# NEW 2019 Edition of

# Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions

We are proud to enclose the updated 2019 edition of **Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions** by co-authors Jack S. Levin and Donald E. Rocap, senior partners in the international law firm of Kirkland & Ellis LLP.

Here is a summary, written by the authors, of major developments reflected in the new edition.

## Highlights of the New Edition

- **LBOs and other acquisitions.**
  - **Limitation on business interest deduction.** Code §163(j), enacted in 2017, limits any deduction for business interest—whether incurred by an entity or an individual (including interest incurred on borrowings to effectuate an LBO)—to 30% of the business's EBITDA (or post-2021, an even lower ceiling equal to 30% of EBIT). This provision applies to all types of taxpayers incurring business interest expense—C corp, S corp, partnership (including LLC), and sole proprietorship.[1] Calculation of the §163(j) limitation is complex as applied to business debt incurred by a C corp and even more complex as applied to business debt incurred by a partnership or S corp.

    Excess business interest expense (i.e., business interest that is non-deductible as a result of §163(j)'s 30% limitation) is carried forward indefinitely, treated as business interest expense incurred in each succeeding taxable year, and subjected to Code §163(j)'s limitation in each succeeding taxable year.

[1] With exceptions for certain small businesses, electing real property businesses, electing farming businesses, businesses with floor plan financing interest, and regulated utilities.

- 2018 proposed IRS regulations (upon which a taxpayer is permitted to rely so long as the taxpayer and its related parties apply the proposed regulations consistently) would clarify certain aspects of §163(j), including:
    - Adopting a very broad definition of "interest" and a very broad anti-avoidance rule that would treat "any expense or loss . . . incurred by a taxpayer in a transaction . . . in which the taxpayer secures the use of funds for a period of time . . . as interest expense . . . if such expense or loss is predominantly incurred in consideration of the time value of money," which could potentially treat, e.g., a sale-leaseback transaction as a borrowing transaction for §163(j) purposes.
    - Confirming the use of Temp. Treas. Reg. §1.163-8T's tracing approach for any entity (other than a C corp) or individual engaged in both business and investment activities in order to determine whether interest expense incurred by such entity or individual is properly allocable to an investment activity, a personal activity, or a business activity.
    - If a C corp with Code §163(j) excess business interest expense (which is being carried forward indefinitely) suffers a Code §382 ownership change, its business interest expense carryforward is thereafter limited by "rules similar to the [Code §382] rules" applicable to NOL carryforwards.
    - If a person or group acquires control of a C corp which has a Code §163(j) excess interest deduction carryforward and the principal purpose for such control acquisition is to secure the benefit of the C corp's deductions or other tax attributes, §269 would disallow such interest deduction carryforward. See discussion at ¶601.1.6.4(1).

- **HSR filing.** A Hart-Scott-Rodino ("HSR") filing with FTC/DOJ is required if the size of an acquisition or investment (and, in certain cases, the size of the parties to the transaction) exceeds specified numerical tests.
  - **Annual inflation adjustment.** The authors have updated the HSR discussion to reflect the 4/19 annual inflation adjustment of all relevant HSR tests, thresholds, and filing fees.
  - **Non-compliance penalty.** A party failing to comply with HSR reporting and waiting period requirements is subject to a civil penalty which (effective 4/3/19) increased to a maximum of $42,530 per day during any non-compliance period. See discussion at ¶501.3.3.1.

- **Regulatory restraints on investments by a PE/VC fund which is a bank holding company affiliate.** Where a PE/VC fund is a bank holding company or a subsidiary or affiliate thereof, the Bank Holding Act permits such fund to make a PE/VC-type investment only if such investment falls into at least 1 of 5 permissive baskets:

- Reg Y and the 5/25 rules,
- the SBIC rules,
- Reg. K,
- the merchant banking rules, or
- the financial-in-nature rules.

The Fed has recently clarified a number of aspects of the complex 5/25 rules. See discussion at ¶209.2.1.1.

