantially certain" to convert the note.

Although the result in Example 4 seems to flow from a literal reading of Code §163*(l)*, we believe the rationale behind Code §163*(l)*'s related party rule should not be viewed as requiring this result. Rather we believe that conversion rights held by a bona fide lender who owns less than 100% of the borrower's stock should not trigger automatic application of Code §163*(l)* merely because the holder is a related party.

Debt in private equity transactions is often issued with warrants. Unfortunately, in the absence of IRS guidance, it is not clear whether Code §163*(l)* applies to debt issued with warrants. The statutory tests outlined above do not neatly apply to arrangements where the equity features are contained in a security (e.g., a warrant) separate from the debt. Whether there is a risk that Code §163*(l)* applies to debt issued with warrants turns on the extent to which the debt and the warrant are separate (e.g., whether the debt and the warrant are separately transferrable and whether the exercise price of the warrant may be, or must be, paid by delivery of the debt).

Example 5

Newco corp issues a 10-year note and a warrant. Interest and principal on the note are payable in cash. The warrant has a 10-year term and is exercisable at any time by delivering the note. The warrant and note can be transferred only as a unit, not separately. If the warrant is sufficiently in the money at issuance so that it is substantially certain to be exercised, the debt is likely to be treated as equity-linked, either because the note plus warrant is considered to be in substance convertible debt or because the note plus warrant is considered to be an "arrangement" reasonably expected to result in conversion or payment of the debt with equity.

Example 6

Same as Example 5, except that the note and warrant are separately transferrable and the warrant is exercisable only by delivering the exercise price in cash. In this case, Code §163*(l)* should not apply. The warrant and note are clearly separate instruments not the equivalent of convertible debt and there is no arrangement that would lead to the payment of the note in equity.

Code §163*(l)* may also apply where all payments of principal and interest on a debt instrument are required to be made in cash if a substantial portion of the interest or principal payments are "determined... by reference to the value of" the issuer's (or a related party's) equity. It is relatively clear that this may pick up contingent payments on a debt instrument based on the future FV of Newco's stock. It is not clear to what extent it may pick up contingent payments based on other tests which are closely correlated to the FV of the issuer's stock.

Example 7

Newco corp issues a 10-year $1,000 note bearing interest equal to (a) 4% plus (b) 2% of the increase in value of Newco's stock over the 10-year term of the debt instrument. All principal and interest

(including the contingent interest) is payable in cash. The interest contingent on Newco's stock value is "determined ... by reference to the value of" Newco's equity so that if the amount of such interest is "substantial," the note is treated as equity-linked and all the interest on the note (not merely the contingent interest) is nondeductible.

Of course, until the end of the 10-year period, neither Newco nor IRS knows the amount of the contingent interest and hence whether the contingent interest is substantial in relationship to either principal or interest on the note. It is not at all clear whether for Code §163*(l)* purposes, the determination as to the substantiality of the contingent interest is designed to be applied at the time the note is issued, each year as Newco pays interest on the note and the value of its stock fluctuates, or at the end when the contingent interest is finally paid.

Example 8

Same as Example 7, except that the contingent interest is 2% of 10 times Newco's EBITDA increase for the 10-year period. Absent guidance from IRS, it appears that this contingent interest should not be regarded as determined by reference to the value of Newco's equity. While an EBITDA multiple may be related to the value of Newco's stock, it does not necessarily track the FV of that stock (e.g., the appropriate multiple may change from time to time). Because of the close relationship in many cases, there is risk, however, that IRS may attempt to assert on audit (or in regulations) that such formulas produce interest determined by reference to Newco's equity.

C. Expansion of Tax-deferred Rollover of Gain on Qualifying Small Corporation Stock

The 1997 Tax Act added Code §1045 allowing an individual to elect to roll over tax-free the proceeds from the sale of stock in a corporation that would (if the 5-year holding period were met) qualify for the special 14% capital gain tax rate under Code §1202),[20] so long as:

- The stock was held for at least 6 months at the time of the sale, *and*
- The proceeds of the sale are reinvested within 60 days after the sale (not before) in stock of another corp that would qualify for the 14% capital gains rate (if the 5-year holding period were met).

Where these tax-free rollover rules apply, (1) the taxpayer takes a low carryover basis in the new stock purchased and (2) tacks his holding period for the old stock to the new stock for purposes of determining whether gain on the new stock qualifies as 12-month 20% LTCG or 5 year 14% §1202 special CG.

