NEW December 2020 Edition of

Mergers, Acquisitions, and Buyouts

by Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap

We are proud to enclose the December 2020 edition of Ginsburg, Levin, and Rocap's **Mergers, Acquisitions, and Buyouts.**

Here is a summary of major developments reflected in the new edition, written by co-authors Jack S. Levin and Donald E. Rocap, senior partners in the international law firm of Kirkland & Ellis LLP.

Highlights of the New Edition

- **Major overhaul of SEC securities rules effective early 2021 significantly broadens P's ability to issue stock without 1933 Act registration.** When P issues stock (or debt instruments) either (i) in its acquisition of T or (ii) for cash, P must register such securities with SEC under the Securities Act of 1933 (entailing significant expense, substantial delay, and public disclosure of information) unless P satisfies an SEC exemption.

  In 11/20 (by 3–2 vote) SEC very substantially broadened most of the 1933 Act exemptions, as described below, effective 60 days after publication in the Federal Register, which publication has not yet occurred at the time of this report letter's issuance, making it considerably easier from an SEC standpoint for P to issue its stock in exchange for T's stock or to raise cash.

  - **Reg. D Rule 504 private placement.** Reg. D Rule 504 has long allowed P (so long as P is not a 1934 Act reporting company or an investment company) to issue up to $5 million of stock in a private placement (without 1933 Act registration) to an unlimited number of both accredited investors (AIs) and non-accredited investors (non-AIs) (including T's shareholders in P's acquisition of T),

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without any express disclosure requirement,[1] so long as there is no general solicitation or advertising (i.e., no GSA[2]), meaning that P or its executives or fund raisers must have a pre-existing substantive relationship with each offeree.[3] Such P stock issued in a Rule 504 private placement is "restricted," meaning the holder cannot generally resell such P stock to the public without 1933 Act registration or an exemption.

The 11/20 SEC amendments (which will become effective in early 2021) (i) double the maximum permitted amount of a Rule 504 offering from $5 million to $10 million and (ii) liberalize the GSA definition so P can participate in events sponsored by certain angel investor groups, educational entities, and governmental agencies without constituting prohibited GSA, while a previous Reg. D amendment (effective 12/20) broadened the AI definition to include individuals with certain professional certifications and licenses (to be identified by SEC from time to time).

- **Reg. D Rule 506(b) private placement.** Rule 506(b) has long allowed P, so long as there is no GSA (other than as permitted by the liberalizing amendment discussed above which is effective 60 days after Federal Register publication), to issue an unlimited amount of restricted stock to an unlimited number of AIs plus up to 35 "sophisticated" non-AIs (including T's shareholders).
- **Reg. D Rule 506(c).** Rule 506(c) has long allowed P to issue an unlimited amount of restricted stock to an unlimited number of AIs (as broadened by the SEC amendment effective 12/20 discussed above), while fully utilizing GSA, so long as no P stock is issued to a non-AI.
- **Reg. Crowdfunding.** Reg. Crowdfunding has since 2013 allowed P to issue up to $1 million of stock in a 12-month period, through an independent intermediary's Internet portal (with limited information portrayed on such portal) to an unlimited number of both AI and non-AI investors for cash (but not as part of the consideration in P's acquisition of T), with a non-AI investor limited to a formula amount (based on the investor's income and net worth) in all crowdfundings purchased by such investor over a 12-month period, which stock becomes freely tradable 12 months after such purchase.

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[1]But 1934 Act Rule 10b-5 nevertheless prohibits P from issuing a security while omitting to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading.

[2]Subject to 3 very narrow long-standing GSA exceptions (which turn on state securities law) which if satisfied permit P to utilize GSA.

[3]Where P is acquiring T and issuing P stock to T's shareholders, P can generally rely on T's relationship with T's shareholders as constituting such a pre-existing substantive relationship for P.

The 11/20 SEC amendments increase to $5 million the maximum amount of stock P can issue under this exemption in a 12-month period.

- **Rule 701.** Rule 701 has long allowed P (so long as not a 1934 Act reporting company) to issue restricted common stock to its service providers (i.e., employees, directors, and consultants) in ''compensatory circumstances'' up to $1 million in a 12-month period (or possibly more than $1 million, depending on the amount of P's assets and/or outstanding stock), without significant disclosure requirements (unless the aggregate service provider offerings exceed $10 million over a 12-month period).

- **Reg. A.** The 11/20 SEC amendments allow P to issue (i) up to $75 million of P unrestricted stock (increased from $50 million) under Reg. A tier 2 (including to T's shareholders in P's acquisition of T), with GSA allowed or (ii) up to $20 million of unrestricted stock (same amount as before the 11/20 SEC amendments) under Reg. A tier 1.

- **Clarifying SEC integration rules.** In the past SEC has viewed multiple P securities offerings effectuated over an expanded period of time as constituting a single offering in applying not only Reg. D but most other exemptions from 1933 Act registration discussed above, by applying a very subjective 5-factor test, i.e., whether:

  - such P offerings were part of the same plan of financing,
  - such P offerings were the same class of securities,
  - such P offering occurred at about the same time,
  - P obtained the same type of consideration from such offerings, and
  - P used the proceeds from such offerings for the same general purpose.