- **Where BuyerCo acquires Target in a highly leveraged LBO and BuyerCo/Target goes bankrupt reasonably soon thereafter, Bankruptcy Code §546(e) may protect Target shareholders from fraudulent conveyance liability.**

  - **Application of fraudulent conveyance doctrine to failed LBO.** Where PE-financed BuyerCo acquires Target in an LBO, the transaction structure generally prejudices Target's old unsecured creditors because (i) the proceeds from BuyerCo's substantial acquisition borrowings are paid out to Target's old shareholders (as the purchase price for Target), (ii) while the acquisition lenders acquire a claim against Target's old assets which (if secured by the BuyerCo/Target assets) is superior to the claim of Target's old unsecured creditors or (if not so secured) is pari passu with the claim of Target's old unsecured creditors.

    If the BuyerCo-Target enterprise then goes bankrupt reasonably soon after the LBO (e.g., because of an unanticipated business downturn combined with BuyerCo's substantial LBO acquisition debt), Target's old trade and general creditors (and in some circumstances Target/BuyerCo's new trade and general creditors) often assert a fraudulent conveyance claim against:

    (a) the LBO acquisition lenders,

    (b) Target's old shareholders (to the extent of each shareholder's proceeds from Target's sale to BuyerCo), and

    (c) the LBO's private equity sponsor(s).

    The validity of such a fraudulent conveyance claim generally turns on the highly subjective issues of whether BuyerCo/Target, immediately after the LBO, either:

    (1) was insolvent (debts greater than asset FV), or

(2) was inadequately capitalized, or

(3) did not reasonably expect to be able to pay its obligations as they mature in the ordinary course of business.

In the context of a complex LBO with many participants (e.g., Target shareholders, acquisition lenders, PE/VC sponsors, Target directors), there is very little law on how the aggregate amount of damages to creditors harmed by a fraudulent conveyance is allocated among those LBO participants who are ultimately determined to be liable for the fraudulent conveyance. Hence, it is unclear:

(i) whether a court would permit a contribution claim—after fraudulent conveyance liability has been established and damages paid—by 1 LBO participant against another participant and

(ii) if so, how the relative fraudulent conveyance liability amount allocated to each participant would be computed.

Indeed, federal case law seems to suggest that no such contribution right is available.

- ▲ **Possible Bankruptcy Code §546(e) protection.** Where a Target shareholder is, or receives payment for Target stock through, a "stockbroker," a "financial institution" (which includes a bank, S&L, or trust company), or a "financial participant" (which includes an entity with at least $1 billion of securities contracts),[2] confusing and poorly worded Bankruptcy Code §546(e) had long been interpreted by several federal courts of appeals as exempting from fraudulent conveyance attack the Target sale proceeds received by a Target shareholder through a protected person.

- ▲ **U.S. Supreme Court 2018 decision.** However, in 2018 the U.S. Supreme Court in the *Merit Management Group* case held that §546(e) does not protect a fraudulent transfer in which the protected person served as a mere *conduit* for a Target shareholder to receive the Target sale proceeds. Rather, the Supreme Court concluded that a court must "look to the transfer that the [bankruptcy] trustee seeks to avoid," i.e., to the cash transfer from BuyerCo to the old Target shareholder, which did not actually involve a protected person as a *substantive* participant.

- ▲ **Remaining routes to §546(e) protection.** There are still, however, several possible routes for a Target shareholder to seek §546(e) protection:

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[2]All of which persons are herein collectively referred to as a "protected person" (a term not used in the Bankruptcy Code).

*First*, where a Target shareholder *itself* falls within §546(e)'s complex definition of a protected person, it still seems clear that the stock sale proceeds received by such Target shareholder are protected by §546(e) from fraudulent conveyance attack. This would apparently include, for example, a stock sale "payment . . . to . . . [a Target shareholder which is itself either] a . . . stockbroker, [a] financial institution" (including a bank or trust company), or a large investment fund either registered under the Investment Company Act of 1940 or with at least $1 billion of "securities contracts" (as defined in the Bankruptcy Code).

*Second*, the Supreme Court's opinion did not discuss the circumstances under which a stockbroker, bank, or other financial institution (i.e., a protected person), although acting on behalf of a Target shareholder (and not on behalf of itself), would be viewed as playing a sufficiently substantive role as to invoke §546(e) on behalf of the Target shareholder.

