NEW 2016 Edition of

Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions

We are proud to enclose the 2016 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, in conjunction with special editors Russell S. Light of Kirkland & Ellis LLP and the late Martin D. Ginsburg of Georgetown University Law Center.

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

Highlights of the New Edition

- **Federal income tax rates for 2016 and thereafter.**
  - **C corp income tax rates.** The top federal *C corp* income tax rate for 2016 and thereafter (on both OI and LTCG) continues at 35% (subject to an approximately 3 percentage point reduction on qualified U.S. production business net income). See discussion at ¶107(5) and (6).
  - **Individual income tax rates.** The top federal *individual* income tax rates for 2016 and thereafter (which also apply to partnership, LLC, or S corp-level income flowing through to an individual equity owner) are as follows:
    - On **OI and STCG,** the top rate continues at 39.6% (subject to an approximately 3 percentage point reduction on qualified U.S. production business net income).
    - On **normal LTCG,** the top rate continues at 20%.
    - On **QDI** (qualified dividend income), the top rate continues at 20% (i.e., the same as LTCG).
    - On **Code §1202 LTCG** (from "qualified small business stock" held more than 5 years), the top rate is:

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- 0% for such stock acquired on or after 9/28/10 (since the 12/15 indefinite extension of the permitted acquisition date for the 0% rate),
- 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. See discussion at ¶107(1) through (3) and (6).

- **Medicare tax rate.** The uncapped Medicare tax rate continues at 3.8% on (1) compensation and self-employment income and (2) passive income. See discussion at ¶107(4)(a) through (c).

- **Formation and operation of PE/VC fund.**

  - **Proposed IRS regulations attack PE/VC fund management fee reduction in exchange for enhanced LTCG allocation, i.e., waived management fee.**

    - **Waived management fee concept.** Some PE/VC fund GPs opt to reduce the management fee payable by the fund to the GP (which is taxable as OI) in exchange for an enhanced allocation of fund profits taxable as LTCG and/or QDI.

      This management fee reduction is most commonly structured as a *cashless contribution* arrangement, under which GP can satisfy a portion of its capital commitment to the fund by making deemed (or "cashless") contributions to the fund equal to the amount by which the management fee was reduced. GP then receives subsequent fund distributions as if it had contributed cash to the fund (i.e., amounts representing a *return of* the cashless contribution plus or minus the positive or negative investment *return on* the cashless contribution), conditioned on the fund earning sufficient profits to support characterization of these distributions as an interest in future fund (LTCG and QDI) profits.[1]

      In some cases the entire waiver is made upfront at the time of fund formation, while in other cases GP reserves the right to elect periodically to waive in advance a portion of the management fee in exchange for such an enhanced allocation of fund future appreciation.

      As long as there is meaningful economic risk that GP may not receive sufficient allocations of fund profits to make GP whole for the foregone management fee (e.g., when the allocation equal to the foregone management fee is out of annual net profits and may not be taken from appreciation in fund assets existing at the time of the management fee-reduction election, but rather may be taken only from subsequent [i.e., post-management-fee waiver] appreciation), this technique should convert management fee income which would have been

[1] Less often, GP receives a *capped* interest in future fund allocations and distributions equal to only the fee reduction amount.

taxed as OI into a profits interest in the fund, so that the character of the item of income allocated to GP—generally LTCG and QDI—flows through to GP.

▲ **7/15 IRS proposed regulations.** 7/15 proposed IRS regulations would treat such a fund management fee reduction arrangement as a "disguised payment for services," resulting in OI characterization, unless the arrangement meets a high "entrepreneurial risk" standard. The proposed regulations would create a presumption of insufficient entrepreneurial risk where GP's profit allocation is:

(i) capped in amount,

(ii) measured by gross income, rather than net income,

(iii) reasonably determinable in amount, or

(iv) even if not reasonably determinable in amount, "designed to assure that sufficient net profits are highly likely to be available to make the allocation" to GP.

Under traditional management fee reduction arrangements, GP's right to receive or retain distributions in respect of waived fees has been conditioned on the fund recognizing sufficient CG or QDI in one or more years in which the fund generates overall net income (ignoring years in which the fund has net losses). Under the proposed regulations, profit allocations would be viewed as "highly likely to be available"—and hence presumed to be disguised payments for services (i.e., OI)—unless profits allocated to GP under the arrangement are limited to the fund's net profits over an extended period (e.g., the fund's cumulative net income over the fund's entire life).

The proposed regulations would apply to arrangements entered into or modified (including by making new fee waivers) after final regulations are issued (expected some time in 2016).

For arrangements entered into before issuance of final regulations (and not thereafter modified), the regulatory preamble asserts that the proposed regulations "generally reflect Congressional intent," although there appears to be little support in pre-existing law for recharacterizing a properly structured cashless contribution arrangement as a disguised payment for services.

▲ **Future modification of Rev. Proc. 93-27.** The preamble to the 7/15 proposed regulations also announced that IRS intends to modify Rev. Proc. 93-27 (which allows a partnership profits interest issued to a service partner to be valued at its $0 LV rather than its speculative FV) so that the Rev. Proc. would not apply "to a profits interest issued in conjunction with a partner foregoing payment of an amount that is substantially fixed." If the Rev. Proc. is so modified, IRS could assert that a fund GP entering into a fee reduction arrangement must recognize immediate OI equal to the FV of the profits interest received by GP even if this profits interest satisfies the high "entrepreneurial risk" standard of the proposed disguised sale regulations. See discussion at ¶1004(6).

- **New DOL apparent prohibition on PE/VC fund investment by small benefit plan investor without sophisticated adviser.** A 4/16 DOL rule apparently prohibits a fund sponsor (e.g., the GP) from typical marketing of an LP interest in the fund to a benefit plan investor unless the decision to invest in the fund is made for such LP investor by an adviser meeting specified sophistication requirements (including that such adviser is either a bank, insurance company, broker-dealer, or adviser with at least $50 million of assets under management). It appears that a fund sponsor can rely on this qualified-adviser exception when marketing to most benefit plans of any significant size, i.e., to a benefit plan which does have a qualified adviser.

  However, if a fund marketed to a benefit plan investor (generally a smaller plan or IRA) without such a qualified decision-making adviser, the fund sponsor would apparently be viewed as a fiduciary, thus creating adverse consequences for the fund sponsor.

  This rule is scheduled to become applicable in 4/17, but may be further ameliorated/interpreted before that date, since it has faced significant opposition and was the subject of a 6/16 Joint Resolution of Disapproval by Congress (vetoed by the President) and several lawsuits challenging its validity. See discussion at ¶1007.2.

- **SEC examination of PE/VC fund's GP under IAA.** Absent an exemption, a fund's GP entity is an "investment adviser" (an "IA") required to register under the Investment Advisers Act (the "IAA"). An IA registered with SEC under the IAA is subject to a myriad of reporting and regulatory rules and is also subject to periodic SEC examination (under IAA's anti-fraud provision) regarding (e.g.):

  - IA's compliance with the fund agreement's complicated terms,
  - accurate calculation of management fees and carried interest payable to GP,
  - identification of expenses for which GP is and is not entitled to reimbursement from the fund,
  - accuracy of GP's periodic valuation of the fund's portfolio companies,
  - permissibility of GP collecting monitoring fees from portfolio companies (without offset against management fees payable by the LPs),

- permissibility of charging the fund or a portfolio company for compensation paid to an "operating partner" (i.e., a member or employee of the GP entity [or of an affiliate] performing services for a portfolio company),
- adequacy of GP disclosures to LPs,
- GP failure to adequately inform LPs about GP's method for allocating co-investment opportunities among LPs and also between LPs and other persons,
- GP altering the fund's investment criteria without adequately informing LPs (i.e., fund strategy drift),
- compliance with securities laws in issuing LP interests (generally Reg. D), including proper verification of accredited investor, qualified client, and qualified purchaser status, absence of GSA (except where fund has elected Rule 506(c)), and timely Form D filing,
- safeguarding customer information, etc.

These examinations have led to large SEC fines against fund GPs (and large SEC-mandated disgorgement payments from a GP back to the fund), e.g., where without adequate disclosure to LPs:

- the fund accelerated a Portfolio Company's obligation to pay future annual monitoring fees to GP when the fund sold the Portfolio Company,
- GP personally used a service provider to the fund (e.g., an attorney or accountant), paying such service provider a lower rate than the fund paid the same service provider,
- GP did not adequately inform LPs about GP's method for allocating (among multiple funds managed by the GP) expenses for which the funds (rather than the GP) were responsible,
- GP did not adequately inform LPs about GP's method for allocating (or not allocating) a portion of broken-deal expenses to persons regularly offered the opportunity to co-invest with the fund. See discussion at ¶1010.1.