  This vague integration doctrine often prevented P from effectuating multiple stock offerings, although each offering would have ostensibly qualified for exemption under 1 of Rule 504, Rule 506(b), Rule 506(c), Reg. Crowdfunding, Reg. A, etc.

  The 11/20 SEC amendments abandoned this subjective integration approach and instead adopted a series of objective integration rules based principally on:

  (i) the length of time between offerings,

  (ii) whether an offering allowed GSA,

  (iii) whether an offering was 1933 Act registered,

  (iv) whether an offering was non-integratable because pursuant to Rule 701 (employee offering) or Reg. S (offshore offering), both of which have long been exempted from SEC's integration doctrine, and

(v) whether 1 offering terminated before the other offering began and, if so, how long before.

See discussion at ¶1702.11.

- **Code §163(j) limit on business interest deduction.** Code §163(j), as amended by the 2017 Tax Act, effective for taxable years beginning after 12/31/17, limits deductibility of business interest expense. This limitation applies to all taxpayers incurring business interest expense—C corps, S corps, partnerships, and individuals—with exceptions for certain small businesses, electing real property businesses, electing farming businesses, businesses incurring floor plan financing interest expense, and regulated utilities.

  - **Application to C corp.** A C corp's deduction for business interest expense is generally limited to (a) the C corp's business interest income plus (b) 30% (50% for taxable years beginning in 2019 and 2020) of its ''adjusted taxable income.'' To apply the §163(j) limitation it is necessary to (i) identify the C corp's ''business interest expense'' and ''business interest income'' and (ii) to calculate its ''adjusted taxable income.'' 2020 final and proposed regulations provide (generally applicable to taxable years beginning after 11/12/20) guidance on these terms.

    First, although Code §163(j) does not grant IRS any regulatory authority to define ''interest expense'' for §163(j) purposes in a manner different than its normal definition for federal income tax purposes generally, the 2020 final regulations define ''interest expense'' for purposes of Code §163(j) far more broadly. Beginning with a general definition that follows general tax principles, ''interest'' includes amounts ''paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement . . . that is [x] treated as a debt instrument [including as a result of application of substance-over-form principles] for purposes of section 1275(a) . . . or . . . is [y] treated as interest under other provisions of the Code.'' This general definition is intended to pick up items including:

    (i) the time value component of a deemed loan embedded within a swap contract providing for significant non-periodic payments,

    (ii) amortization of loan issuance premium,

    (iii) OI or OL with respect to contingent payment debt instruments, and

    (iv) income or loss from factoring transactions.

    In addition, the 2020 regulations, asserting general regulatory authority to achieve the purpose of §163(j), include a broad anti-avoidance rule treating as §163(j) business interest expense any ''expense or loss economically equivalent to interest if a principal purpose of structuring the transaction(s) is to reduce an

amount incurred by the taxpayer that otherwise would have been'' treated as interest expense for §163(j) purposes. Under this regulation, any deductible expense or loss is treated as ''economically equivalent to interest'' if incurred ''in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time'' and is ''substantially incurred in consideration of the time value of money.'' The regulations contain examples applying the anti-abuse rule, including where (i) a U.S. subsidiary corporation seeks to reduce its business interest expense by having its more creditworthy non-U.S. parent guarantee the subsidiary's debt, with the subsidiary paying a guarantee fee to the parent, and (ii) where a partnership seeks to reduce its business interest expense by raising capital through issuance of preferred equity (so that preferred return allocations on such partnership preferred equity would be deductible) rather than debt.

Particularly in light of the questionable regulatory authority for this anti-avoidance rule, we believe that such rule should apply fairly narrowly. For example, where a non-U.S. parent guarantees debt of a U.S. subsidiary in order to reduce such U.S. subsidiary's financing costs or where a partnership raises capital by issuing preferred equity rather than debt in order to improve the partnership's balance sheet, we believe the anti-abuse rule should not apply unless the potential §163(j) benefit of such financing arrangement was a principal purpose for choosing the financing arrangement.

However, IRS apparently regards the ''anti-avoidance'' rule as less an ''anti-abuse'' rule and more an ''anti-acting-rationally-with-knowledge-of-applicable-tax-provisions'' rule. The regulations state that ''the fact that the taxpayer has obtained funds at a lower pre-tax cost based on the structure of the transaction(s) does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense.''

This anti-avoidance rule focuses on the intent of the party incurring the expense subject to possible recharacterization as §163(j) business interest expense and not on the intent of the counterparty. The regulations permit the counterparty to treat the corresponding interest-equivalent income item as §163(j) business interest income only if and to the extent the counterparty ''knows that an expense or loss is treated by the payor as interest expense'' under the anti-avoidance rule.

For good measure, the regulations (again without support of any specific regulatory authority) throw in a mirror anti-avoidance rule that can treat actual business interest income earned with bad intent as not §163(j) interest income: ''any income realized by a taxpayer in a transaction or series of integrated or related

transactions is not treated as interest income of the taxpayer if and to the extent that a principal purpose for structuring the transaction(s) is to artificially increase the taxpayer's business interest income.''