*Third*, the Bankruptcy Code's "financial institution" definition (somewhat confusingly) includes a person who is a "customer" of a "financial institution" when the financial institution "is acting as *agent* . . . for . . . [such] customer . . . in connection with a securities contract" (emphasis added). Hence it appears that in the case of a Target shareholder who utilizes a financial institution to act as its "agent" (a term not defined in the Bankruptcy Code), with the financial institution playing a more substantive role than merely serving as a conduit transferring the wire transfer proceeds to the Target shareholder, "such customer" (i.e., the Target shareholder) may qualify as a protected person for §546(e) purposes with respect to the proceeds from the securities contract being collected by the financial institution as "agent" for such customer. The Supreme Court's *Merit Management Group* decision did not discuss this issue.

*Fourth*, in a 4/19 federal district court decision, BuyerCo (which was acquiring Target) retained a financial institution to act as *BuyerCo's* (not as the Target shareholders') "agent" in distributing the LBO proceeds to Target's shareholders, so that such financial institution was not the Target shareholders' agent but rather was *BuyerCo's* "agent . . . tasked with making payments on [BuyerCo's] . . . behalf to [Target's] Shareholders upon the tender [to the financial institution agent] of their [Target] stock certificates" as part of a "securities contract."

The district court concluded that BuyerCo "itself was a financial institution" (although BuyerCo was in the newspaper and broadcasting business, rather than a financial business) based on the following reasoning:

(i) BuyerCo had retained a financial institution to serve as BuyerCo's "agent or custodian" "in connection with the LBO transaction," i.e., to distribute the LBO proceeds to Target's shareholders, so that BuyerCo was the financial institution's "customer."

(ii) §546(e) states that "when [a financial institution as defined in §546(e)] is acting as agent or custodian for a customer [here BuyerCo] . . . in connection with a securities contract . . . such customer" is a financial institution and hence a §546(e) protected person.

(iii) Since BuyerCo was a financial institution for purpose of §546(e), BuyerCo's payments to Target's shareholders (apparently all of Target's shareholders) were made "*by* . . . a financial institution" (emphasis added), and thus were within the statutory language protecting a settlement payment "made *by* or to (or for the benefit of) a . . . financial institution" (emphasis added). See discussion at ¶501.4.3.9(5).

- **BuyerCo may have U.S. taxable income if BuyerCo's non-U.S. corporate subsidiary lends credit support to BuyerCo's LBO borrowing (or any other BuyerCo debt).** If BuyerCo's borrowing (e.g., to finance an LBO) is supported (as defined below) by a BuyerCo *non-U.S.* corporate subsidiary, BuyerCo is generally treated for U.S. tax purposes as receiving taxable OI in an amount based on (a) the amount of debt so borrowed and supported and (b) the amount of BuyerCo's share of the non-U.S. subsidiary's earnings not previously taxed to BuyerCo. However, if BuyerCo is a C corp, BuyerCo does not recognize such OI to the extent that an actual dividend payment by the non-U.S. subsidiary to BuyerCo would qualify for the post-2017 100% dividends received deduction for certain dividends received from a controlled foreign corporation.[3]

  Each of the following types of credit support invokes this OI tax rule:

  (i) BuyerCo's *non-U.S.* corporate subsidiary guarantees BuyerCo's debt, or

  (ii) BuyerCo's *non-U.S.* corporate subsidiary pledges assets to secure BuyerCo's debt, or

  (iii) BuyerCo pledges at least two-thirds of a *non-U.S.* corporate subsidiary's *voting* stock to secure BuyerCo's debt *and* such non-U.S. corporate subsidiary or BuyerCo also enters into a negative covenant effectively restricting the non-U.S. corporate subsidiary's ability to dispose of assets or incur debt.

[3]While the OI can be viewed as analogous to a dividend from the non-U.S. subsidiary to its shareholders, the Code treats such amount as OI, hence not qualifying for certain pro-taxpayer rules regarding dividend income, e.g., the 20% tax rate for individuals receiving QDI.