Example 1

A purchases newly-issued T1 stock for $100 and sells the T1 stock 7 months later for $500. Within 60 days thereafter, A purchases newly-issued T2 stock for $500 or more. Both T1 and T2 meet the requirements of Code §1202 discussed in footnote 20. A's $400 gain on the sale of his T1 stock qualifies for deferral under Code §1045 and hence (so long as A so elects) A owes no tax on sale of the T1 stock. A takes a $100 carryover basis in the T2 stock and his holding period for the T2 stock includes the 7-month period for which A held the T1 stock for

20 Code §1202's 14% capital gain rate generally applies to stock in a corp (a "qualified small business corp") if:

- the stock was acquired directly from the corp at its issuance,
- the stock was held more than 5 years,
- the corp conducts an active business at all relevant times (excluding certain specified types of businesses),
- the aggregate gross assets of the business do not exceed $50 million immediately after the issuance of the stock (and did not exceed $50 million at any time from 8/10/93 until the issuance), and
- a number of other technical requirements are met.

For a detailed discussion of the requirements, see Ginsburg & Levin, ¶215.

purposes of determining whether A's future sale of his T2 stock meets the more than 12-month holding period for 20% LTCG or the more than 5-year holding period for Code §1202's 14% LTCG rate.

Under the literal words of Code §1045 as initially adopted by the 1997 Tax Act, rollover benefits were limited to stock "held by an individual" and thus apparently did not apply to stock held indirectly by an individual through a flow-through partnership, LLC, or S corp. However, the 1998 Tax Act expanded Code §1045 so that rollover treatment applies to the sale of qualifying stock "held by a taxpayer other than a corporation" where new qualifying "stock [is] purchased by the taxpayer." Thus, rollover treatment now applies to the portion of the qualifying stock sold which was owned by an individual through a flow-through partnership, LLC, or S corp, even if the flow-through entity has other equity owners (such as a C corp) who do not qualify for Code §1045 rollover.[21]

Example 2

Same as Example 1, except that a private equity fund, which is a limited partnership, purchases, holds, and sells the qualifying T1 stock and then purchases the qualifying T2 stock. Under Code §1045 as expanded by the 1998 Tax Act, A, as an individual who is a partner of the private equity fund, may defer his share of the gain on the T1 stock. Another partner that is a C corp may not defer its share of the gain on the T1 stock.

Code §1045 rollover treatment should also apply where qualifying stock is sold by a flow-through entity, but the reinvestment is made by an individual who owns an interest in the flow-through entity, and it appears that rollover treatment should also be available when the subsequent reinvestment is made by another flow-through entity in which the individual owns an equity interest.

Example 3

Private equity fund #1, a limited partnership, purchases newly issued T1 stock for $100 and sells its T1 stock 7 months later for $1,000. A, an individual who is a 10% limited partner in private equity fund #1, is allocated $72 of the fund's gain (10% of the $720 gain remaining after allocating to the fund's general partner a 20% carried interest in the $900 profit on sale of the T1 stock).

Within 60 days thereafter private equity fund #2, a limited partnership in which A also is a 10% limited partner, invests at least $820 in T2 stock, so that A's $82 share of the investment in T2 is equal to his $10 capital invested through fund #1 in T1 plus his $72 share of the gain on fund #1's sale of T1 stock.

So long as both the T1 and T2 stock qualify under Code §1202, A may defer his $72 share of the gain on the T1 stock under Code §1045.

Because Code §1045's 1998 expansion thus makes rollover treatment available to individual investors in private equity funds, such funds may want to track whether their investments and dispositions qualify under Code §1202 and promptly furnish this information to their individual partners.

D. Private Equity Fund Distribution of Publicly Traded Stock In-Kind Treated as Cash Distribution in Certain Circumstances

The distribution of appreciated portfolio company stock in-kind by a private equity fund (formed as a partnership or LLC) generally does not result in the recognition of taxable gain by either the fund or the fund's investors.[22] Rather the recipient partner simply takes a carryover tax basis in the stock received equal to the lesser of (1) the fund's basis in the stock distributed and (2) the partner's basis in his fund interest.

21 The benefits of Code §1045 should also extend to certain trusts and estates with individual (i.e., non-corporate) beneficiaries.

22 There is an exception for appreciated property contributed in kind to a partnership which is subsequently distributed in kind by the partnership (within 7 years after the contribution). See Code §§704(c)(1)(B) and 737. Private equity funds typically do not receive such in-kind contributions of property.

Recently enacted Code §731(c)[23] creates an exception to this rule, treating a partnership or LLC distribution of *publicly traded stock* as a cash distribution equal to the FV of the stock distributed.[24] To the extent this deemed cash distribution exceeds the partner's tax basis in his fund interest, the partner recognizes gain, unless one of the exceptions described below applies.