Second, the determination of a C corp's ''adjusted taxable income'' requires numerous adjustments and a circular calculation, since the ''adjusted taxable income'' determination starts with the C corp's taxable income, but the C corp's taxable income in turn depends on the C corp's allowable interest expense *after* giving effect to the §163(j) deduction limitation.

The 2020 regulations avoid this circular calculation problem by providing that the ''adjusted taxable income'' determination starts with ''tentative taxable income,'' a hypothetical federal taxable income amount calculated as if §163(j)'s interest deduction limitation did not apply (but does take into account any other limits on interest deductibility). The 2020 regulations provide guidance on the numerous adjustments to ''tentative taxable income'' in calculating ''adjusted taxable income.''

- **Application to partnership (or LLC taxed as a partnership).** While the §163(j) rules are complicated as applied to C corps, they are even more so as applied to a partnership. The first partnership complexity is that while all of a C corp's activities are treated as ''business'' activities, a partnership may be treated as engaged in both ''business'' and ''investment'' activities, requiring the partnership to allocate its interest income, interest expense, and other items of income and expense between its ''business'' and its ''investment'' activities.

  The 2020 §163(j) regulations confirm use (with minor adjustments) of long-standing Temp. Reg. §1.163-8T's tracing approach to determine whether items of interest expense incurred by a taxpayer other than a corporation are properly allocable to an investment activity (or to a personal expenditure) or to a business activity. (The regulations do not, however, permit a tracing approach to be used for purposes of allocating items of business interest expense and business interest income between businesses that are subject to §163(j) and those that are exempt.)

  Neither Code §163(j) nor Temp. Reg. §l.163-8T addresses the characterization of interest on debt traced to distributions made by a pass-through entity to its equity owners. Under 2020 proposed regulations, a partnership's (or an S corp's) distributed debt proceeds would first be allocated to the entity's ''available expenditures,'' i.e., expenditures made by the entity in the same taxable year as the distribution to its equity owners, but only to the extent other debt proceeds are not otherwise allocated to such expenditures. The interest expense attributable to such debt proceeds would be characterized based on the nature of such entity-level expenditures (i.e., as business or investment expense). Any remaining amount of

distributed debt proceeds would be allocated to distributions to the entity's equity owners. To the extent an owner is allocated a proportionate share of the partnership's or S corp's related interest expense that does not exceed the owner's proportionate share of the distributed debt proceeds, the related interest expense would be characterized based on the owner's use of the distributed proceeds (i.e., as business, investment, or personal). To the extent an owner is allocated a proportionate share of the partnership's or S corp's related interest expense that exceeds the owner's proportionate share of the distributed debt proceeds, the related interest expense would be characterized based on the relative adjusted basis of the borrowing entity's assets used in business or investment activities.

The second partnership complexity is that partnership business interest deductions disallowed by §163(j) are not carried forward by the partnership which incurred such interest deductions but rather flow through to the partnership's equity owners and are held in suspense at the equity owner level (under the "silo" rule) until the equity owner is allocated "excess taxable income" or "excess business income" from such applicable partnership (i.e., the same partnership as incurred the not-yet-deductible business interest expense). The 2020 regulations provide detailed guidance on how these excessively complicated rules operate.

Under the partnership §163(j) rules, flow-through to a partner of not-immediately-deductible interest expense produces an immediate reduction in the partner's tax basis in its partnership interest, which basis reduction is reversible if the suspended interest expense has not been freed up for deduction by the time the partner disposes of her equity interest in the partnership. The statutory language is unclear on whether any reversal of such basis reduction occurs upon disposition by a partner of part, but not all, of the partner's interest in the partnership. Under the 2020 regulations the disposition of a portion (but not all) of a partnership interest results in a partial reversal of the partner's basis reduction corresponding to the portion of the partnership interest disposed of (and also a corresponding reduction/extinguishment of the partner's unused excess business interest expense), with such portion based on the ratio of the transferred partnership interest's FV to the total FV of the transferor's partnership interest immediately prior to such disposition.

The 2020 final regulations do not address whether a partnership distribution that has the effect of reducing the distributee partner's partnership interest is treated as a "disposition" by the partners for this purpose. 2020 proposed regulations provide that a partnership distribution of cash or property in complete liquidation of a partner's interest would be treated as a complete "disposition," but that a partnership distribution in partial liquidation of a partner's interest would not be treated as a partial "disposition" for this purpose.

Under the 2020 regulations, any partnership-level business interest income that is not netted against business interest expense at the partnership level flows through to partners as "excess business interest income" and is available to be netted against partner-level business interest expense. The 2020 proposed regulations would add a taxpayer-favorable rule for a self-charged lending transaction—if a partner makes a loan to the partnership and is allocated excess business interest income from the partnership, a corresponding amount of the lending partner's interest income from the loan would be treated as an allocation of excess business interest income from the partnership.

