HOW VC/PE FUNDS CAN DELIVER SPECIAL LTCG TAX BENEFITS TO INDIVIDUAL LPS AND GPs

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Changes in Federal Income Tax Law in recent years grant two important tax benefits to an "individual" (i.e., a human being or a trust or estate for the benefit of one or more human beings) who owns (either directly or indirectly through a VC/PE fund or other tax flow-through entity) stock of a "qualified small business" (a "QSB"):

• First, Code §1202 reduces from 20% to 14% the federal income tax rate on capital gain ("CG") from sale of QSB stock held more than 5 years.
• Second, Code §1045 allows CG from sale of QSB stock held more than 6 months to be rolled over tax-free if an amount equal to the sale proceeds is quickly reinvested (i.e., within 60 days after sale of the old QSB stock) in new QSB stock.

These benefits are potentially available both to (1) an individual limited partner ("LP") investor in a VC/PE fund and (2) an individual who, as a partner in the VC/PE fund's general partner ("GP") entity, is allocated CG, including carried interest ("CI") CG.

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However, where an individual invests in a QSB indirectly through a fund or other tax flow-through entity (either as LP or GP), these two significant tax benefits are available only if the entity through which the individual realizes such QSB CG supplies the individual with information necessary to claim the benefits on his or her tax return. Currently few VC/PE funds supply their individual GPs and LPs with such information.

Part I of this article (a) describes the information a VC/PE fund can supply to LPs and GPs to enable them to claim these two tax benefits.

Part II summarizes the numerous technical requirements necessary to satisfy Code §1202 and §1045 (including requirements relating to the nature of the individual investor, the nature of the QSB portfolio company (the “PC”), and the timing of the purchase and sale transactions). Thus, a VC/PE fund can use the Part II tests to determine whether a particular PC transaction qualifies for either or both of these QSB tax benefits, in which case the fund can supply its LPs and GPs with the information (in the form described in Part I).

I. Form of Information Fund Can Supply to LPs and GPs

To enable an individual GP or LP to take advantage of preferential tax treatment under Code §1202 and §1045, a VC/PE fund can supply the following information to such investor with respect to each sale or purchase of stock which qualifies for QSB treatment (as described in Part II below):

1. When the fund sells QSB stock, the fund can notify investors as to the sale date and amount of CG the fund believes qualifies (a) for the 14% Code §1202 tax rate (where the fund held QSB stock more than 5 years) and (b) for the Code §1045 tax-free rollover (where the fund held QSB stock more than 6 months).

2. Where the fund held QSB stock more than 5 years, an individual investor can elect to take advantage of either Code §1202's 14% rate or §1045’s tax-free rollover.²

An individual investor who desires to roll over the proceeds from a sale of QSB stock tax-free under Code §1045 can mix and match the fund’s sales of QSB stock with purchases of QSB stock by the same fund or by the individual investor (directly or indirectly through another tax flow-through entity) within 60 days after (but not before) such QSB sale.

Obviously, where an individual investor desires to utilize Code §1045’s tax-free rollover privilege, the information described above (as well as the information described in 2 and 3 below) is more useful when supplied to the individual immediately after the QSB transaction, so that the individual can use the information to time other matching QSB stock transactions to meet Code §1045’s 60-day rule. However, even if such information is not supplied to the individual until later (e.g., after year end as part of the fund’s K-1 tax reporting to its partners), the individual can still use this information to ascertain whether any QSB stock transaction by the fund can be matched with a QSB stock transaction made by the same fund or by the individual (directly or indirectly through another flow-through entity) within the relevant 60-day period.

2. When a fund distributes QSB stock in kind to investors, the fund can notify investors whether the fund believes (a) such stock — if immediately sold by the investors — qualifies for Code §1202 treatment (e.g., 5-year holding period already satisfied) or would qualify if retained by an individual distributee for a specified additional period and (b) such stock — if immediately sold by the investors — qualifies for Code §1045 treatment (e.g., 6-month holding period already satisfied) or would qualify if retained by an individual distributee for a specified additional period.