- **Prohibition on carried interest for PE/VC fund GP registered with SEC as IA.** No investment adviser ("IA") registered (or required to register) with SEC under the Investment Advisers Act ("IAA") may receive carried interest except as set forth in four exceptions.
  - **4 exceptions.** The Fund's GP will generally seek to avoid the IAA's carried interest prohibition by fitting within one of the four exemptions:

(1) §3(c)(7) QP fund statutory exception. GP is permitted to receive carried interest from any fund which qualifies as an ICA §3(c)(7) fund, i.e., 100% of the fund's LPs are qualified purchasers ("QPs").

(2) SEC qualified client regulatory exemption. GP is permitted to receive carried interest from each LP in a §3(c)(1) no-more-than-100-LPs fund, which is a qualified client (a "QC"), i.e., a person who either:

(a) has at least $1 million of assets under the GP's management, *or*

(b) has more than $2.1 million ($2.0 million prior to 8/15/16) of net worth, *or*

(c) is a QP, i.e., in general, a human being (or an entity owned by a single family) owning at least $5 million of investments or an entity (not owned by a single family) owning at least $25 million of investments, *or*

(d) is a human being who is a Knowledgeable Employee, *or*

(e) is a donee of any of the foregoing.

In determining whether an *entity* LP is a QC for purposes of (a) through (e) above, SEC applies a look-through approach where both the fund (the "lower-tier entity") and such entity LP (the "upper-tier entity") are exempt under ICA §3(c)(1)'s 100-or-fewer rule, i.e., focuses on the upper-tier entity's equity owners (or if such §3(c)(1) upper-tier entity has an equity owner which is also a 100-or-fewer ICA §3(c)(1) fund [the "upper-upper-tier entity"], focuses on the equity owners of such upper-upper-tier entity), with such upward look-through continuing so long as there are additional upper-tier §3(c)(1) entities. Thus, an indirect equity owner (owning an interest in a §3(c)(1) lower-tier fund through one or a series of §3(c)(1) upper-tier entities) can be burdened by a carried interest under this QC regulatory exemption only if such indirect equity owner satisfies one of the tests set forth in (a) through (e) above.

SEC's increase in the QC test (e.g., the net worth test increase from $2 million [not counting primary residence] to $2.1 million effective 8/15/16) does not apply retroactively to an existing advisory contract, so that (i) if a registered IA entered into an advisory contract with a client before 8/15/16, the client's status as a QC is determined based on the threshold in effect at the time the advisory contract was entered into and (ii) if the IA was exempt from IAA registration at the time it entered into an advisory contract with a client (or with the fund in which the client is an LP), the IAA's carried interest prohibition does not apply to such IA-client relationship even after the IA registers under the IAA.

However, if a person first becomes subject to a pre-existing advisory agreement after adoption of the threshold or after the IA ceases to be exempt from IAA registration, such person's QC status is determined when such person first becomes subject to the advisory agreement (not at the earlier time when the IA entered into the advisory agreement). For example, where IA is (and has long been) an adviser to (i.e., generally GP of) a private fund and a person not previously an LP of such private fund acquires an LP interest in such private fund, the new LP's QC status is determined based on the IAA rules in effect when the new LP acquires its interest in the fund.

(3) U.S. non-resident. GP is permitted to receive carried interest from a person not a resident of the United States.

(4) BDC. GP is permitted to receive up to a 20% carried interest in a fund's "realized capital gains . . . net of all realized capital losses and unrealized capital depreciation," so long as the fund qualifies as a BDC and meets certain other requirements. See discussion at ¶1010.3.

- **PE/VC fund GP's obligation to register with SEC as broker-dealer.** In general, "any person engaged in the business of effecting transactions *in securities* for the account of others" (i.e., an "adviser") must (1) register with SEC as a broker-dealer under the 1934 Act and (2) become a member of FINRA (the brokerage industry's self-regulatory organization), a labor-intensive process taking six months or more and imposing FINRA testing and licensing requirements on many of the adviser's personnel.

Although neither PE/VC funds nor their GP entities have traditionally registered as 1934 Act brokers, SEC in 2013 began taking the position that such registration and testing may well be required if the GP receives compensation in connection with securities sales or issuances.

Activities which prompted this SEC position include:

(1) the fund's or its GP entity's receipt of transaction fees from portfolio companies for such activities as:
   - assisting in disposition of a portfolio company or portion thereof,
   - assisting a portfolio company's fundraising by sale of additional portfolio company stock or debt securities,
   - assisting a portfolio company's acquisition or disposition of a business and

(2) the GP entity's or its personnel's receipt of transaction fees from the fund (which is in the process of formation) for assisting in the sale of the fund's LP interests.

Failure to register the fund or its GP entity as a 1934 Act broker (if required) can give rise to serious consequences, including SEC sanctions, notification to fund LPs (and potential LPs) of such SEC sanctions, and potential voiding of transactions.

- **SEC 2016 enforcement action.** In 6/16 SEC entered into a consent order settling its enforcement action against a PE/VC fund's GP entity, alleging that the adviser had acted as a broker in connection with the fund's acquisition and disposition of portfolio companies—by soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing transactions—for which the adviser received transaction-based compensation from the fund without registering as a broker. The fund adviser agreed to disgorge $1.9 million of transaction fees it had received plus pay a substantial civil penalty.

  This SEC settlement is silent as to whether the result would have been different if (a) the fund or its adviser had also retained an investment bank (registered as a broker under the 1934 Act) or (b) the GP transaction fee had been fixed rather than contingent on transaction closing or (c) there had been a 100% offset of GP's transaction fee against GP's annual fee for managing the fund (which SEC has in the past suggested may make a difference).

- **Broker registration seems burdensome and unnecessary.** It seems strange that SEC would now (decades after enactment of the broker-dealer registration obligation) seek to require a fund GP to register as a broker since by definition buying and selling portfolio companies for the fund is a part of its regular duties as investment adviser to the fund, while SEC-registered brokers on the other hand typically make themselves available to effect securities transactions for the public.

  Moreover, most fund GPs are already registered with SEC under the IAA, requiring them to file extensive information with SEC about the adviser and their funds, so registration as a broker provides no meaningful additional protection for investors.

  Finally, a registered IA is already subject to a more stringent IAA fiduciary duty standard than the 1934 Act standard for a registered broker.

  Indeed, if there were some societal benefit to imposing yet another SEC registration regime on a fund GP, it is strange that SEC is now advancing (through a substantial fine and disgorgement) an ambiguous position on which it has long declined to give the PE/VC industry any intelligible guidance, i.e., legislating through an enforcement proceeding without first promulgating guidelines. See discussion at ¶1011.

- **Allocation of PE/VC fund income and loss between buyer and seller of LP interest.** If a fund's taxable income is changed as a result of an IRS audit (e.g., fund's year 1 taxable income is increased as a result of an audit resolved in year 3), the additional income has in the past been taxable on a flow-through basis to the fund's year 1 partners (generally forcing the year 1 partners to file in year 3 amended year 1 tax returns reporting the additional taxable income). As a result, a person who purchased an LP interest in the fund in year 2 was generally not affected by the year 1 IRS audit.

  However, Congress changed the partnership tax audit rules in 2015 (effective for audits of 2018 and subsequent years, but with a partnership permitted to accelerate applicability to 2016 or 2017).

  Under the new rules, a partnership may elect to have year 1 audit adjustments (including interest and penalties) flow through (when the audit is completed in year 3) to its year 1 partners. But absent such a partnership-level election, the partnership itself will be responsible for paying additional taxes, interest, and penalties attributable to audit adjustments. Thus, a fund not making such election could incur tax liabilities in year 3 as a result of an audit of year 1, and a person who purchased an interest in PE Fund in year 2 would bear a share of such year 1 tax liabilities paid in year 3.

  Once these new audit rules are in effect, purchasers of interests in funds may wish to obtain indemnification from sellers against their share of any taxes, interest, and penalties paid by the fund as a result of an audit adjustment for a pre-purchase year. See discussion at ¶1015.5.