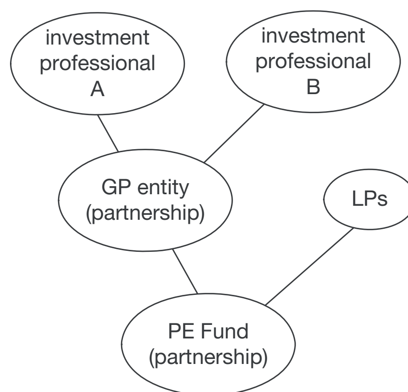
- **Application to S corp.** Under the 2020 regulations, the §163(j) rules for an S corp differ from those applicable to a partnership in the treatment of §163(j)-limited business interest expense. Rather than allocating §163(j)-limited business interest expense to an S corp's equity owners, §163(j)-limited interest expense deductions are carried forward at the S corp level (as is the case for a C corp). In the event of an ownership change of the S corp, such excess business expense carryforwards are subject to limitation under the rules of Code §382.

- **Code §163(j)-exempt business.** Where a taxpayer is engaged in both §163(j) exempt real property business activity (or any other §163(j)-exempt business activity) and business activity subject to §163(j), the taxpayer must determine whether items of business interest expense, business interest income, and other §163(j)-relevant items are properly allocable to the §163(j)-exempt business(es) or the business(es) subject to §163(j). The 2020 regulations provide a detailed set of rules for making such determinations. For purposes of allocating business interest expense and business interest income, the regulations specifically reject a tracing approach and instead allocate interest income and interest expense among the exempt and non-exempt businesses based on the relative amounts of the taxpayer's adjusted tax basis in the assets used in its exempt and non-exempt businesses. See discussion at ¶1305.1.

- **Code §409A executive compensation penalty tax when P acquires T, with old T executive who becomes P executive receiving new P NQO in substitution for old T NQO.** Code §409A imposes a penalty tax if the old T executive's new P NQO is more favorable to the executive than was the old T NQO. The authors analyze and explain the confusing IRS regulatory test which must be satisfied in order to avoid such tax penalty. See discussion at ¶1506.8.2.1(9).

- **Post-2017 3-year holding period requirement for PE/VC fund's investment professionals to qualify for LTCG tax rate on carried interest CG.** An individual investment professional (including a member of PE/VC fund's GP entity) holding a "carried interest" in an investment partnership (i.e., a share of partnership profits

disproportionate to contributed capital) was long entitled to the LTCG tax rate (which is lower than the OI tax rate) for such investment professional's allocable share of carried interest CG on assets held by the fund for more than 1 year. However, very complex Code §1061 (effective for taxable years beginning after 12/31/17) imposed a special 3-year holding period requirement in order for such an investment professional's carried interest gain to achieve LTCG status.[4]



Specifically, if an "applicable partnership interest" (an API) is held (directly or indirectly) by an individual (e.g., investment professional A or B), LTCG that would otherwise be recognized by the individual with respect to that interest is recharacterized as STCG (and hence is taxable at the higher OI rate) to the extent such net LTCG exceeds the net LTCG that would have been recognized if the LTCG holding period was more than 3 years, rather than more than 1 year.

- **API definition.** An API is any partnership interest "which, directly or indirectly, is transferred to (or held by) the [individual] taxpayer in connection with the performance of substantial services by the taxpayer, or any related person, in any applicable trade or business." An "applicable trade or business" is an activity conducted through one or more entities that "consists, in whole or in part of . . . (A) raising or returning capital and (B) either (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets."

  Specified assets are:

  - Securities, as defined in Code §475(c)(2), which means (i) corporate stock, (ii) equity interests in a widely held[5] or publicly traded partnership or trust,

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[4]But §1061 does not apply to recharacterize QDI.
[5]Code §475 and the regulations thereunder do not provide guidance on the meaning in this context of the term "widely held."

(iii) debt instruments, (iv) interest rate, currency, or equity notional principal contracts, (v) derivative financial instruments in any of the above list of securities or any currency, and (vi) any identified hedge with respect to such list of securities;

- Commodities, as defined in Code §475(e)(2), are (i) commodities that are actively traded (i.e., traded on an established securities market) and (ii) notional principal contracts, other derivative instruments, and identified hedges with respect to such commodities;
- Real estate held for rental or investment;
- Cash or cash equivalents;
- Options or derivative instruments with respect to specified assets; and
- Non-widely held partnership interests to the extent of the partnership's proportionate interest in specified assets.

The API definition is aimed at partnership interests in GP entities held by PE, VC, mezzanine debt, and hedge fund *investment professionals* who typically:

(a) share in fund carried interest or incentive allocation through partnership interests in the fund's GP entities,

(b) acquire or hold such GP interests in connection with their performance of substantial services for the GP entity or for an affiliated management company entity, and

(c) perform activities (through GP or management company entities) including raising and returning capital as well as investing and disposing of assets (including "specified assets") for the fund.

The API definition also appears to cover partnership interests in *PE management company entities* held by PE investment professionals. Although the management company is not investing in or developing specified assets, the PE fund and its GP entity are, and Code §1061(c)(2) provides that the API-activity determination is made "regardless of whether the activity is conducted in one or more entities."