² As discussed in II(E), we assume for purposes of this article that the fund does not make an entity-level Code §1045 election, but rather allows each partner to decide whether to make an individual-level election.
3. When a fund purchases QSB stock, the fund can, with respect to each stock purchase the fund believes qualifies for Code §1045 matching, notify investors as to the date on which the stock was purchased by the fund and the amount of stock cost allocable to each investor.

Each investor can mix and match the fund's QSB stock purchases with QSB stock sales by the same fund or by the individual investor (directly or indirectly through another flow-through entity) within 60 days prior to such QSB purchase to qualify for Code §1045 tax-free rollover.

4. Additional disclosure. Because the law (as described in Part II) is quite complex as to whether a particular PC or a particular batch of PC stock meets the QSB rules, a VC/PE fund supplying the type of information described in 1 through 3 above should make clear to its partners that the fund is supplying them with its view of the transactions, based upon (1) such information as is available to the fund regarding each PC and (2) the fund’s interpretations (which the fund believes reasonable) as to the scope and meaning of applicable Code provisions (with no guarantee as to the correctness of the fund's factual information or legal interpretations), so that the fund's partners can determine the tax consequences of the transactions based on consultations with the partners' personal tax advisers.

II. Requirements of Code §1202 and §1045

In order for stock to qualify for the two tax benefits described herein, the Code imposes a number of complex requirements, some relating to the nature of the owner, some relating to the nature of the PC, and some relating to the timing of the purchase and sale transactions:

A. Eligible Owners

The tax benefits under Code §1202 and §1045 are available only to individuals (i.e., human beings and trusts or estates taxed as individuals) and apply whether the individual owns QSB stock directly (in his or her own name or in street or nominee name) or owns QSB stock indirectly (through a tax flow-through entity, such as a partnership, LLC, or S corporation).

Where an individual owns QSB stock indirectly through a tax flow-through entity (e.g., VC/PE fund), the individual cannot utilize Code §1202 or §1045 to the extent that the individual's share of the flow-through entity's gain is greater than when the entity acquired the QSB stock, e.g., the individual cannot use these tax benefits to the extent he or she purchased an interest in the entity after it acquired the QSB stock.

None of the Code §1202 or §1045 tax benefits are available to a corporate taxpayer owning QSB stock directly or indirectly.

B. Holding Period Requirements

Code §1202's 14% reduced CG rate is available only where the individual investor holds QSB stock (directly or indirectly through a tax flow-through entity) longer than 5 years. Code §1045's tax-free rollover benefit is available only where the individual investor holds QSB stock (directly or indirectly through a tax flow-through entity) longer than 6 months.

For both the 5-year and the 6-month holding period tests, where an individual gifts or bequeaths QSB stock (or an interest in a tax flow-through entity holding QSB stock) to another individual, the transferee takes the transferor's holding period and other characteristics. Similarly, if a partnership or LLC (e.g., a VC/PE fund) distributes QSB stock to an individual equity owner of the entity, the individual takes the entity's holding period and other characteristics for the QSB stock, so long as the individual held his or her interest in the entity when the entity acquired the QSB stock and continuously thereafter.

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3 Thus, where a VC/PE fund has multiple closings, an individual investor who became an LP at the second closing would not qualify with respect to QSB stock purchased by the fund before the second closing.

4 Complex rules apply if the investor has hedged its position with respect to the QSB stock.
C. PC Requirements

In order for stock to qualify as QSB stock, the following requirements must be satisfied with respect to the PC which issued the stock:

1. Domestic C corporation. The PC must be a United States C corporation. Stock of an S corporation or a foreign corporation and interests in a partnership or an LLC taxed as a partnership do not qualify as QSB stock (although, as mentioned above, stock of a C corporation held by an individual through a tax flow-through entity does qualify).

2. $50 million maximum assets at issuance. The PC’s gross assets must not exceed $50 million at any time during the period beginning 8/10/93 and ending “immediately after” issuance of the QSB stock.