- **Formation of §3(c)(7) PE/VC fund.** If a fund being formed as an ICA §3(c)(7) (QP only) fund relies on SEC Rule 506(c) (permitting general solicitation and advertising) in a private placement of its LP interests, the fund must perform "enhanced" verification of each investor's *accredited investor status* (rather than relying on LP self-verification) in order to satisfy SEC Rule 506(c)'s requirements. However, this enhanced verification requirement apparently does not extend to the investor's *QP status*, which apparently can still be satisfied by self-verification, so long as the fund reasonably believes the LP's QP representation. See discussion at ¶1008.4.

- **Allocating PE/VC Fund profits, losses, and distributions among GP and LPs.** There are a myriad of different approaches for allocating profits and losses between and making distributions to a fund's GP and its LPs. The authors describe some of the most frequently used approaches, including:

  - allocation-driven versus distribution-driven approach,

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- ▲ pro-LP distribution approach: full LP payout first, called European-style waterfall,
- ▲ pro-GP distribution approach: first distribute to LPs contributed capital and allocated expenses on only realized deals, called American-style waterfall,
- ▲ intermediate approach: American-style waterfall with FV test,
- ▲ special allocation of certain types of fund expenses,
- ▲ alternative approaches to reducing management fee after approximately 5 years,
- ▲ alternative approaches to management fee offset for other fees earned by GP, and
- ▲ alternative approaches to allocation of management fee expense among GP and LPs.

See discussion at ¶1002–¶1004.

- ■ **Volcker Rule prohibitions on BHC group.** The Volcker Rule (enacted in 2010) (a) prohibits short-term securities trading by a BHC group and (b) prohibits a BHC group from engaging in the following activities, unless such activities qualify for one of 3 exclusions or one of 5 exemptions:

  (1) acquiring or retaining any equity interest in a covered fund (generally a PE/VC fund exempt from ICA registration by ICA §3(c)(1) or §3(c)(7)), or

  (2) sponsoring a covered fund by:

  (i) serving as GP, managing member, or trustee, or

  (ii) having the power to select or control (or having employees or agents who constitute) a majority of a covered fund's directors, trustees, or management, or

  (iii) sharing the same name or a variation with a covered fund.

  A BHC group subject to these Volcker Rule prohibitions includes (a) a bank organized in a U.S. jurisdiction, (b) a U.S. bank's holding company, regardless of where organized, (c) a bank organized in a non-U.S. jurisdiction which is treated as a bank holding company by virtue of its U.S. banking nexus, and (d) any subsidiary or affiliate of any of the foregoing.

  - ▲ **Effective date.** The Volcker Rule's final implementing regulations (Fed. Reg. VV issued 12/13) and a subsequent Fed release extended the Volcker Rule conformance period from 7/21/14 to 7/21/15 for all Volcker Rule activities and investments.

In 12/14 the Fed issued a second blanket extension from (7/21/15 to 7/21/16) for investments in and relationships with a covered fund entered into prior to 12/13, and in 7/16 issued the final 1-year extension (to 7/21/17) for pre-12/13 activities, leaving an additional extension of up to 5 years in the Fed's discretion for an "illiquid fund" investment with respect to which the BHC group had a contractual obligation as of 5/1/10.

However, the Fed's regulations state that the Fed "expects" a BHC group to engage in good faith efforts resulting in conformance of its activities to the Volcker Rule by the applicable deadline and that a BHC group can make new PE/VC fund investments or engage in new sponsorship activities only to the extent such investments and activities qualify for a Volcker Rule exclusion or exemption. See discussion at ¶1014.

- **Purchase of a business, including an LBO.**
  - **Avoiding Target shareholder vote (and SEC proxy rules) on second-step squeeze-out merger of Target's minority shareholders after BuyerCo first acquires majority of Target's stock by tender offer.** Where BuyerCo acquires Target in a two-step transaction, i.e., a cash tender offer for Target's stock followed by a squeeze-out reverse cash merger of BuyerCo (or BuyerCo's subsidiary) into Target, with Target's remaining shareholders (who did not sell their Target stock in the cash tender offer) receiving cash for their Target stock in the squeeze-out merger, state law generally requires a Target shareholder vote on the second-step merger.

Where Target is a 1934 Act reporting company, Target must (before such a shareholder vote on the squeeze-out merger) prepare and file an extensive proxy statement with SEC, mail the proxy statement to its shareholders, and satisfy an SEC (or stock exchange) prescribed waiting period.

Delaware law, including a 2016 amendment (and the law of certain other jurisdictions), contains two exceptions under which such a shareholder vote on the second-step merger (and thus an SEC-mandated 1934 Act proxy statement) can typically be avoided:

First, a long-standing exemption where BuyerCo (organized as a corporation, partnership, or LLC) owns at least 90% of Target (organized as a corporation), whether acquired by BuyerCo in a tender offer for Target's stock or otherwise, and both BuyerCo and Target are formed in Delaware (or in another state permitting such a short-form merger). In such case Target's shareholders need not vote on the squeeze-out merger and hence (even though Target is a 1934 Act reporting company) no SEC-mandated proxy statement is necessary for Target's shareholders.

Second, under Delaware §251(h) (as enacted in 2013 and amended through 2016), a vote of Target's shareholders (and hence a 1934 Act proxy statement) on a forward or reverse merger of Target and BuyerCo (or BuyerCo's subsidiary) can be avoided where:

(a) Target (organized as a corporation) has more than 2,000 shareholders or is exchange traded immediately prior to executing the merger agreement,

(b) BuyerCo or its corporate subsidiary makes a first-step tender or exchange offer for any and all Target stock,

(c) after such first step, BuyerCo owns sufficient Target stock (including Target Rollover Stock as defined below) to approve the second-step squeeze-out merger (under Delaware law and Target's charter), generally more than 50%,

(d) all non-tendering Target shareholders (other than holders of Target Rollover Stock as defined below) receive in the merger the same consideration as the tendering Target shareholders received in the tender offer (i.e., where the tender offer consideration was cash, the non-tendering Target shareholders receive the same amount of cash as the tendering shareholders),

(e) Target is incorporated in Delaware, and

(f) the merger agreement expressly permits this procedure.

A 2016 amendment to Delaware §251(h), effective 8/1/16, created the concept of "Target Rollover Stock," so that:

- ▲ one or more Target shareholders (including Target executives) can, before effectuation of the §251(h) merger, agree in writing that immediately before the merger they will transfer their Target stock ("Target Rollover Stock") to Newco in exchange for Newco stock,
- ▲ in which case such Target Rollover Stock is exempted from requirement (d) above that its holders receive (in exchange for such Target Rollover Stock) the same merger consideration as the tendering Target shareholders received, and
- ▲ such Target Rollover Stock is treated as having been acquired by Newco before the merger in determining under (c) above whether Newco owns sufficient Target stock to approve the second-step merger under Delaware law and Target's charter.

This amendment allows (e.g.) a Target executive to delay his or her swap of Target stock for Newco stock until Newco's tender offer for Target's stock has been successful, and then agree in writing to swap his or her Target shares for Newco shares immediately before the merger is effectuated (because the amendment exempts the executive's post-merger stock-for-stock swap from the same-consideration rule—(d) above—and also counts the executive's rollover stock toward the sufficient-stock-to-approve rule—(c) above). Thus the executive's swap can qualify for Code §351 tax-free treatment (as part of Newco's formation) without violating the SEC tender-offer rule that while the tender offer is in progress, Newco can't acquire any Target stock for consideration different than the tender offer consideration, because the executive's stock swap takes place after the tender offer has been completed. See discussion at ¶503.3.2.7.

- **Acquisition structure.** When PE-financed Newco is acquiring Target in an LBO, the transaction can be structured in a number of alternative forms, each with its own advantages and disadvantages. This treatise has long discussed:

  - Newco's purchase of Target's stock,
  - Newco's purchase of Target's assets,
  - Newco's purchase of Target's stock plus amalgamation of Target and Newco (e.g., by merger or liquidation),
  - a reverse subsidiary cash merger of Newco's subsidiary into Target,
  - a reverse two-party cash merger of Newco into Target,
  - Newco's purchase of some of Target's stock plus Target's redemption of its remaining stock.

  The authors have added discussion of:

  - Newco's purchase of Target's stock for part cash (generally the cash Newco received from PE fund and other investors in their purchase of Newco's stock) and part 60-second note, with Target then immediately borrowing the acquisition debt financing and using the proceeds of such debt financing to pay a cash dividend to Newco, which in turn uses the dividend cash to pay off the 60-second note. See discussion at ¶501.4.3.