Exception #1 — Portfolio Company Stock was not Publicly Traded when Acquired. If the portfolio company stock was not publicly traded when acquired by the fund, its later distribution after it has become publicly traded will not be treated as a deemed cash distribution, but only if each of the following requirements is met:

- The portfolio company had no outstanding marketable securities at the time the fund acquired its stock in the portfolio company,
- The fund held the portfolio company stock for at least 6 months before it became publicly traded, *and*
- The fund distributed the portfolio company stock within 5 years after it became publicly traded.

This exception will typically be available where a fund invests in non-traded stock of a portfolio company, unless the portfolio company has other traded stock or marketable debt at that time (or within 6 months thereafter) or the fund retains the portfolio company stock for more than 5 years after it becomes publicly traded.

Where a fund exchanges portfolio company stock that could have been distributed without being treated as a cash distribution (either because it was not publicly traded at the time of the exchange or because it was publicly traded but qualified for Exception #1) in a tax-free exchange (e.g., a merger) for marketable securities, the marketable securities received in the exchange, if distributed by the fund, will not be treated as a cash distribution to the same extent as the exchanged securities.[25]

Exception #2 — Fund Qualifies as an "Investment Partnership." If the fund qualifies as an "investment partnership," its distribution of publicly traded portfolio company stock will not be treated as a cash distribution to the recipient partners. A fund is an investment partnership if both of the following requirements are met:

- The fund has never been engaged in a business, *and*
- Substantially all of the fund's assets (measured by value) have always consisted of "investment assets" such as stocks, debt instruments, cash, and certain other financial assets.

For this purpose, the fund is treated as (1) engaged in any activities carried on by a partnership or LLC in which it has an equity interest and (2) owning its pro rata share of any assets owned by a partnership or LLC in which it has an equity interest.

Many private equity funds qualify for this exception. The fund's investment activities with respect to "investment assets" as defined above generally do not cause it to be deemed to be engaged in a business.[26] In addition, IRS regulations state that a number of common activities engaged in by private equity funds or their management companies will not be viewed as a business for this purpose, including:

23 Code §731(c) was enacted in 12/94 and interpretive regulations were promulgated in 12/96.

24 Code §731(c) also applies to distributions of marketable securities (as broadly defined in Code §731(c)(2)) other than publicly traded stock.

25 Thus, if a fund exchanges publicly traded stock that would have qualified for Exception #1 for another 3 years (because the stock was not publicly traded when acquired by the fund and has been publicly traded for 2 years at the time of the exchange) in a tax-free exchange for new publicly traded stock, the new publicly traded stock received in the exchange can be distributed for 3 years after the exchange without being treated as a cash distribution.

26 Indeed, a fund will not be deemed to be engaged in a business for this purpose, even if it is a trader or a dealer, so long as such activities are limited to "investment assets."

- "The receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to" the fund's activities, *and*

- The provision of "reasonable and customary services ... in assisting the formation, capitalization, expansion, or offering of interests in a corporation (or other entity) in which the [fund] holds or acquires a significant equity interest (including the provision of advice or consulting services, bridge loans, guarantees of obligations, or service on a company's board of directors), provided that the anticipated receipt of compensation for the services, if any, does not represent a significant purpose for the [fund's] investment in the entity and is incidental to the investment in the entity."[27]

However, a private equity fund generally does not qualify as an investment partnership for purposes of Exception #2 if it invests in one or more flow-through partnerships or LLCs engaged in an active business, because the fund is treated as engaged in the business activities of the flow-through partnerships or LLCs.

Exception #3 — Reduction of the Portfolio Company Stock's Value by the Partner's Share of Gain on such Stock. To the extent that no other exception applies, a partner in a private equity fund who receives a distribution in kind of publicly traded portfolio company stock is entitled to reduce the amount of the in-kind distribution treated as a cash distribution by the amount of the partner's pro rata share of the gain with respect to the distributed stock (taking into account the general partner's carried interest) that would have been recognized in a taxable sale of such stock. Where a fund makes a pro rata in-kind distribution of publicly traded stock this will generally reduce the amount treated as a cash distribution to the amount of the Partner's original capital contribution used to purchase the stock being distributed in kind.

Example 1

Private equity fund purchases T stock for $100. The fund distributes the T stock in kind to its limited partners and general partner when the stock is publicly traded and has a $1,000 FV. The general partner receives $180 of T stock in respect of its carried interest (20% of the $900 inherent gain in the T stock) and the remaining $820 of T stock is distributed to the partners in proportion to their capital commitments to the fund. Limited partner A has a 10% stake in the fund and receives $82 of T stock (equal to his $10 share of the fund's original capital contribution to purchase T stock plus his 10% share of the fund's $720 profit after reduction for the carried interest allocated to the general partner).