For this purpose, the PC’s gross assets are measured by their adjusted tax basis (generally cost less depreciation), except that assets contributed to the PC by shareholders (e.g., patents, machinery and equipment, land, goodwill) are measured by their fair value at contribution rather than their tax bases.

This $50 million calculation is made after taking into account the amount received by the PC for the new QSB stock being issued to the fund or individual. Hence, if a PC with $45 million of gross assets issues stock to VC/PE fund and other buyers for $6 million cash, none of the newly issued stock qualifies, because the PC has $51 million of gross assets “immediately after” such stock issuance. Thus, the fund may suggest that the PC delay receipt of any third party borrowings or equity contributions which would increase the PC’s gross assets to or above the $50 million level until after the fund completes its purchase of the PC’s stock.

Where VC/PE fund is making a series of staged investments in the PC (some for common stock and some for fixed (nonconvertible) preferred stock or debentures), it may be helpful for the earliest fund purchases to consist of PC common stock (which has the potential for substantial appreciation) and the later purchases to consist of the fixed instruments, since the PC may cross the $50 million hurdle after the early fund investments and before the later investments.

It is not wholly clear whether, in making the $50 million determination, the PC must take into account preplanned future contributions. For example, where a PC with $45 million of gross assets issues stock to VC/PE fund for $4 million at a time when the PC has agreements with the same VC/PE fund or with third parties to issue additional stock (or debt) for $2 million, the fund’s $4 million stock purchase would not qualify if the PC’s preplanned future sale of $2 million of additional stock (or debt) is taken into account. Literally read, Code §1202’s $50 million test looks only to the PC’s “gross assets...immediately after the issuance [to the fund] (determined by taking into account amounts received in the issuance)” and not to assets committed to be transferred to the PC in the future. Some uncertainty arises, however, because IRS has taken the position in other contexts that “immediately after” takes into account preplanned future events, especially (but not exclusively) where there are contractual arrangements calling for the events to occur in the future.

Nevertheless, in the absence of IRS guidance, taxpayers should certainly be able to take the literal position, interpreting the $50 million test as taking into account the state of affairs (and hence only amounts “received” by the PC) before or simultaneously with the fund’s stock purchase.

However, should IRS take a hostile position, the likelihood of IRS step-transaction victory would increase where the subsequent commitment (a) is unconditional, (b) is intended to occur soon after the fund’s PC stock purchase, and (c) has been delayed only to allow the fund’s PC stock purchase to qualify. Conversely, the likelihood of IRS step-transaction victory is reduced where the subsequent commitment (a) is conditional (e.g., within the third party investor’s discretion or mandatory only if unpredictable future events occur), (b) is intended to occur (if at all) far in the future, and (c) was not deferred with any intent to allow the fund’s PC stock purchase to qualify.
For purposes of the $50 million test, where a PC has a more-than-50% corporate subsidiary or parent (measured by vote or value), the PC is treated as owning 100% of such parent's or subsidiary's assets.  

3. Active business. The PC must meet two “active business” tests. The first test is met if, during “substantially all” of the fund’s holding period for the PC’s stock, the PC uses at least 80% of its assets (by value) in conducting one or more businesses other than:

(a) banking, insurance, financing, leasing, investing, and similar businesses, including operating as a RIC or REIT,
(b) production or extraction of percentage depletion minerals,
(c) farming,
(d) operating a hotel, motel, restaurant, or similar business, or
(e) any other service businesses in which the principal asset is the reputation or skill of one or more employees, including financial services, engineering, consulting, athletics, performing arts, health, accounting, or law.

The second test is failed if either:

(a) more than 10% of the PC’s assets (by value), net of liabilities, consist of stock or securities in other corporations (except controlled subsidiaries as described below), or
(b) more than 10% of the PC’s assets (by value), net of liabilities, consist of real estate not used in an active business, and for this purpose renting real property is not treated as an active business.

For purposes of these active business tests, there is a look-through rule under which the PC is treated as owning directly its percentage share of the assets, liabilities, and business of each more-than-50% subsidiary corporation (measured by vote or value).