- **HSR filing for acquisition—annual inflation adjustment.** A Hart-Scott-Rodino filing with FTC/DOJ is required if the size of BuyerCo's purchase price for acquiring Target (and, in certain cases, the size of the parties to the transaction) exceeds specified tests. The authors have updated the entire HSR discussion to reflect the 2/16 annual inflation adjustment of all the HSR tests, thresholds, and filing fees. See discussion at ¶501.3.3.1.

- **Exit scenarios.**

  - **Portfolio Company shareholders' private secondary resale of restricted securities.** A holder of Portfolio Company restricted stock (purchased from Portfolio Company under Reg. D or Rule 701)—e.g., PE/VC fund or a Portfolio Company executive—can resell such stock in a private placement (without 1933 Act registration) under any of three 1933 Act exemptions.

- **1933 Act §4(a)(1½) resale.** There is a longstanding implicit exemption from 1933 Act §5 registration where a holder of restricted Portfolio Company stock resells such restricted stock in a private placement to one or a few (generally) accredited investors, in which case the stock continues to be restricted in the buyer's hands.

  Although SEC generally applies Reg. D principles by analogy in determining whether a *secondary* sale of restricted stock involves a private offering and hence qualifies for the §4(a)(1½) exemption, SEC has never enunciated specific parameters for applying the §4(a)(1½) exemption. Thus apparently:

  - The case for such a secondary private placement is strongest if all buyers are accredited investors, although it may be acceptable for a few non-accredited investors (so long as sophisticated alone or with a purchaser representative) to participate, although likely substantially fewer than Reg. D's 35 permitted non-accredited investors.
  - If one or more non-accredited buyers are permitted to participate, such buyers should receive substantial information about Portfolio Company, and perhaps even the information that would be required in a Reg. D private offering memorandum.
  - No general solicitation or advertising is permitted, i.e., the seller (or the seller's investment adviser) must have a pre-existing substantive relationship with each prospective buyer being solicited, and it is unlikely that a seller would be permitted to elect a Rule 506(c)-type sale (which does permit general solicitation and advertising so long as all buyers are accredited investors).
  - The seller should have held the restricted securities being sold for a substantial period, perhaps at least 90 days, or perhaps longer, e.g., 180 days.

  Thus, while the existence of an implicit §4(a)(1½) exemption is well accepted, SEC has not provided guidance on its contours and hence its requirements are vague.

- **1933 Act §4(a)(7) resale.** Because of the §4(a)(1½) exemption's ambiguity, Congress in 2015 enacted 1933 Act §4(a)(7), which allows:
  - a holder of Portfolio Company restricted stock to sell such stock without 1933 Act registration,
  - to an unlimited number of accredited investors,
  - without any general solicitation or advertising,
  - so long as, where Portfolio Company is not a 1934 Act reporting company, the buyer(s) obtain specified information from Portfolio Company, and

- so long as securities of the class being sold under §4(a)(7) have been outstanding for at least 90 days,

in which case the stock in the hands of the buyer(s) continues to be restricted.

- **Rule 144 resale.** SEC Rule 144, allows a holder of Portfolio Company restricted stock to resell such stock *publicly* without 1933 Act registration if such seller meets specified requirements—with more onerous requirements where the seller is (or has within 3 months been) a Portfolio Company affiliate—in which case the buyer receives unrestricted stock, but Rule 144 is not limited to a *public* resale of restricted stock and hence can also be invoked by a seller who is not (and has not at any time during the 3 months preceding the sale been) a Portfolio Company affiliate[2] for a *private* resale of restricted stock, so long as such seller meets the requirements set forth in Rule 144, including:
  - the seller has a 6 month or 1 year holding period for the stock being sold, depending on whether Portfolio Company is a 1934 Act reporting company, and
  - extensive information about Portfolio Company is publicly available where the seller has not held the Portfolio Company stock for at least 1 year.

Where restricted stock is sold in compliance with Rule 144, the buyer receives *unrestricted* stock, which the buyer can generally publicly resell without 1933 Act registration, although the buyer in a sale effectuated pursuant to 1933 Act §4(a)(1½) or §4(a)(7) exemptions receives *restricted* stock which cannot be publicly resold without either 1933 Act registration or an applicable exemption. Hence if a secondary sale can be structured to meet Rule 144's requirements, the buyer would generally prefer that it be so structured.

Apparently no election between the three exemptions (§4(a)(1½), §4(a)(7), and Rule 144) need be made (by buyer or seller) at the time of the secondary sale. See discussion at ¶904.

- **Reduced tax rate for Portfolio Company shareholder's gain on sale of Code §1202 "qualified small business stock."** Code §1202 grants a reduced LTCG tax rate (and a reduced Medicare tax rate) for an individual's gain from sale of a C corp's stock which has been held more than 5 years and meets several other requirements.

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[2]Technically Rule 144 could also be used by a seller who is (or has at some time during the 3 months preceding the sale been) a Portfolio Company affiliate, but in such case one of the Rule 144 requirements (for a sale by an affiliate) is that the sale be effectuated through a broker or market maker without solicitation. In such case, the sale would more properly be categorized as a *public* Rule 144 secondary sale into the market than as a *private* Rule 144 secondary sale and hence the applicable rules are as described in ¶903 dealing with an unregistered *public* Rule 144 resale.

▲ **§1202 tax rate.** The extent of the tax rate reduction (from the normal 20% LTCG and 3.8% Medicare tax rates) turns on when the taxpayer acquired the stock:

Date stock acquired	Reduced LTCG tax rate	Portion of LTCG subject to 3.8% Medicare tax
8/11/93 thru 2/17/09	14%	50%
2/18/09 thru 9/27/10	7%	25%
9/28/10 and thereafter	0%	0%

The 0% LTCG and Medicare tax rate would have expired with respect to stock acquired after 12/31/14 if 12/15 legislation had not permanently extended the 0% rate to cover stock acquired any time after 9/28/10.

To be eligible for Code §1202's 0% individual LTCG and Medicare tax rate, the transaction must meet a number of requirements, including:

- The gain must be taxable to an individual (directly or through a flow-through entity).
- The individual must have acquired the stock from the corporation at original issuance, not from a third party, with exceptions for gifts and bequests.
- The stock must have been held longer than 5 years, with tacking for gifts, bequests, and certain §351 (incorporation) and §368 (reorganization) events.
- The stock must have been acquired for cash, property other than stock, services, or (under certain circumstances) in a Code §351 incorporation or §368 reorganization in exchange for §1202 stock of a predecessor corporation.
- The corporation must be a U.S. C corp.
- The corporation must have had no more than $50 million of aggregate gross assets immediately after the shareholder acquired the stock.
- The corporation must meet a complex active business requirement during "substantially all" of the shareholder's holding period for the stock.

▲ **Maximum amount of gain eligible for §1202 reduced rate.** The maximum amount of an individual's LTCG from sale of a single corporation's stock eligible for the reduced rate is the greater of:

- **Aggregate limitation:** $10 million (taking into account the individual's gain during the year of sale and all prior years) and

- **Annual limitation:** 10 times the individual's aggregate basis in such stock sold by the individual during the year of sale.

Thus, there are circumstances where a single qualified shareholder can realize more than $10 million of §1202 gain on a single corporation's qualified stock by (1) selling sufficient stock in one or several years to produce $10 million (or more) of cumulative §1202 gain (thus using his or her entire §1202 $10 million *aggregate* limitation) and (2) selling additional stock of the same corporation in (one or several) subsequent years to produce additional gain which qualifies for the §1202 *annual* limitation (equal to 10 times the basis of the stock sold in the subsequent year or years).

▲ **Expanding $10 million aggregate limitation.** A transfer of stock (which qualifies for tacked §1202 holding period) from one qualified shareholder to one or more other qualified shareholders can multiply the number of $10 million §1202 *aggregate* limitations available to such shareholders, e.g., a parent (who is eligible for one $10 million §1202 aggregate limitation) transfers part or all of his or her qualified stock *by gift or death* to numerous descendants, each of whom would apparently also be eligible for a separate $10 million §1202 aggregate limitation.

