

USE OF LLC'S IN PEG TRANSACTIONS

2008 Minnesota Business Law Institute

Sean P. Kearney
Fredrikson & Byron, P.A.
200 South Sixth Street
Minneapolis, MN 55402
(612) 492-7128
skearney@fredlaw.com

AGENDA

- Entity of Choice?
- Equity Flexibility
- Blocker Entities and Umbrella Agreements
- Profits Interests for Management Equity
- Tax-Free Roll-Over
- Tax Distribution Provisions
- LLC Transaction Planning

Entity of Choice?

- Familiarity with LLC Structure and Issues
- Increase in LLC Agreement Complexity
- Tax Guidance on Equity Compensation
- Tax Guidance on Mergers
- Tax Guidance on Warrants and Convertible Debt

Entity of Choice?

- Multiple Transaction Example
 - Nutrition Supplement Company
 - Philadelphia PEG partial acquisition
 - Public company acquires 80%
 - No mention to switch entity type
- Joint PEG Example
 - Software Business with one round of investment
 - Two PEGs Use LLC as Joint Acquisition Vehicle
- MN PEG's Use of LLC's

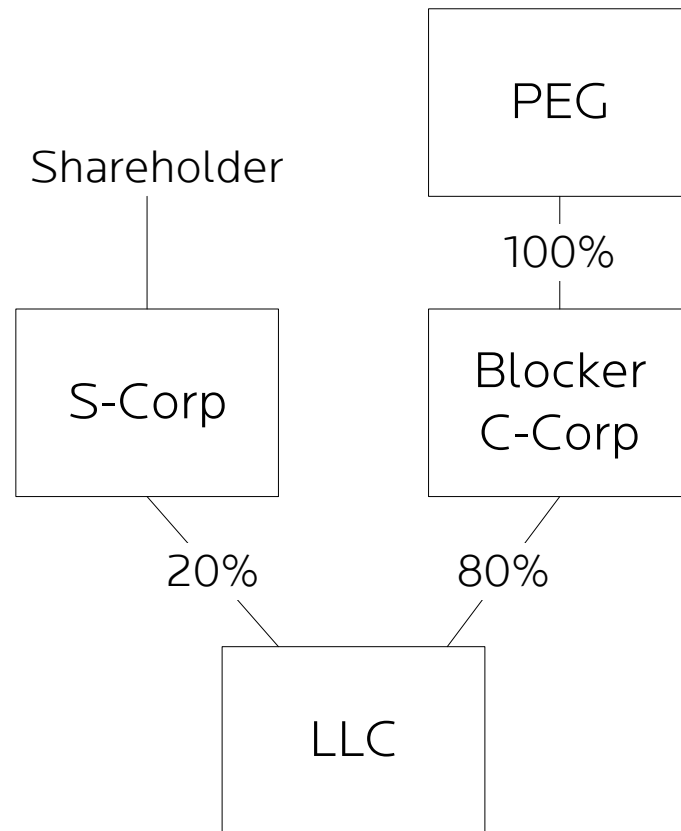
Equity Flexibility

- Priority Return of Capital to PEG
- All of Same Class
- Straight Priority for PEG
 - 10M PEG
 - 10M Roll-Over
 - 50/50 Thereafter
- Alternating Priority with PEG and Roll-Over Equity
 - 5M PEG
 - 5M Roll-Over
 - 5M PEG
 - 5M Roll-Over
 - 50/50 Thereafter
- Priority Returns

Blocker Entities

- PEG LP's may have issues with UBIT
- Originally a significant hurdle
- Increased used of Blocker Entities
- PEG owns C-corp which owns LLC Interest
- PEG's exit goal is to sell C-corp equity interest

Blocker Example



Use of Umbrella Agreements

- Tiering Issues Addressed in LLC Agreement or Separate Umbrella Agreement
- Buy-Sell Provisions
- Tag-Along/Draft-Along Rights
- ROFR
- Change of Control

Use of Umbrella Agreements

- Proceeds Allocation if Sale of Blocker Equity Part of Exit Transaction
- Single Level Tax for PEG
- No step-up for Buyer of the underlying assets
- Purchase of LLC interest from non-blocker owners will result in asset step-up for the Buyer
- Is the Blocker equity less valuable to the Buyer?
- Should the Umbrella Agreement address allocation of sale proceeds?

Profits Interests

- Rev. Proc. 93-27
 - Profit Interest v. Capital Interest
- Rev. Proc. 2001-43
 - Treat service provider as owner
 - No deduction upon grant or vesting
 - 93-27 conditions are met
 - No 83(b) election is required
- Equity without tax hit
- Long Term Capital Gain on Exit – Avoids ISO/NQSO Ordinary Income Surprise

Profits Interests

- Increasing Use of Gross Revenue, EBITDA or Similar Hurdles in Addition to Employment Condition
- Base Performance and Super Performance
- 1x, 2x, 3x, 4x Return of Capital
- 15% Allocation – what are real economics?
- Issues
 - Change of Control Vesting
 - Distribution Cut Off
 - Puts/Calls

Prop. Regs. On Compensatory Interests

- Section 83 will now apply
- Section 83 elections will be back for unvested profits interests
- Rev. Procs. 93-27 and 2001-43 are history
- Need a safe harbor election for liquidation value to apply (and will apply to test both capital and profits interests)
- If don't opt for safe harbor, traditional valuation methods (including expectancy value and applicable discounts) will be used to determine if a profits interest
- Confirmed LLC does not recognize gain/loss on the issuance (eliminates deemed sale and LLC recognition event concern)