4. Stock acquired at original issuance. Stock qualifies as QSB stock only if acquired subsequent to 8/10/93 (the date Code §1202 was enacted) and at the stock’s original issuance, i.e., either directly from the PC or through an underwriter in a primary offering. A secondary purchase of stock from an existing shareholder (directly or through an underwriter) does not qualify.

As discussed above, if an individual gifts or bequeaths QSB stock (or an interest in a tax flow-through entity holding QSB stock) to another individual, the transferee takes the transferor’s holding period and other characteristics. Similarly, if a partnership or LLC (e.g., a VC/PE fund) distributes QSB stock to an individual equity owner of the entity, the individual takes the entity’s holding period and other characteristics for the QSB stock, so long as (i) the individual held his or her interest in the entity when the entity purchased the QSB stock and continuously thereafter (ii) to the extent the distribution does not increase the individual’s share of the QSB stock gain.

5. Options, convertibles, and nonvested stock. Stock acquired from the PC by an investor (such as VC/PE fund) exercising an option or warrant or converting convertible debt is treated as acquired from the PC at original issue. Unfortunately, however, whether the PC meets the $50 million gross assets test is determined at the time of such exercise or conversion (not when the option, warrant, or convertible debt was issued) and the Code §1202/$1045 holding period of such stock begins only at the time of exercise or conversion.

5 In determining whether PC has a more-than-50% corporate subsidiary or parent, (a) a corporation is treated as owning stock which it has an option to purchase and as owning a pro rata portion of any stock owned by a partnership or LLC in which it has an equity interest and (b) where a corporation owns exactly 50% of a second corporation’s stock, a number of IRS rules require stock in the second corporation owned by third parties to be disregarded under certain circumstances, so that in such circumstances the corporation is treated as owning more than 50% of the second corporation’s stock.

6 The active business requirement is not applicable to PC stock purchased by a “specialized small business investment company.”
On the other hand, in the case of convertible preferred stock, the $50 million gross assets determination is made when the convertible preferred stock was originally issued, and the investor's holding period for the convertible preferred stock tacks to the common stock acquired by the investor upon conversion.

Stock received by a service provider ("SP") in connection with the performance of services is treated as issued when the resulting compensation income, if any, is included in the SP's income in accordance with the rules of Code §83 (i.e., (i) at issuance where the stock is vested at issuance, (ii) at issuance where the stock is subject to vesting but the SP makes a timely §83(b) election, or (iii) at vesting where the stock is subject to vesting and the SP does not make a timely §83(b) election).

6. Stock acquired for cash or qualified consideration. The stock must be issued in exchange for either (a) cash, (b) stock that itself was QSB stock, (c) property other than stock, or (d) services. Hence, the stock must not be issued in exchange for stock that was not QSB stock.

7. Tax-free reorganizations. Where a fund holding QSB stock exchanges such QSB stock in a tax-free merger or similar reorganization (e.g., a tax-free merger of the PC into Bigco) in exchange for Bigco stock which does not qualify as QSB stock (e.g., because Bigco has more than $50 million of gross assets at the time of the merger), the Bigco stock received in exchange for QSB stock nevertheless qualifies as QSB stock, and the Bigco stock's holding period includes (i.e., tacks to) the surrendered QSB stock's holding period, but the amount of gain eligible for Code §1202/§1045 is limited to the appreciation in the old QSB stock on the merger date. Hence, subsequent appreciation in the Bigco stock does not qualify.

The same rule—gain qualifying for Code §1202/§1045 limited to appreciation at time of exchange—also applies to a tax-free recapitalization of PC, where the fund swaps one type of PC stock for another type of PC stock tax free when PC no longer qualifies as a QSB (e.g., because PC no longer satisfies the $50 million gross asset test), unless the transaction constitutes a mere conversion of PC convertible preferred stock into PC common stock, in which case the gain limitation rule does not apply.