7/20 proposed regulations (which would generally apply to taxable years beginning on or after the date final regulations are issued) adopt an expansive interpretation of the API definition. In particular, the proposed regulations provide that:

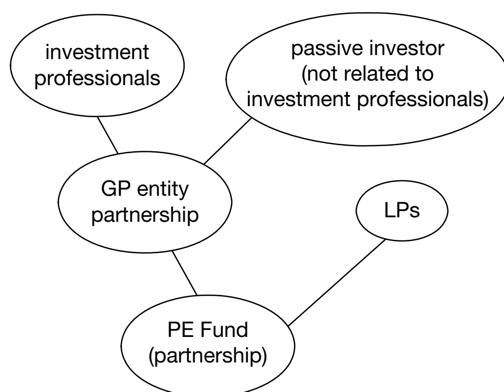
(i) activities in the "raising or returning capital" and the "investing or developing" action prongs of the applicable trade or business test need not occur in the same year,

(ii) activities by taxpayers or related persons through different entities are aggregated, and

(iii) actions taken by an agent or delegate of a principal (e.g., a PE fund management company that is delegated authority to perform investment management services by the PE fund's GP) are attributed to the principal.

The proposed regulations make clear that the API definition generally covers interests in a PE management company partnership.

- **Application to passive investor.** The statutory API definition does not appear to pick up a partnership interest in a GP entity held by a *passive* investor (not related to an investment professional) who purchased such interest in the GP entity, because such investor does not appear to be a "taxpayer" acquiring such interest "in connection with the performance of substantial services by the taxpayer, or any other related person."



However, the 7/20 proposed regulations would expand this statutory API definition to create an entity-level API taint extending to equity owner(s) who neither provide services to the entity nor are related to a person who does so. Based on the statutory language, we believe that such a passive investor should not be swept into Code §1061—either with respect to the passive investor's gain from sale of a GP interest or with respect to allocations of fund gain to such passive investor through the GP entity—merely because the GP entity acquired its carried interest in the underlying fund "in connection with the performance of substantial services" by the GP entity or by persons related to the GP.

The 2020 proposed regulations acknowledge that Code §1061 makes the API characterization at the level of the person who is reporting partnership income on an income tax return and refer to such a person as an "Owner Taxpayer." However, the proposed regulations would broaden the statute's scope by adding the new concept of a "Passthrough Taxpayer" (e.g., a partnership) that the

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regulations would "treat . . . as a taxpayer for the purpose of determining the existence of an API." As a result of such treatment, a partnership interest (in, e.g., a PE fund) acquired by such a Passthrough Taxpayer (e.g., the partnership entity which acts as PE fund's GP) in connection with the performance of substantial services by such GP entity (including agents or delegates of the entity) or a related person in an applicable trade or business would be an API in the hands of a Passthrough Taxpayer. Under the proposed regulations, not-more-than-3-year-CGs flowing through such a Passthrough Taxpayer would retain their §1061 taint (subject to a limited exception discussed below) even if allocated (directly or through 1 or more intermediate flow-through entities) to a *passive investor*.

- **Absence of specified assets.** Limited types of PE funds may escape the scope of Code §1061. In particular, the API definition does not pick up a partnership interest in a GP entity with respect to a fund that does not invest in "specified assets."[6] For example, an oil and gas exploration/production fund investing solely through non-widely held partnerships, as opposed to corporate portfolio companies, does not appear to be conducting an "applicable business." However, a business may be an "applicable business" even if it consists only "in part" of investing in, disposing of, or developing specified assets.

- **§1061 exceptions.** The statute contains several specific §1061 exceptions and there are several potential regulatory exceptions.

  The *first statutory exception* is Code §1061(c)(4)(A), which excepts "any interest in a partnership directly or indirectly held by a corporation," appears broader than likely intended. Although it is sensible to except a U.S. C corp from Code §1061 because C corps do not benefit from a reduced tax rate on LTCG, an S corp does pass through the character of LTCG. Thus Treasury/IRS quickly announced in Notice 2018-18 its intention to issue regulations (retroactive to 1/1/18) providing that this statutory exemption does not apply to a partnership interest held by an S corp, and the 7/20 proposed regulations take this position for an S corp (effective for taxable years beginning after 12/31/17) or a passive foreign investment corporation with respect to which a qualified electing fund election has been made (effective for taxable years beginning after 8/14/20). Although legal authority for this regulation is questionable, it reaches a sensible result, hence we doubt many taxpayers will feel comfortable taking a contrary position.

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[6]Due to the absence of specified assets, carried interest in a fund partnership should not be an API if the fund invests only in portfolio companies each of which:

(i) is treated for federal income tax purposes as a partnership (or disregarded entity),
(ii) is not widely held, and
(iii) is engaged in a business not involving ownership of specified assets (such as corporate stock, equity in a widely held or publicly traded partnership or trust, debt, etc.).

The *second statutory exception* is Code §1061(c)(4)(B), which excepts any capital interest in the partnership which provides the taxpayer with "a right to share in partnership capital commensurate with . . . the amount of capital contributed," which should apply where an investment professional invests capital in the fund (directly or through the GP entity) at the same time, and in exchange for the same interest in partnership capital, as passive fund investors.