Indeed there is some risk IRS might take the position (which we believe would be wrong) that these rules apply even more broadly to cause BuyerCo to recognize such OI where BuyerCo pledges not the non-U.S. subsidiary's stock but rather the stock of BuyerCo's U.S. subsidiary (U.S. Holdco) which holds at least two-thirds of the voting stock of 1 or more BuyerCo non-U.S. subsidiaries and grants negative covenants to the lenders with respect to 1 or more of such non-U.S. subsidiaries' asset dispositions or debt incurrences outside the ordinary course of business, perhaps where U.S. Holdco is a U.S. special purpose entity formed as a BuyerCo subsidiary in connection with the pledge and is prohibited by loan covenants from conducting other business activities. See discussion at ¶501.4.3.10(2).

- **Federal income tax rates for 2019 and thereafter.**
  - **C corp income tax rate.** The federal *C corp* income tax rate for 2019 and for some years thereafter (on both OI and LTCG) is 21%.
  - **Individual income tax rates.** The top federal *individual* income tax rates for 2019 and for some years thereafter (which also applies to partnership, LLC, or S corp income flowing through to an individual equity owner) are as follows:
    - For **OI**, the top rate is 37%,
      - with a possible reduction of the top rate to 29.6% for U.S. "business" OI flowing through a partnership, LLC, proprietorship, or S corp to a qualified individual equity owner (as further discussed below).
    - For **normal LTCG**, the top rate is 20%.
    - For **STCG**, the top rate is 37%.
    - For **QDI** (qualified dividend income), the top rate is 20% (i.e., the same as for LTCG).
    - For **Code §1202 LTCG** (from sale of "qualified small business stock" held more than 5 years), the top rate is:
      - 0% for such stock acquired after 9/27/10,
      - 7% for stock acquired between 2/18/09 and 9/27/10, and
      - 14% for stock acquired between 8/11/93 and 2/17/09.
  - **Individual income-based Medicare tax** (in addition to regular income tax discussed above):
    - On **compensation and self-employment income**, the rate is 3.8%, with (a) 2.9% imposed half on an employer and half on an employee or 100% on a self-employed person plus (b) an additional 0.9% on such income in excess of a threshold amount ($250,000 for a joint-return individual) imposed 100% on an employee or self-employed person.

- On **passive income (including OI, QDI, and CG) from investments and businesses as to which an individual is not active**, the rate is 3.8%, to the extent the individual's AGI exceeds a threshold amount ($250,000 for a joint-return individual).

- **Individual itemized deduction and personal exemption phase-outs** which previously affected individual income taxes are no longer in effect.

See discussion at ¶107.

- **PE/VC funds and other partnership/LLC issues.**

  - **Code §199A reduced individual OI rate for "qualified U.S. business income" from flow-through entity.** Code §199A, enacted by the 2017 Tax Act, provides a special deduction equal to up to 20% of an individual's "qualified business income" ("QBI"), thus reducing such individual's federal income tax rate on QBI by up to 20%, e.g., from 37% to 29.6% for an individual otherwise taxed at the maximum 37% federal rate but who qualifies for the maximum Code §199A deduction.

    2019 regulations have clarified many of §199A's more ambiguous/convoluted provisions, including:

    - the types of businesses for which a higher income individual does not not qualify for §199A's reduced rate (called a "specified service business"),

    - the circumstances under which 2 related businesses are aggregated for §199A qualification and calculation purposes or are viewed as 2 separate businesses (e.g., 1 of which may qualify for §199A and 1 of which may not), with the new 2019 edition containing several examples illustrating application of these complex rules, and

    - application of the W-2 wages/unadjusted asset basis limitation which a higher income individual must satisfy to qualify for §199A. See discussion at ¶302.2.2.

  - **GP and LP liability for insolvent limited partnership's debts.** Where an entity (e.g., a PE/VC fund or a portfolio company) is formed as a limited partnership, the limited partners are generally not liable (under state law) for the entity's unpaid debts in case of the partnership's insolvency, but the GP is generally liable. However, by forming the partnership as a "limited liability partnership" in 1 of the many states which have now adopted "limited liability partnership" legislation, the partnership can—through proper filings—obtain limited liability for its GP (or GPs) in almost all states.