Under §1202's words, a person's (here the parent's or the descendant's) $10 million §1202 aggregate limitation is reduced only for such person's own prior gain on sales of §1202 stock, not for any sales by his or her transferees or transferors: a "*taxpayer*['s] . . . $10,000,000 [aggregate limitation is] reduced by the aggregate amount of . . . [§1202] gain taken into account *by the taxpayer* . . . for prior taxable years attributable to dispositions of stock issued by such corporation . . ." (emphasis added). A parent and his or her descendants each qualifies as a separate "taxpayer," since the Code defines "taxpayer" as "any person subject to any internal revenue tax."

However, with respect to a husband and wife each of whom owns §1202 stock, the law is more complicated. First, it appears that when a husband and wife file a joint return, each qualifies as a taxpayer, because each is "subject to . . . internal revenue tax," which, "if a joint return is made, . . . shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several," thus suggesting that a husband and wife, whether filing joint or separate returns, are each entitled to a $10 million §1202 aggregate limitation.

Indeed in an analogous situation IRS did treat a husband and wife as two separate taxpayers, each entitled to a separate statutory exemption. Code §453A imposes an annual interest charge on a taxpayer's tax liability deferred by use of the installment sale rules to the extent that the face amount of the installment

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obligations held by "the taxpayer" exceeds $5 million. In a 1998 TAM IRS concluded that spouses A and B were *each* entitled to receive $5 million of obligations without being subject to the §453A penalty interest charge where simultaneous with a sale of corporate stock, one spouse (A) gifted a portion of his or her stock to the other spouse (B), so long as A's "transfer of his stock . . . to [B], his spouse, was a bona fide transaction [which] should, in fact, be respected for federal income tax purposes."

Second, Code §1202 attempts to deal explicitly with the husband-wife issue in the context of the $10 million aggregate limitation, but falls short, at least for a husband and wife filing a joint return. Code §1202(b)(3)(A) states that where married individuals file *separate returns*, the $10 million aggregate limitation is allocated $5 million to each, which could be read as implying (but not stating) that where the spouses file a *joint return* they would *share* a single $10 million aggregate limitation.

However, Code §1202(b)(3)(B) states that "in the case of a *joint return*, the amount of [§1202] gain taken into account" shall be allocated equally between the spouses for purposes of applying both of the §1202 limitations "to *subsequent years*" (emphasis added). Thus, Code §1202(b)(3)'s literal language does not bar each of the two "taxpayers" (i.e., the two spouses) who are filing a *joint return* for the year of a §1202 stock sale from claiming the $10 million §1202 aggregate limitation for such year (i.e., $20 million total aggregate limitation for husband and wife).

In summary, while §1202(b)(3)(A)—married individuals filing *separate* returns each receive only a $5 million aggregate limitation—suggests that Congress intended married individuals filing a *joint* return to receive only one $10 million §1202 aggregate limitation, nothing in §1202(b)(3)'s explicit statutory wording changes the normal rule that (except when filing separate returns) two spouses are separate "taxpayers," each entitled to a $10 million aggregate limitation under §1202(b)(1). See discussion at ¶907.1.

- **Securities law changes.**
  - **Crowdfunding.** The crowdfunding exemption from 1933 registration was enacted by Congress in 2012 (1933 Act §4(a)(6)) and became effective in 5/16 (when SEC implementing rules were finalized), creating a new type of *public* securities offering without 1933 Act registration. In summary, such an offering is:
    - by a privately held U.S. issuer,
    - issuing up to $1 million of securities in a 12-month period,

- through a new type of Internet portal established by an independent 1934 Act registered intermediary used to communicate with potential public buyers of the §4(a)(6) securities,
- which are then purchased in modulated amounts by public buyers (who need not be accredited or sophisticated investors),
- with limitations on the buyers' resale of the §4(a)(6) securities for one year following issuance, after which the stock becomes publicly tradable.

However, it is highly unlikely any PE/VC fund of substance would invest in a company that had raised (or was planning to raise in the near future) a relatively small amount ($1 million or less) from a large number of small (generally non-professional) investors, so that the company's stock would become (thinly) publicly traded a year after the crowdfunding offering.

In more detail, the company (and its affiliates) can publicly sell, during any 12-month period, up to $1 million of securities in the aggregate in reliance on §4(a)(6)—not counting sales under (e.g.) Reg. D, even if simultaneous with §4(a)(6) sales, unless a particular Reg. D buyer discovered the company because of its §4(a)(6) offering. However, the following types of entities may not use the §4(a)(6) exemption:

- a non-U.S. company,
- a 1934 Act reporting company,
- an investment company, even if exempt from ICA registration (e.g., a PE/VC fund), or
- a company without a specific business plan.

A company (using the §4(a)(6) exemption) does not prepare and circulate a prospectus, POM, or other document, but rather files information on an independent intermediary's Internet portal and with SEC (but SEC does not review or comment upon this information).

The financial statements that must be filed vary depending on the size of the §4(a)(6) offering: generally statements certified by the company's CEO if the offering is $100,000 or less, reviewed by an independent CPA if more than $100,000 but not greater than $500,000, or audited by an independent CPA if greater than $500,000.

Post-offering, the company is required to make ongoing annual filings with SEC and place on its website information similar to the information described above.

There is a maximum amount of §4(a)(6) securities any one investor can buy from all §4(a)(6) issuers (including those issuers wholly unrelated to the company) in any 12-month period:

- If either (or both) of an investor's annual income or net worth is below $100,000, the maximum amount of §4(a)(6) securities such investor can buy is the greater of $2,000 or 5% of the investor's annual income or net worth (whichever is lower). For example, if the lower of the investor's annual income or net worth is $50,000, the investor can buy no more than $2,500 of §4(a)(6) securities from all issuers in any 12-month period.
- If both of the investor's annual income and net worth are $100,000 or above, the maximum is 10% of the investor's income or net worth (whichever is lower), up to a maximum of $100,000. For example, if the lower of the investor's income or net worth is $150,000, the investor can buy no more than $15,000 of §4(a)(6) securities from all issuers in any 12-month period.

An individual's income and net worth are calculated in the same manner as for accredited investor status, so that (e.g.) an individual's primary residence (and indebtedness secured thereby) are excluded and income and net worth can be calculated jointly with spouse. Investors can self-certify their financial status (i.e., no enhanced verification is necessary), and Newco can rely on the intermediary's review.

Investors can also self-certify compliance with the 12-month-formula maximum amount a single investor can invest in all §4(a)(6) securities.

A §4(a)(6) transaction must be conducted through one SEC-registered independent intermediary's Internet portal, with the company's financial and other information described above posted to this portal. Potential investors then communicate with the company (including asking questions and receiving answers) and with each other through this portal.

Potential investors can also communicate with each other outside the portal, but the company cannot communicate about the offering with potential investors outside the portal nor can the company hire anyone to do so. SEC expects the "crowd" to communicate with each other and to "share information and opinions."

The independent intermediary does not, however, participate in these communications. And indeed the independent intermediary cannot recommend investments, offer investment advice, or solicit purchasers, but merely makes available on its portal information supplied by the company.

It appears that §4(a)(6) potential investors are not allowed to meet (in person or by phone) with the company's management or to talk (in person or by phone) to the company's management (e.g.) about the company's business, plans, competition, risks, etc. However, it appears that the portal can be constructed so as to allow (1) recorded videos (e.g., introducing the company's management, products, and plans) to be posted *or* (2) live Q&A sessions between management and potential buyers which are recorded so other potential investors can later view them on the portal.

All money ultimately paid by purchasers of §4(a)(6) securities is transmitted through a designated bank and disbursed to the company only when such sales have reached the company's stated target amount.

No transfer of §4(a)(6) shares is permitted during the 1-year period after completion of the offering except:

- to the company,
- to an accredited investor,
- to a family member, or
- as part of a 1933 Act registered offering.

However, after expiration of a one-year holding period, the §4(a)(6) shares are freely transferable. See discussion at ¶207.8.

- **Compliance with state securities laws.** In addition to compliance with the federal 1933 Act, any offering of a company's securities—including primary sales by the company to existing or new shareholders (such as VC, other financing parties, and company executives), as well as secondary resales by any shareholder to third parties—must (absent federal preemption) also comply with the applicable securities (blue sky) laws of each state where:

  - an offer to sell securities originates,
  - an offer to sell securities is directed, or
  - sale of securities occurs (i.e., where the act occurs that creates an irrevocable contractual commitment).