However, the 7/20 proposed regulations contain an excessively narrow interpretation of this exception, so that as drafted many or most allocations with respect to the invested capital of PE professionals may fail to qualify for the qualified capital interest exception. Under the regulations, qualified capital interest allocations must be made both to an API holder and to the fund's unrelated non-service providers "based on their respective capital account balances." In most private equity funds, income allocations with respect to an investment are based on the partners' respective capital contributions which funded the applicable investment or based on the partners' respective aggregate capital commitment to the fund, and hence are not "based on . . . capital account balances."

In addition, the proposed regulations require that the allocations be made in the "same manner" to an API holder and to the fund's unrelated non-service partners, subject to a qualification that "an allocation to an API Holder will not fail to qualify because it is not reduced by the cost of services provided by the API Holder or a Related Person to the partnership." In many PE funds, the invested capital of a PE professional is not subject to GP carried interest. It is not clear whether, for purposes of the qualified capital interest exception, the carried interest is a "cost of services" that an investment professional's capital is permitted not to bear.

Also, under the proposed regulations, in applying the qualified capital interest exception, a capital account would not include "the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership." PE firms often provide financing for the capital commitments of junior investment professionals or provide credit support for such financing provided by unrelated lenders. Under the proposed regulations, such financing would prevent the capital interest of such junior investment professionals from meeting the qualified capital interest exception. This proposed limitation is in no way suggested by Code §1061's statutory language, but rather appears to reflect an IRS desire to impose a limitation that was included in pre-2017 proposed (but unenacted) carried interest legislation not included in §1061.

The preamble to the proposed regulations suggests that the final regulations may broaden the qualified capital interest exception, stating that the "Treasury Department and the IRS understand that the allocations in the proposed regulations do not include all allocation arrangements . . . [and] request comments

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on other allocation arrangements that appropriately could be treated as [eligible for the exception] . . . under the regulations without inappropriately expanding the capital interest exception.''

The 7/20 proposed regulations would add a *new regulatory exception*. As described earlier (in our discussion of the API definition), the proposed regulations would extend the scope of §1061 to cover a passive investor in a ''Passthrough [Entity] Taxpayer'' that holds an API (such as a passive investor in a GP partnership that in turn holds a carried interest in a PE fund). That is, the Passthrough Entity Taxpayer's service activities would generally cause the passive investor's interest in the Passthrough Taxpayer to be treated as an API.

However, as a partial limitation on this extension of §1061's scope, such an API taint would not (under the proposed regulations) apply to a person who:

(i) purchases a Passthrough Taxpayer interest for FV in a taxable transaction,

(ii) has not provided services and is not anticipated to provide future services for the Passthrough Taxpayer or any lower-tier partnership, and

(iii) is not related to any person who provides services for the Passthrough Taxpayer or any lower-tier partnership.

The proposed regulations' preamble makes clear that this exception would not, however, apply to a passive investor who acquires an interest in a Passthrough Taxpayer in exchange for a capital contribution to the Passthrough Taxpayer, as opposed to acquiring the interest through a taxable purchase of the interest from another partner. We fail to discern a good reason preventing such a passive investor from qualifying for this potential exception and hope IRS will rethink this point in drafting the final regulations.

Code §1061(b) contemplates a *future regulatory exception* ''To the extent provided by the Secretary, [§1061] (a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.'' This exception appears intended to exempt from §1061 recharacterization gains attributable to a PE fund's enterprise value (as distinct from value attributable to carried interest in assets held by the PE fund), although the benefit of this exception may be limited if it requires effectuating Treasury regulations, and the 7/20 proposed regulations provide no guidance on implementation of this exception.

- **Holding period measurement.** As described above, under a plain reading of §1061, in the case of a sale of a partnership interest, the seller's holding period in the partnership interest (i.e, whether or not more than 3 years) controls, not the partnership's holding period in its underlying assets. However, the 7/20 proposed regulations would override this statutory language in 2 fact patterns.

Under the first override (the "indirect-not-more-than-3-year-API-equity look-through rule"), if an individual recognizes CG from sale of an interest in a pass-through entity (e.g., a partnership or S corp) in which the individual has a more-than-3-year holding period, but the assets of the pass-through entity include a direct or indirect API in which the pass-through entity has a holding period of 3 years or less, the portion of the individual's gain attributable to such underlying API with a holding period of 3 years or less would be treated as §1061 STCG.

Under the second override (the "substantially-all-not-more-than-3-year-assets look-through rule"), if an individual recognizes CG from a direct or indirect sale of an API with a more-than-3-year holding period, a look-through rule would apply if 80% or more of the API partnership's assets (excluding cash, cash equivalents, unrealized receivables, and inventory) consist of assets (i) the sale of which would produce CG or CL (excluding assets, such as §1231 assets, which are not subject to Code §1061 recharacterization) and (ii) which have a holding period of 3 years or less. Under this look-through rule, a portion of the individual's LTCG from the direct or indirect API sale would be treated as §1061 STCG corresponding to the portion of LTCG that would have been subject to §1061 recharacterization had the API partnership sold all of its assets.