8. No redemptions. A PC's stock ceases to be QSB stock where the PC makes certain types of stock redemptions. Specifically, a PC's stock ceases to qualify if:

(a) the PC redeems stock from the shareholder seeking the benefit of Code §1045/§1202 (or from certain persons related to the shareholder seeking the benefit) during the 4-year period beginning 2 years before and ending 2 years after the purported QSB stock's issuance, or

(b) the PC redeems stock from any shareholder(s) (even though not related to the shareholder seeking the benefit) aggregating more than 5% of the aggregate value of all PC's stock (measured 1 year before the purported QSB stock's issuance) during the 2-year period beginning 1 year before and ending 1 year after the purported QSB stock's issuance.

For this purpose, certain stock redemptions that are de minimis in amount or occur in connection with the redeemee's termination of employment, death, disability, or divorce are disregarded.

This limit on redemptions generally precludes QSB qualification for stock issued in an LBO designed to qualify for recap accounting, e.g., where a fund purchases newly issued Target stock and, as part of the transaction, Target redeems a substantial portion of its previously outstanding stock. On the other hand, in a traditional LBO transaction where Newco is formed to purchase Target's stock, a redemption of Target stock as part of the buyout transaction does not preclude Newco stock from qualifying.

D. Maximum Limitation on Code §1202 Gain

1. Code §1202. The amount of an individual's gain that can ultimately qualify for the 14% Code §1202 tax rate (calculated at the individual—not the fund—level) is limited in the case of any one PC to the greater of (a) $10 million cumulatively for such PC or (b) 10 times the
individual's aggregate basis in the PC's stock sold during the tax year.

For example, VC/PE fund purchases $15 million of PC stock, holds such stock more than 5 years, and sells it for $250 million, i.e., a $235 million gain:

- 80% of which (i.e., $188 million) is allocated to the fund's LPs and GP in proportion to contributed capital and
- 20% of which (or $47 million) is allocated to the GP as a CI.

Individual A, an LP who invested 10% of the fund's capital, calculates the amount of his or her CG eligible for Code §1202's reduced rate as follows:

\[
\text{Millions} \\
- \text{CG allocable to A: 10\% of $188 million} \quad \cdots \quad $18.8 \\
- \text{Limitation (a): $10 million cumulative per PC, of which none previously used} \quad \cdots \quad $10.0 \\
- \text{Limitation (b): 10\% of A's stock basis (i.e.,} \\
\quad 10 \times $15 \text{ million cost of fund's stock} \times \\
\quad A's \ 10\% \text{ contribution thereto)} \quad \cdots \quad $15.0
\]

Hence, $15 million of A's $18.8 million CG qualifies for Code §1202's 14% rate (and the remaining $3.8 million is taxed at the regular 20% LTCG rate). The overall result would be the same if the fund sold part of its PC stock in one year and the remainder in another year.

Individual B, a partner of the GP entity who, through the GP, contributed 0.5% of the fund's capital and holds 30% of the CI calculates the amount of his or her CG eligible for Code §1202's reduced rate as follows:

\[
\text{Millions} \\
- \text{CG allocable to B: 0.5\% of $188} \\
\quad \text{million plus 30\% of $47 million} \quad \cdots \quad $15.040 \\
- \text{Limitation (a): $10 million cumulative per PC, of which none previously used} \quad \cdots \quad $10.000 \\
- \text{Limitation (b): 10\% of B's stock basis} \\
\quad (i.e., 10 \times $15 \text{ million cost of fund's stock} \times \text{B's 0.5\% contribution thereto}) \quad \cdots \quad $0.075
\]

Hence, $10 million of B's $15.04 million CG qualifies for Code §1202's 14% rate (and the remaining $5.04 million is taxed at the regular 20% LTCG rate).

There is no need for the fund to make any Code §1202 limitation calculations in supplying information to its investors pursuant to Part I above, i.e., each individual investor is charged with the responsibility of calculating such individual's own limitation once the fund supplies him or her with information as to his or her share of the fund's cost basis and proceeds from a particular QSB stock sale.