  Where federal preemption applies, a state is prohibited from requiring anything more than form filing plus a fee. In general, the following types of offerings are covered by federal preemption:

  - a Rule 506 private offering,
  - an offering of securities traded on NYSE, Nasdaq Stock Market, or any other national securities exchange designated by SEC (or any security of the same

issuer that is equal or senior to a security so traded), whether or not such offering is registered under the 1933 Act (no form filing or fee can be required),

- a 1933 Act §3(a)(6) crowdfunding offering,
- a 1933 Act §3(a)(7) secondary private offering, and
- a Reg. A Tier 2 offering.

Most states have an exemption (although some impose additional conditions) for the following types of securities offerings:

- a Rule 505 offering and
- a Rule 701 offering.

The following types of securities offerings typically require more extensive state compliance:

- a Rule 504 offering,
- a 1933 Act §4(a)(2) offering outside Reg. D, and
- a 1933 Act registered offering of securities not traded on a national securities exchange (unless equal or senior in priority to a security of the same issuer which is so traded). See discussion at ¶208.

- **PE/VC fund issues arising from financially troubled Portfolio Company.**
  - **Court decision expands PE/VC fund's ERISA liability for bankrupt portfolio company's underfunded pension plan.**
    - **Upstream and horizontal ERISA liability migration for PE fund's 80%/50%-owned portfolio company.** Where a fund acquires a substantial equity ownership interest in a portfolio company which later encounters financial problems ("Badco"), there is risk that ERISA imposes contingent liability on the fund (and on each of the fund's other portfolio companies in which the fund has a substantial equity ownership interest) for Badco's unpaid ERISA obligations, including unfunded pension liabilities.

      This potential upstream ERISA liability from Badco to the fund applies where the fund's ownership (the "requisite ownership") of Badco is 80% or greater (measured by vote or value if Badco is a corporation or by capital or profits if Badco is a partnership or LLC), after application of various attribution and disregard rules.

      Under the attribution rules, for example, an equity interest owned by an entity is treated as owned proportionately by the entity's equity owners.

Under the disregard rules, where the fund owns 50% or more of Badco, an equity interest in Badco owned by a person other than the fund is disregarded if either (1) such person is a Badco employee and such equity interest is subject to vesting, repurchase option, right of first refusal, or other transfer restriction or (2) such person bears certain ownership or executive relationships to the fund (even if such person's equity interest is not subject to restrictions). Thus, if the fund owns 50% of Badco and one or more disregarded persons own the other 50%, the fund is treated as owning 100% of Badco for ERISA liability purposes.

Similarly, potential horizontal ERISA liability—making the fund's other portfolio companies liable for Badco's unpaid ERISA liabilities—applies where the fund's ownership of both Badco and its other portfolio companies meets the requisite ownership test after application of the attribution and disregard rules (as described above).

All these ERISA liability rules apply whether the fund holds the requisite ownership of a portfolio company directly or indirectly through one or more vehicles (e.g., where the fund owns a portfolio company through an intermediate holding company formed by the fund to acquire such portfolio company).

▲ **ERISA liability migration to PE fund formed as partnership/LLC applies only if the fund is engaged in "trade or business."** The ERISA contingent liability rules described above clearly apply where the fund is a corporation (e.g., a corporate subsidiary of a BHC or of an insurance company). However, where the fund is a partnership or an LLC (rather than a corporation) and the fund is *not* engaged in a "trade or business," (1) ERISA's regulatory language does not impose contingent liability on the fund for bankrupt portfolio company's ERISA group liabilities and (2) there is a strong argument that the fund's portfolio companies are not (by virtue of the fund's requisite common ownership) liable for each other's ERISA group liabilities, although PBGC has indicated its disagreement with (2).

In a 2013 decision the First Circuit concluded that the defendant Sun PE fund "was not merely a 'passive' investor, but sufficiently operated, managed, and was advantaged by its relationship with its [now bankrupt] portfolio company" as to be engaged in a trade or business.

▲ **Possible ERISA liability expansion where multiple PE funds (or perhaps others) who do not individually own the requisite percentage act in concert.** In the above-discussed 2013 case, the bankrupt portfolio company was owned 70%-30% by two Sun serial funds which means the funds:

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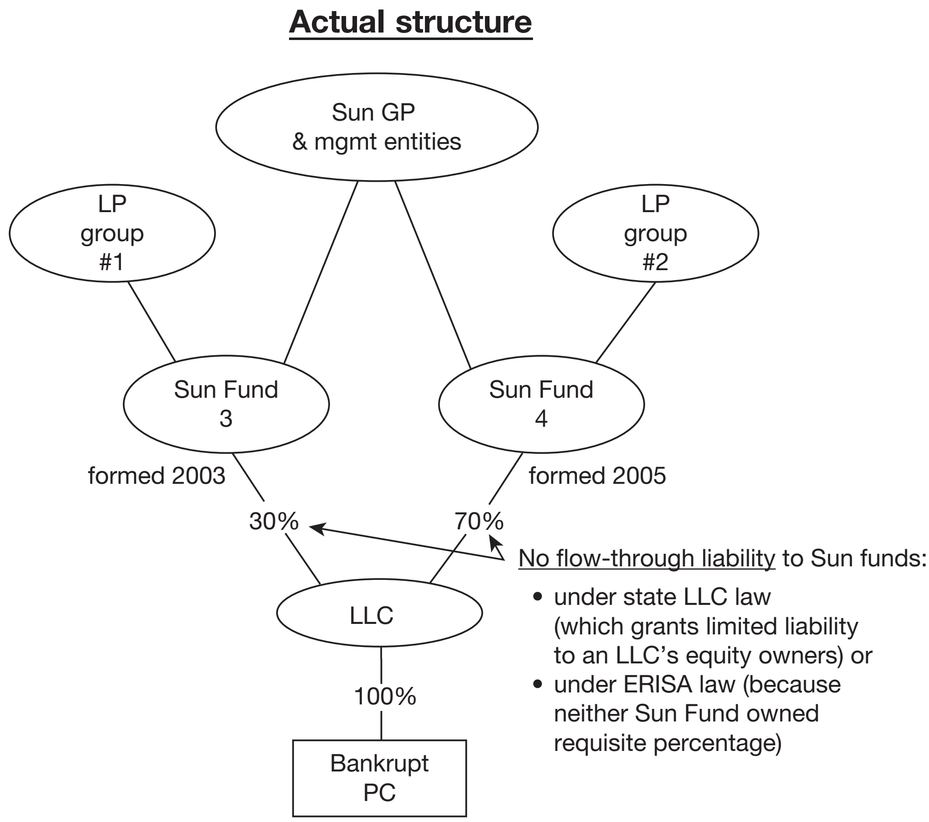
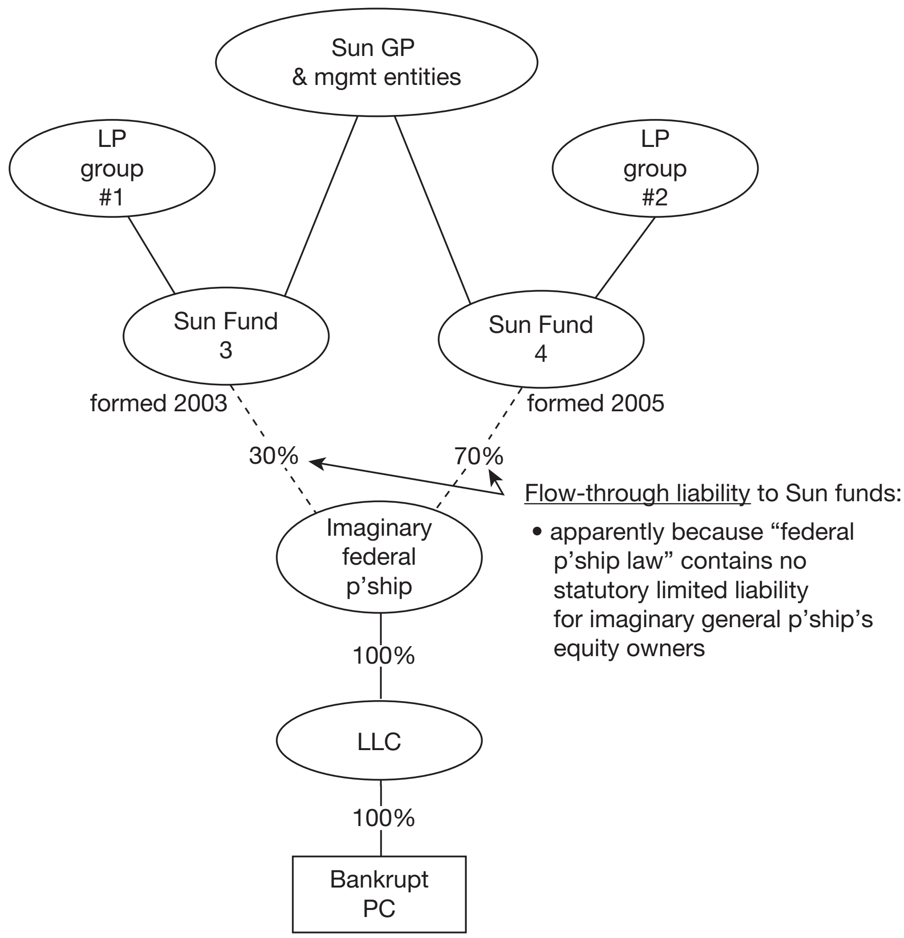
◦ had been formed several years apart by the same sponsor group (Sun),
◦ did not generally invest in the same portfolio companies,
◦ had minimal common LPs, and
◦ if they did occasionally invest in the same portfolio company, the investments were not proportionate to each fund's capital.