    Generally such protection from partnership liabilities would be achieved by selecting Delaware as the partnership's organization state and making additional filings in a few other states. See discussion at ¶302.1.2(2).

- **U.S. withholding tax imposed on person purchasing partnership/LLC interest from non-U.S. seller.** If a PE fund (or any other business) formed as a partnership or LLC is treated as engaged in a U.S. trade or business (either because of PE fund's own U.S. activities or because PE fund owns an equity interest in 1 or more partnership or LLC portfolio companies engaged in a U.S. trade or business), a non-U.S. partner (including an LP) who sells a partnership interest in such PE fund is treated as receiving income effectively connected with a U.S. trade or business ("ECI"[4]), which triggers a U.S. tax obligation, if and to the extent that the non-U.S. LP would have been allocated ECI if the PE fund (or the flow-through portfolio company) had sold its assets at FV.

  Beginning in 2018, if such a non-U.S. LP sells an interest in a partnership or LLC (e.g., a PE fund) that holds ECI assets directly, or indirectly through flow-through entities, the buyer of such LP interest is generally required to withhold (from the purchase price the buyer of such LP interest is paying to the non-U.S. seller) and pay over to IRS an amount equal to 10% of the gross amount realized by the selling non-U.S. LP. This arbitrary 10%-of-proceeds withholding tax obligation may substantially exceed any U.S. income tax the seller would owe (e.g., where only a small portion of the partnership's assets are ECI assets) and may even exceed the entire sale proceeds (because the "amount realized" from sale of a partnership interest includes not only the proceeds received by the seller but also the selling LP's proportionate share of partnership-level liabilities).

  If the buyer of a partnership interest fails to pay such required withholding to IRS, the partnership is itself obligated to withhold the required amounts (plus interest) from distributions that would thereafter have been made to the buyer (although IRS has temporarily suspended this secondary withholding obligation pending issuance of further guidance).

  A 2018 IRS notice (the "certification notice") exempts the buyer of the partnership interest from the withholding obligation described above if the buyer receives a certification:

  (a) from the seller of the partnership interest that the seller is a U.S. person, or

  (b) from the seller that the seller is not recognizing any gain from the transfer, or

  (c) from the seller that less than 25% of the seller's allocated income with respect to the partnership interest for each of the 3 preceding taxable years was ECI, or

[4]ECI means effectively connected income, i.e., income effectively connected to a U.S. trade or business.

(d) from the partnership that, if the partnership were to sell its assets at FV, less than 25% of the gain realized on such asset sale would be ECI.

5/19 proposed regulations, if and when finalized, would replace the above-discussed 2018 IRS certification notice and would:

- ▲ narrow certification exception (c) above by (i) reducing the prior-3-year ECI threshold from 25% of total allocated partnership income to the lesser of 10% of total allocated partnership income and $1 million and (ii) requiring the seller to certify that it has filed timely federal income tax returns reporting such ECI,
- ▲ narrow certification exception (d) by reducing the deemed asset sale ECI threshold from 25% to 10%,
- ▲ add an additional withholding exception where the seller certifies that its gain on the partnership interest sale is not subject to U.S. tax pursuant to an applicable tax treaty,
- ▲ in the case of a non-US partnership seller owned in whole or in part by U.S. persons, allow the selling partnership to certify the portion of the amount realized that is attributable to U.S. partners, which portion would then be exempt from withholding, and
- ▲ implement the requirement that the partnership withhold tax from distributions to the purchaser if the partnership does not receive sufficient evidence that the purchaser has satisfied its withholding obligation (or that the transfer qualifies for an exception from withholding).

For a post-2017 sale of an LP interest, both the PE fund's GP and the LP-interest buyer should ensure that appropriate certifications, representations, and indemnities are obtained to protect the LP interest buyer and the PE fund from risk of liability for failure to comply with this required tax withholding obligation. See discussion at ¶1015.7.

- **. . . and much, much more . . .**