- **Carried interest waiver.** Where a PE fund recognizes carried interest CG from sale of an investment with a less-than-3-year holding period, the fund's partnership agreement often permits GP to waive its right to carried interest distributions and allocations from such sale and instead to receive subsequent distributions and allocations—in an amount equal to the waived carried interest CG—from PE fund's future CG on the sale of a different PE fund investment that has met Code §1061's 3-year holding period.

  Where properly structured and permitted by PE fund's partnership agreement, such a waiver should (a) prevent GP from being allocated carried interest CG on PE fund's sale of the investment that has not met Code §1061's 3-year holding period (so no CG is recharacterized under §1061) and (b) allow GP instead to take an increased carried interest CG allocation on a future sale of an investment that has met Code §1061's 3-year holding period.

  While the 7/20 proposed regulations do not address such carry waiver/catch-up arrangements, the preamble to the proposed regulations states that Treasury and IRS "are aware that taxpayers may seek to circumvent section 1061(a) by waiving their right to gains generated from the disposition of a partnership's capital assets held for three years or less and substituting for these amounts gains generated from capital assets held for more than three years. . . . Taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under section 707(a)(2)(A), §1.701-2 and §1.704-1(b)(2)(iii), and/or the substance over form or

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economic substance doctrines." Although these bases for possible IRS challenge should be considered in structuring a carry waiver/catch-up arrangement, we expect that such arrangements will continue to be commonly used. See discussion at ¶1505.2.2.

- **Dissenters' rights of appraisal in acquisition of T corp.** Because Delaware (i) typically updates each year its business-entity-formation-and-operation statutes (i.e., its corporate, partnership, and LLC codes) and (ii) has specialized courts focusing on business-entity litigation, a large percentage of U.S. business entities have been and are being formed in Delaware (whether or not the entity plans to have substantial business operations in Delaware). For this reason, Delaware entity law plays an outsize role in disputes involving mergers and acquisitions.

  At least 1 aspect of Delaware law is unusually complicated: the right of T Corp's shareholders to dissent from a proposed merger and instead seek appraisal rights, when T Corp is being acquired by another business entity. Delaware's complex corporate law grants appraisal rights in a T merger unless at least 1 of the following 2 fairly broad exceptions apply:

  (1) Such class or series of T shares are listed on a national securities exchange *and* also only a "small" number of such T shares seek appraisal (with "small" meaning that such T shares seeking appraisal do not exceed 1% of T's outstanding shares of such class or series eligible for appraisal *and* also that the aggregate merger consideration for such T shares seeking appraisal does not exceed $1 million) *or*

  (2) Such class or series of T shares are:

  (a) either listed on a national securities exchange or held of record by more than 2,000 shareholders *and*

  (b) 100% of the merger consideration (other than cash for fractional T shares) consists of:

  (i) stock of the surviving corporation (whether or not publicly listed or widely held) and/or

  (ii) stock of another corporation which is either listed on a national securities exchange or held of record by more than 2,000 holders.

  However, neither exception (1) nor (2) applies (so that appraisal rights *are* available) if there is no T shareholder vote with respect to the merger because of Delaware Corporation Law §253 (i.e., acquiring entity owns at least 90% of T's stock before the merger).

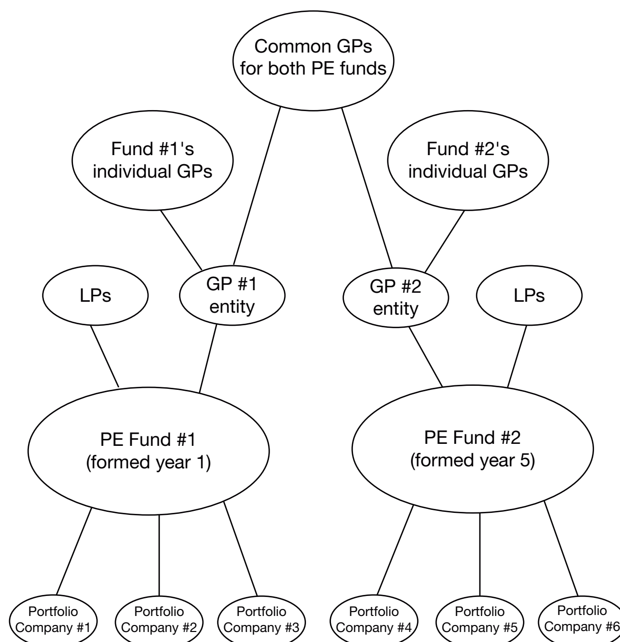
However, a Delaware corporation may in its charter provide additional appraisal rights not otherwise required by law. See discussion at ¶1702.7.3.

- **HSR filing for acquisition.** 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.
  - **Application of HSR reporting rules to acquisition by private equity fund.** Under current HSR rules, where a private equity fund formed as a partnership or LLC (here PE Fund #1) or a PE Fund #1 controlled portfolio company (regardless of whether formed as a corporation, partnership, or LLC) is making an acquisition, the size-of-person test is generally measured at the PE Fund #1 level by taking into account the assets and sales of PE Fund #1 and all its controlled portfolio companies. But PE Fund #1's size does not take into account:

    (a) the assets and sales of PE Fund #2, a separate private equity fund which is under common investment management with PE Fund #1 (formed perhaps 4 or 5 years after PE Fund #1 by some or all of the same individual PE professionals who own PE Fund #1's general partner ["GP"] entity), generally with a name similar to PE Fund #1, or

    (b) the assets and sales of PE Fund #2's controlled portfolio companies,

    although there is substantial overlap in the individual professionals who own PE Fund #1's GP entity and PE Fund #2's GP entity.