If no other exception applies, A is entitled to reduce the amount of the in-kind distribution treated as cash by $72 (his share of the gain inherent in the distributed stock) so that only $10 of the $82 in-kind distribution is treated as a cash distribution. To the extent such $10 deemed cash distribution exceeds A's basis in his fund partnership interest, A recognizes taxable gain.

E. Abolition of Continuity of Shareholder Interest Rules in Tax-Free Reorganizations

Striking a rare but important blow for tax simplification, IRS 1998 regulations effectively abolish the traditional continuity of shareholder interest ("COSI") requirement necessary in order for Bigco's acquisition of Target (e.g., by merger) to constitute a tax-free reorganization under Code §368. The traditional COSI doctrine required that historic Target shareholders (1) receive at least 40% of their consideration in the reorganization in the form of

27 IRS regulations also state, with respect to a fund management company, that the provision of "reasonable and customary management services (including the receipt of reasonable and customary fees in exchange for such management services)" to an "investment partnership" (such as a qualifying private equity fund) in which the management company holds a partnership interest are not a business. This is relevant where a management company acting as general partner of a fund receives its share of a fund's in-kind distribution and then the management company redistributes the securities to its partners.

Bigco stock and (2) intend to retain such Bigco stock for the long term so that the ultimate disposition of the Bigco stock is not part of the same plan as Bigco's acquisition of Target (in a step transaction doctrine sense).

Example 1

A, B, C, and D each hold 25% of T's stock. Bigco acquires T (before the effective date of the new COSI regulations) in a merger for $400 of Bigco stock and $600 cash. Pursuant to a pre-existing plan, A, B, and C immediately sell all of the Bigco stock received by them in the merger. Under the traditional COSI doctrine, it was likely that the sales by A, B, and C prevent Bigco's acquisition of T from qualifying as a tax-free reorganization, even with respect to D who continued to hold the Bigco stock received in the merger.[28]

Under the 1998 COSI regulations, pre- and post-reorganization continuity of shareholder interest is no longer required. The 1998 COSI regulations generally require only that Bigco issue at least the continuity amount of Bigco stock in the acquisition (which should generally be 40% of the reorganization consideration),[29] regardless of whether Target shareholders are historic shareholders and regardless of whether Target shareholders retain the Bigco stock received in the reorganization.[30]

Example 2

Same as Example 1, except that Bigco acquires T after the 1/28/98 effective date of the new COSI regulations. Under the new COSI regulations, the immediate sale of Bigco stock by A, B, and C generally does not prevent Bigco's acquisition of T from qualifying as a tax-free reorganization, because Bigco issued at least 40% of the merger consideration in the form of Bigco stock.

The 1998 COSI regulations do impose pre- and post-reorganization continuity requirements in three limited situations. Thus, COSI may not be present (and Bigco's acquisition of Target may be taxable) where:

- Bigco (or a related corp) redeems (or purchases) the Bigco stock issued in the acquisition of Target (other than for Bigco stock), *or*
- Bigco (or a related corp) purchases Target stock prior to, but in connection with, the reorganization (other than for Bigco stock), *or*
- Target redeems part of its stock prior to, but in connection with, the reorganization.

Although Bigco cannot acquire the Bigco stock issued in the acquisition of Target without creating a COSI problem, Bigco can take steps to help the Target shareholders achieve liquidity.

Example 3

Same as Example 2, except that, pursuant to the acquisition agreement, Bigco grants the T shareholders registration rights with respect to their Bigco shares received in the merger and agrees to assist them in effecting a public sale of such Bigco stock. Immediately after the merger, A, B, and C exercise their registration rights and, with Bigco's assistance, sell their stock into the market for cash. So long as the Bigco stock sold by A, B, and C is not purchased by Bigco or a related corp, such sales do not prevent the COSI requirement from being satisfied.

The abolition of the traditional COSI requirement should greatly simplify most tax-free dispositions of portfolio

28 Thus, Bigco would often request that T's shareholders sign lock-up agreements committing not to sell their Bigco stock for a period of time (e.g., 2 years) after the reorganization and/or representing that they had no plan or intention to sell the Bigco stock received in the reorganization.

29 IRS ruling guidelines have long required 50% continuity in order to obtain an IRS ruling that a reorganization is tax-free. Courts and practitioners have, however, generally found adequate continuity at the 40% level. The 1998 COSI regulations did not alter the quantum of required continuity.

30 The new COSI regulations do not apply to spin-offs.

companies by private equity investors. In particular, it should no longer be necessary to enter into tax-oriented lock-up agreements or to give representations regarding the lack of an intent to sell Bigco stock received in the transaction.[31]

31 Where Bigco's acquisition of Target is structured to qualify for "pooling of interests" accounting, Target affiliates are generally required to agree not to dispose of any Bigco stock received in the acquisition until Bigco and Target have published financial statements showing at least 30 days of combined operations.