The district court in 2016 (on remand from the First Circuit) concluded that both of the serial Sun funds were liable for the bankrupt portfolio company's ERISA obligation (although neither Sun fund owned the requisite 80%) because, in the district court's view, they had created a new entity, a "federal" "partnership-in-fact" (owned 70/30 by the two serial Sun funds), to serve as the LLC's 100% owner (so the imaginary partnership was [under the ERISA rules] liable for the ERISA obligation the LLC had inherited [under the ERISA rules] from the bankrupt portfolio company). The court then concluded (without discussion) that the partners of the imaginary "federal" partnership (the two Sun funds) were liable (i.e., apparently as the imaginary partnership's general partners) for the imaginary partnership's ERISA obligation.

Court's imaginary structure



The court (relying on the Internal Revenue Code's broad definition of a partnership for tax purposes) reasoned that the two Sun funds' "smooth coordination [was] indicative of a 'partnership-in-fact' sitting atop the LLC: a site of joining together and forming a community of interest." However, if the court believed the two Sun funds needed an entity in order to engage in such joint activity, it is unclear why the LLC *actually* formed by the two Sun funds (which under state law afforded its members protection from the LLC's unpaid obligations)—rather than an imaginary "federal" "partnership-in-fact" created by the court—wouldn't serve as the repository for such coordinated activity.

Because there is in fact no federal partnership law (i.e., all partnerships are formed under state, not federal, law), it is not surprising that the court's "federal" "partnership-in-fact" (unlike the LLC which the two Sun funds actually did create) afforded no *explicit* equity owner-level protection against unpaid "partnership"-level liabilities.

▲ **Possible extension of imaginary partnership approach to investments made in concert by several wholly independent PE funds or by PE fund and co-investors.** If the 2016 *Sun Capital* district court decision were to stand, there is a possible argument that multiple investments in a portfolio company (made in concert) should be amalgamated, i.e., treated as made by an imaginary partnership, even if made:

(a) by two wholly independent PE funds (i.e., where one fund's GP/ management company/sponsor is unrelated to the other fund's GP/ management company/sponsor) or

(b) by a PE fund along with one or more co-investors (e.g., one or more of the fund's limited partners and/or one or more persons who are not limited partners in the fund).

In such case, all of the co-investors (including even a 1% co-investor) could be viewed as GPs in an imaginary general partnership, with full unlimited liability for the bankrupt portfolio company's ERISA liability. See discussion at ¶501.3.5.2, ¶501.5.3, and ¶1018.

- **LBO fraudulent conveyance issues.** Where an LBO is structured so that Target's old creditors are disadvantaged—generally because liability for the new acquisition debt ends up in the same entity as Target's old trade and general creditors (rather than in a parent company which owns Target's stock) while the borrowed money is paid out to Target's old shareholders—courts have sometimes held (where the entity with the old Target creditors and the LBO debt defaults on its obligations not long after the LBO) that the transaction constituted a fraudulent conveyance.

  Fraudulent conveyance law is located in both a federal statute (Bankruptcy Code) and state statutes: 34 states have enacted the Uniform Fraudulent Transfer Act, 9 states have enacted the Uniform Voidable Transactions Act (a relatively new statute based on the Uniform Fraudulent Transfer Act), 2 states have enacted the Uniform Fraudulent Conveyance Act, and approximately 5 states have enacted some form of the old Statute of Elizabeth. See discussion at ¶501.4.3.9.

- **S corp tax issues.**
  - **Forming S corp to minimize income taxes.** An S corp (like a partnership or LLC) is a flow-through entity for federal (and generally for state) income tax purposes and hence normally pays no income tax at the entity level, i.e., an S corp's income is generally subject to only one level of income tax (imposed at the shareholder level) rather than double tax for a C corporation (once at the C corp level and once at the shareholder level). See discussion at ¶301.2.
  - **S corp double tax in certain circumstances.** However, Code §1374 subjects an S corp to a corporate-level penalty tax on asset-sale gain (or deemed asset-sale gain on a stock sale with an SUB election)—so that such S corp gain is subject to double tax—under two circumstances:

(1) where the S corp was formerly (within a specified period) a C corp but switched to S corp status *or*

(2) where the S corp (although always an S corp) acquired assets tax-free with carryover basis from a C corp (within a specified period).

In such cases Code §1374 has long subjected the S corp's asset-sale gain (which accrued before the S election or the tax-free-carryover-basis asset acquisition) to corporate-level (and hence double) tax if such assets were sold (or deemed sold) within 10 years after (a) the conversion from C to S corp or (b) the S corp's tax-free acquisition of carryover basis assets from a C corp.

However, beginning in 2009, a series of legislative enactments reduced this 10-year penalty period first to 7 years and then to 5 years, with each such enactment generally covering only 1 year. Finally, 2015 legislation permanently reduced the penalty period to 5 years. See discussion at ¶301.2.

- **Avoiding restrictions on S corp shareholders.** A corporation can elect to be taxed as an S corp (and hence subject to S corp flow-through taxation rather than C corp double taxation) only if it meets certain arbitrary rules relating to its stock and its shareholders, including:

  ▲ all of the corporation's outstanding shares of stock are identical from an economic standpoint (although not necessarily from a voting power standpoint) and

  ▲ each of its shareholders is an individual (or the estate of an individual) who is a U.S. citizen or resident, i.e., no shareholder can be a corporation, partnership, LLC, or non-U.S. citizen and resident.[3]

  However, one technique for minimizing the impact of these arbitrary rules and allowing an existing S corp to raise new money from a PE/VC fund, often for preferred or formula participation stock, is for:

  (1) such S corp to drop its existing business and assets (in a tax-free Code §721 transaction) down to a newly formed partnership or LLC ("lower-tier operating entity") and

  (2) PE/VC fund either to make an investment in lower-tier operating entity (rather than in S corp) or to purchase an interest in lower-tier operating entity from S corp.

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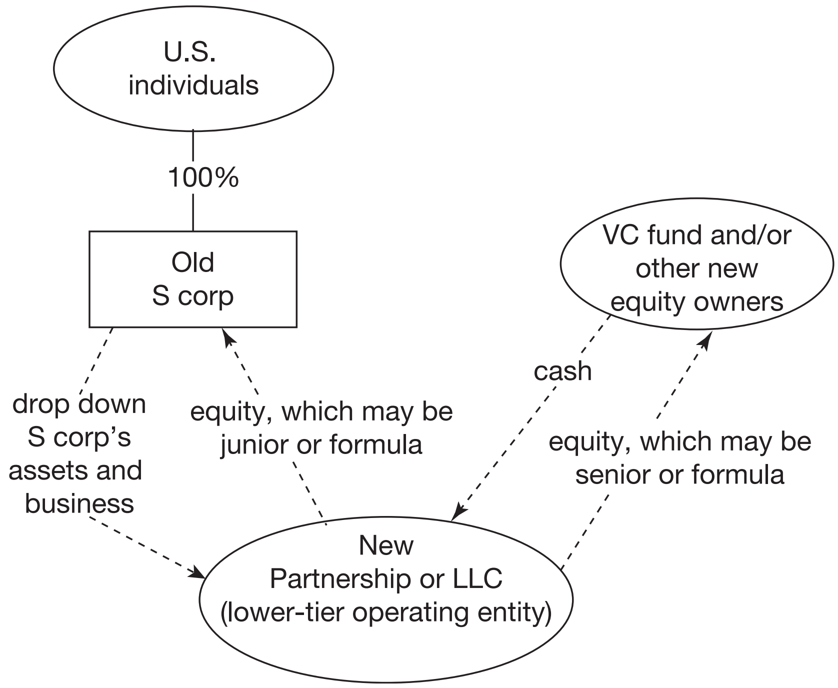
[3]Under certain circumstances a trust for a U.S. individual *or* a single-member LLC owned by a U.S. individual *or* a TEO can be an S corp shareholder.