This is so because a PE fund is generally a partnership without any GP entity or limited partner entity having HSR "control," i.e., the right to 50% or more of the partnership's profits or assets (after payment of its debts) on dissolution of such fund, i.e., the HSR control test for a non-corporate entity.

In 9/20 FTC proposed an HSR rule change that would affect how the size-of-person test is applied to PE funds. Under the proposed rule, many PE funds would be required to aggregate the holdings of investment managers and entities under common investment management—such as master limited partnerships, families of investment funds, or limited partnerships managed by the same general partner—to determine whether the HSR size-of-person test is satisfied and HSR reporting is thus required.

Moreover, the proposed rule would also require PE funds under common investment management to aggregate the value of an acquisition effectuated by both for purposes of the HSR size-of-transaction test. Under current HSR rules, if PE Fund #1 and PE Fund #2 are each acquiring $50 million of T corporation voting securities, each transaction would be analyzed separately for HSR purposes and neither would be reportable because neither PE fund is acquiring voting securities in excess of the HSR $94 million size-of-transaction threshold. Under the proposed rule, however, if PE Fund #1 and PE Fund #2 are under common investment management, the value of their acquisitions of T corporation voting securities would be aggregated. Since these funds would collectively hold in excess of $94 million of T corporation's voting securities, an HSR filing would be required under the proposed rule (assuming the appropriate size-of-person test were satisfied and no exemption applied).

If adopted, this proposed rule change would likely result in more transactions being subject to HSR notification with significantly more information required to be analyzed and reported in the HSR filing. See discussion at ¶1707.1.2.7.

- **Proposed HSR exemption for up to 10% of T corp's voting stock if P and T have no competitively significant relationship.** In 9/20 FTC proposed to add a new exemption from HSR reporting that would cover an acquisition of up to 10% of T corporation's voting securities provided P (including its ultimate parent entity and any controlled entities) does not have a "competitively significant relationship" with T. This proposed exemption would be available even if the acquisition is not solely for the purpose of investment and even if interaction with management is anticipated. The proposed exemption would be available only where:

(1) P is not a competitor of T,

(2) P does not hold a more than 1% interest in a T competitor,

(3) P does not have a director, officer, principal, or agent serving as a director or officer of T, and

(4) P and T do not have a vendor-vendee relationship with sales in the most recently completed fiscal year exceeding $10 million.

However, the exemption incorporates a broad definition of "competitor" that is likely to limit its application. Moreover, if adopted, this "competitor" definition would also apply to the long-standing passive 10%-or-less exemption, likely limiting application of that exemption as well. See discussion at ¶1707.1.3.1.

- **Sample acquisition agreements.**
  - **P's purchase of T stock, T assets, or a T division.** Volume 5 contains sample acquisition agreements covering P's taxable acquisition of T (for cash and/or cash and debt) via:
    - P's purchase of T's stock,
    - P's purchase of T's assets, or
    - P's purchase of a T division, including both the T division's assets and the stock of 1 or more division subsidiaries,

  with a pro-buyer, pro-seller, and neutral version for each of these 3 acquisition methods.

  The authors have added to these 9 sample acquisition agreements new provisions (R&Ws, conditions, definitions) dealing with COVID-19 and/or other pandemics.

  While each of these 9 sample acquisition agreements assumes P will pay a fixed price for T's stock, T's assets, or the T division, volume 5 also contains formula purchase price adjustment provisions which can be incorporated into any of these 9 agreements in the event the parties intend to adjust the purchase price for T based upon various T financial metrics at closing.

  - **P's acquisition of T by merger.** In addition to the stock purchase, asset purchase, and divisional purchase agreements discussed above, Volume 5 also contains 2 sample merger agreements:
    - 1 covering a 3-party taxable reverse subsidiary cash merger of P's subsidiary (S) into T with T's shareholders receiving cash in exchange for their T stock and
    - 1 covering a 2-party tax-free forward merger of T into P with T's shareholders receiving P stock in exchange for their T stock.

Both of these sample merger agreements contain very limited R&W provisions (based primarily on *publicly held* T's SEC filings) so that these 2 sample merger agreements are suitable for use where T is publicly held and any R&W claim would be limited to inaccuracy in T's SEC filings.

However, where P and T have agreed that some post-acquisition R&W provisions will survive the merger (which would most often be the case only where T is *privately*, rather than *publicly*, held T), each of these 2 sample merger agreements can be amended to adopt the more extensive R&W provisions contained in the pro-buyer, pro-seller, or neutral versions of the stock purchase, asset purchase, or divisional purchase sample acquisition agreements discussed above (which now contain provisions dealing with COVID-19 and/or other pandemics).

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

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