2. Code §1045. There is no limit on the amount of gain that can be rolled over tax free under Code §1045.

E. Making a Code §1045 Election

An individual seeking the Code §1045 rollover benefit must make an election on his or her timely filed tax return (including extensions) for the taxable year in which QSB stock is sold by (1) reporting the entire gain from sale of QSB stock on his or her Schedule D and (2) writing "Section 1045 rollover" directly below the line on which the gain is reported and entering the amount of the gain deferred under Code §1045 on such line if it were a loss.

The effect of a Code §1045 rollover election is that (1) the individual recognizes gain on sale of the old QSB stock only if (and to the extent) such individual's share of the sale proceeds exceeds such individual's cost for replacement QSB stock, (2) the individual's basis in the replacement QSB stock is reduced by the amount of deferred gain on sale of the old QSB stock, and (3) the individual's holding period in the replacement QSB stock tack[s] the holding period of the old QSB stock. Thus, for example, where an individual sells old QSB stock held 3 years and rolls the proceeds over into replacement QSB stock which he or she then holds more than 2 years, the replacement QSB stock qualifies for Code §1202's 5 year test.

There is, however, no need to physically trace proceeds from sale of old QSB stock to payment of purchase price for replacement QSB stock. Once an individual elects Code §1045 treatment with respect to a sale of old QSB
stock, such individual is treated by Code §1045 as (1) rolling the proceeds into the first QSB stock purchased thereafter (and within 60 days) and (2) if the purchase price for the first QSB stock purchased is less than the proceeds from the old QSB stock sale, as rolling the remaining proceeds into the next QSB stock purchase, and then the next, etc., until all the proceeds from the old QSB stock sale are used up (or 60 days has expired).

Where a VC/PE fund purchases new QSB stock within 60 days after the same fund sold old QSB stock, the fund can itself make an entity-level Code §1045 rollover election on its tax return for the year in which the old QSB stock was sold, in which case the fund is obligated to keep track of the new QSB stock's low rollover basis and tacked holding period. We assume for purposes of this article that the fund does not make any such entity-level Code §1045 election but rather supplies its partners with the information described in Part I and allows each partner to decide whether to make an individual-level Code §1045 election, in which case each individual (rather than the fund) is obligated to keep track of the new QSB stock's low rollover basis and tacked holding period.

F. Gathering Necessary Factual Information From PCs

In order to assist a VC/PE fund in gathering the facts as to a particular PC's qualification as a QSB, the fund may ask each PC to fill out a questionnaire when the fund invests in the PC's stock, covering such matters as:

• PC is a United States corporation, taxable under Subchapter C of the Code, and has not filed an election to be treated as an S corporation.

• Immediately after consummation of fund's purchase of PC stock, PC's aggregate gross assets (as measured for tax purposes under Code §1202(d)) did not exceed $50 million at any time since 8/10/93.

• PC is engaged in an "active business," as defined in Code §1202(c) and intends to engage in an "active business" while fund holds PC's stock.

• PC has not redeemed (a) within the past 2 years, any of PC's stock from fund or a person related to fund or (b) within the past 1 year, PC stock with an aggregate value exceeding 5% of the aggregate value of all PC's stock (measured 1 year before the issuance date of the stock), and PC does not intend to do so.

The fund could later (when it sells or distributes in kind PC's stock) request PC to fill out another similar questionnaire, with changes in wording to pick up the time period between the fund's purchase of PC's stock (when PC first filled out a questionnaire) and the fund's later sale or distribution of the stock. Even where the fund did not request PC to fill out a questionnaire at purchase, the fund may well request PC to fill out a questionnaire at sale or distribution whenever the fund's investment in PC was made after Code §1202's 8/93 effective date.

III. Conclusion

It is unfortunate that the tax incentives granted by Code §1202 and §1045 are undermined by unnecessarily complex and restrictive limitations. Nonetheless, Code §1202 and §1045 do provide two significant potential tax benefits for individual LPs and GPs which can be utilized only if the VC/PE funds through which they hold QSB stocks supply them with appropriate and timely information.

This article sets forth most, but not all, of the complex rules for determining whether transactions qualify for Code §1202 or §1045 benefits and where the tax rules are ambiguous, this article sets forth reasonable interpretations to fill the void.