S corp's old business is then owned and operated by lower-tier partnership or LLC entity—a form of organization not subject to the S corp arbitrary rules discussed above—which is in turn owned in part by S corp and in part by the fund:



However, where an actual transfer of S corp assets to a lower-tier operating entity is not desirable (e.g., because of the need for third-party asset-transfer consents), the same result can be achieved by utilizing the entity conversion mechanism available under Delaware and most other state laws. Under this alternative, (1) the existing S corp shareholders contribute all their S corp shares to a new S corp ("New S corp"), (2) the old S corp elects under state law to convert into a partnership or LLC, and (3) the new investors invest in the newly converted partnership/LLC or purchase a portion of such partnership/LLC's equity from New S corp.

Steps (1) and (2), taken together, are treated, for federal income tax purposes, as a tax-free "F" reorganization, which views New S corp as a continuation of old S corp, while step (2) (old S corp's state-law election to become a partnership/LLC) is not treated for state law purposes as an asset transfer, so that the state law drawbacks of an actual asset transfer (e.g., retitling of assets and possible need for third-party consents) can typically be avoided. See discussion at ¶301.4.

- **Portfolio Company debt financing.**
  - **Code §385 proposed regulations reclassify certain intercompany debt as equity.** 4/16 proposed IRS regulations would mandate equity characterization for certain related party debt, without regard to the strength of the applicable instrument's "debt" characteristics under the subjective debt/equity factors, with the result, that (1)

“interest” on such debt would be treated for tax purposes as non-deductible preferred dividends by the payor and as dividend rather than interest income by the payee and (2) the holder’s redemption proceeds (if treated as essentially equivalent to a dividend under Code §302) would be treated as dividend income rather than non-taxable return of basis.

These regulations would apply to debt instruments issued between corporations that bear an 80%-or-greater parent-subsidiary or brother-sister relationship (but are not part of a single group filing a consolidated federal income tax return), referred to as an “expanded group.” These rules would apply where, for example, a U.S. corporation issues debt to its 80%-or-greater foreign parent corporation or where a partnership owns 80% or more of the stock of two U.S. corporations and one of those corporations issues debt to its sister corporation.

The proposed regulations would, with limited exceptions (including an exception for debt instruments not exceeding $50 million in the aggregate), automatically treat a debt instrument as equity if issued by one expanded group member to another:

- as a dividend or redemption distribution,
- in exchange for stock of another group member, or
- in exchange for property of another group member in certain types of asset reorganizations.

The same treatment would apply if a debt instrument is issued by one expanded group member to another member for cash or other property, with “a principal purpose” of funding one of the three distribution or acquisition transactions described immediately above. The proposed regulations would treat debt as issued with a principal purpose of funding such a distribution or acquisition if the debt is issued during the period beginning 36 months before, and ending 36 months after, such a distribution or acquisition, with a narrow exception for certain debt issued for property in the ordinary course of business. This portion of the regulations would apply to debt instruments issued after 4/3/16.

To facilitate IRS audits, the proposed regulations would also impose new record-keeping requirements for debt instruments issued between members of an “expanded group” (as defined above) if:

- the stock of any member of the group is publicly traded or
- a financial statement of the group shows total assets exceeding $100 million or
- a financial statement of the group shows annual total revenue exceeding $50 million, regardless of the type of transaction being financed.

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Such a debt instrument would automatically be treated as equity unless:

(a) documentation is prepared within 30 days of the debt instrument's issuance evidencing a binding obligation to repay the funds, the creditor's rights to enforce the terms of the instrument, and a "reasonable expectation" of the borrower's ability to repay the instrument on its terms and

(b) ongoing documentation is prepared and maintained evidencing a continuing and genuine debtor/creditor relationship, including payments of interest and principal and, if applicable, enforcement actions upon default.

This documentation portion of the regulations would apply to a debt instrument issued after the regulations are issued in final form. See discussion at ¶601.1.6.1.

- **Issues arising out of Portfolio Company executive compensation.**
  - **Reductions in Portfolio Company GAAP earnings because of stock grants, sales, or options to executives.**
    - ▲ **Stock sale or award.** When a company makes a stock sale or award to an executive, (1) the company's accounting net income is reduced (over the executive's service period, generally the vesting period) by the compensation expense, which in turn is equal to the stock's FV at the time of sale or award *less* the price (if any) paid by the executive, and (2) the company's accounting net income is increased by its expected tax saving from any tax deduction created by the stock sale or award.
    - ▲ **Stock option.** When a company grants a stock option to an executive, the company's compensation expense (which reduces its accounting net income over the executive's service period, generally the vesting period) is equal to the FV of the option at the grant date, taking into account both (1) the spread (if any) at grant between the stock's FV and the option price and (2) the value of the option privilege, i.e., the value to an executive from deferring the purchase decision and payment of the option price (generally 20% to 40% of the option stock's grant date FV for an option that is not significantly in the money at grant), while the company's tax expense is reduced by its expected tax saving from any tax deduction created by the option grant and exercise, so that the company's accounting net income is reduced by such compensation expense net of the tax benefit.
    - ▲ **Tax saving calculation.** Under pre-3/16 GAAP rules, the tax savings from any tax deductions in excess of the company's accounting expense ("excess tax benefits") are generally credited directly to net worth as paid in capital and do not flow through the company's income statement. However, GAAP rules adopted in 3/16 eliminate the concept of "excess tax benefits," effective 1/17 for a

public company using the calendar year and 1/18 for a private company using the calendar year, with early adoption permitted.

Under the new rules, the company is required to adjust its tax benefits (generally calculated pursuant to Code §83, §409A, and §404(a)(5)) from a sale, award, or option grant and exercise as estimated at grant to reflect its actual tax benefits (e.g., because of FV fluctuations between sale/grant and vesting if no §83(b) election was made for a stock sale/award or between grant and exercise/vesting for an option) and such adjustments, whether positive (the company's actual tax benefits are greater than estimated) or negative (the company's actual tax benefits are smaller than estimated), flow through the company's income statement and affect GAAP net income.

- ▲ **Vesting rules.** An executive's stock or option is frequently subject to vesting based on a "service condition" (requiring the executive to provide services to the company) or a "performance condition" (requiring both (i) the executive to provide services to the company and (ii) satisfaction of a performance target relating to the employer's operations or activities, either during or after the requisite service period).

  Stock or option FV is not reduced based on the possibility the executive will not vest in the award and hence will forfeit the compensation; rather, compensation expense is recognized only for an award that ultimately vests. Under GAAP rules adopted in 3/16 (effective 1/17 for a public company and 1/18 for a private company as described above), the company must either (i) estimate the portion of its awards expected to vest based on the provision of services and subsequently adjust such estimate from time to time in light of vesting expectations and ultimately based on actual vesting results or (ii) take forfeitures based on failure to provide services into account as they actually occur.

  Prior to the 3/16 rules' effective date a company must estimate the forfeitures expected to occur based on the failure to provide services and adjust the estimate from time to time based on vesting expectations and actual forfeitures. See discussion at ¶409.1(1), (2), and (4).

- ■ **Mandatory clawback of incentive-based executive compensation.** If a company's stock is listed on a national securities exchange, 1934 Act §10D requires (once proposed SEC rules are finalized), the company to claw back any incentive-based compensation wrongly paid to its executive officers on account of a material misstatement of financial information.

In more detail, proposed 7/15 SEC rules (once final) impose strict liability on all executive officers of a company listed on a national securities exchange to return incentive-based compensation (including stock options and compensation where vesting or amount is based on any type of financial information), calculated on a pre-tax basis, if the company restates its financial performance on account of a material error, even if such error was inadvertent and such executive had no involvement in preparing financial statements, to the extent the compensation exceeds the amount the officer would have received based on the restated financial statements, for the three completed fiscal years preceding the restatement. See discussion at ¶901.12.

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