Liquidation Value Safe Harbor and Election

- Statement attached to the partnership tax return
- LLC Agreement must contain provisions binding on all members that states the LLC is authorized and directed to elect the safe harbor and that each member agrees to comply with the requirements of the safe harbor
- If Agreement does not contain safe harbor language, a separate document can be executed by all parties but it must be effective ON OR BEFORE the transfer of the interest.
- Will apply to test both capital and profits interests
- Beginning to see LLC Agreements with Safe Harbor Election Authority

Profits Interest Assumptions

| | Book | Tax | FMV | | Book | Tax | FMV |
|--------|------|-----|-------|---|------|-----|-------|
| Assets | 500 | 500 | 1,000 | A | 250 | 250 | 500 |
| | | | | B | 250 | 250 | 500 |
| | | | | | 500 | 500 | 1,000 |

Assumptions

1. Award Employee C a 10% interest for future appreciation for \$0
2. \$0 to C on liquidation
3. \$5 FMV of a 10% interest with applicable discounts
4. Section 83(b) election is made

Profits Interest With Liquidation Value

| | Book | Tax | FMV | | Book | Tax | FMV |
|--------|-------|-----|-------|---|-------|-----|-------|
| Assets | 1,000 | 500 | 1,000 | A | 500 | 250 | 500 |
| | | | | B | 500 | 250 | 500 |
| | | | | C | - | - | - |
| | | | | | 1,000 | 500 | 1,000 |

Employee C recognizes no income

1. Partnership has no deduction
2. Initial Capital Account of C is \$0
3. Book-up A+B to \$1,000
4. Employee prefers liquidation value

Profits Interest With Liquidation Value

| | Book | Tax | FMV | | Book | Tax | FMV |
|--------|-------|-----|-------|---|-------|-----|-------|
| Assets | 1,100 | 600 | 1,100 | A | 545 | 295 | 545 |
| | | | | B | 545 | 295 | 545 |
| | | | | C | 10 | 10 | 10 |
| | | | | | 1,100 | 600 | 1,100 |

Entity Has \$100 of Appreciation

1. Employee shares 10% of \$100 Appreciation
2. Similar to FMV Option But No Exercise Price (e.g. would have paid \$100 to obtain \$110 of value)

Tax-Deferred Roll-Over

- Contribution of Appreciated Property to Corporation – Section 351
- Triggers Gain unless fits within Section 351
- Need Control by Contribution Group – 80% Test
- OK on initial transaction
- Hard to meet 80% threshold on add-ons
- Risk of Non-Qualified Preferred Stock
- Liabilities in excess of basis triggers gain

Tax-Deferred Roll-Over

- Contribution of Appreciated Property to LLC – Section 721
- Triggers Gain unless fits within Section 721
- No control requirement – Big Advantage
- Contribution for 1% interest is acceptable
- Works for initial transaction and add on transactions
- No NQPS Concept
- Liabilities in excess of basis may not trigger gain

Tax Distribution Provisions

- Based on What?
 - Book Income
 - Taxable Income Pro Rata Based on Ownership
 - Taxable Income Pro Rata Based on Taxable Income Allocated
- If PEG Step-Up is via Section 754 election, should this be factored into the tax distribution?

Tax Distribution Provisions

Assumptions:

- PEG purchases 50% for \$1M, B retains 50%
- B has 1,000,000 Book Cap. Account, \$400,000 Tax Cap. Account
- 100% of the retained value relates to 10 year property
- Use traditional method under 704(c)
- Entity earns \$250,000 in year 1 excluding depreciation
- Assume a 40% tax rate

Tax Distribution Provisions

- PEG is allocated \$125,000 of income and \$50,000 of dep. for \$75,000 of book income; \$125,000 of tax income and \$40,000 of dep. for \$85,000 taxable income.
 - PEG needs \$34,000 to cover the tax liability
- B is allocated \$125,000 of income and \$50,000 of dep. for \$75,000 in book income; \$125,000 of tax income and \$0 dep. for \$125,000 taxable income.
 - B needs \$50,000 to cover the tax liability

Tax Distribution Provisions

- Pro Rata Based on Book Income –
 - PEG and B each receive \$30,000;
 - neither PEG nor B received enough to cover their tax liability

Tax Distribution Provisions

- Based on Taxable Income Allocated by Ownership
 - PEG and B each receive \$42,000
 - PEG receives a distribution greater than tax obligation (\$34,000)
 - B receives a distribution less than tax obligation (\$50,000)

Tax Distribution Provisions

- Based on Taxable Income Allocated by Taxable Income Allocation
 - PEG receives \$34,000
 - B receives \$50,000
- Given 50/50 ownership, is this “right”?

Tax Distribution Provisions

- Considerations
 - #1 is rejected by both
 - B would like #3 but not 50/50; is this right flow of funds?
 - Base on taxable income to member requiring greatest distribution but then make distribution pro rata so as to maintain economic relationship?
- Lenders are paying more attention to whether the tax distribution provisions is used to actually pay taxes or is their some leakage (e.g. method alone or 754 issues mentioned later)

Tax Distribution and 754 Step-Up

- PEG Acquires LLC equity in a transaction that requires a 754 election for the PEG to get a step-up in asset basis
- 754 step-up is not an entity level step-up (i.e. does not decrease overall entity taxable income)
- 754 step-up is calculated at PEG level and reduces taxable income allocated to PEG by the LLC
- Noted on the Schedule K-1 but is a separately listed item

Tax Distribution and 754 Step-Up

- Assume PEG is allocated \$1M of taxable income and PEG has a \$1M deduction from the 754 election - \$0 net taxable income
- Should the tax distribution to the PEG be adjusted?
- If yes, better tracks actual out-of-pocket tax payment.
- If no, distribution does not track out-of-pocket tax payment.
- Other equity owner issues
- Lender issues

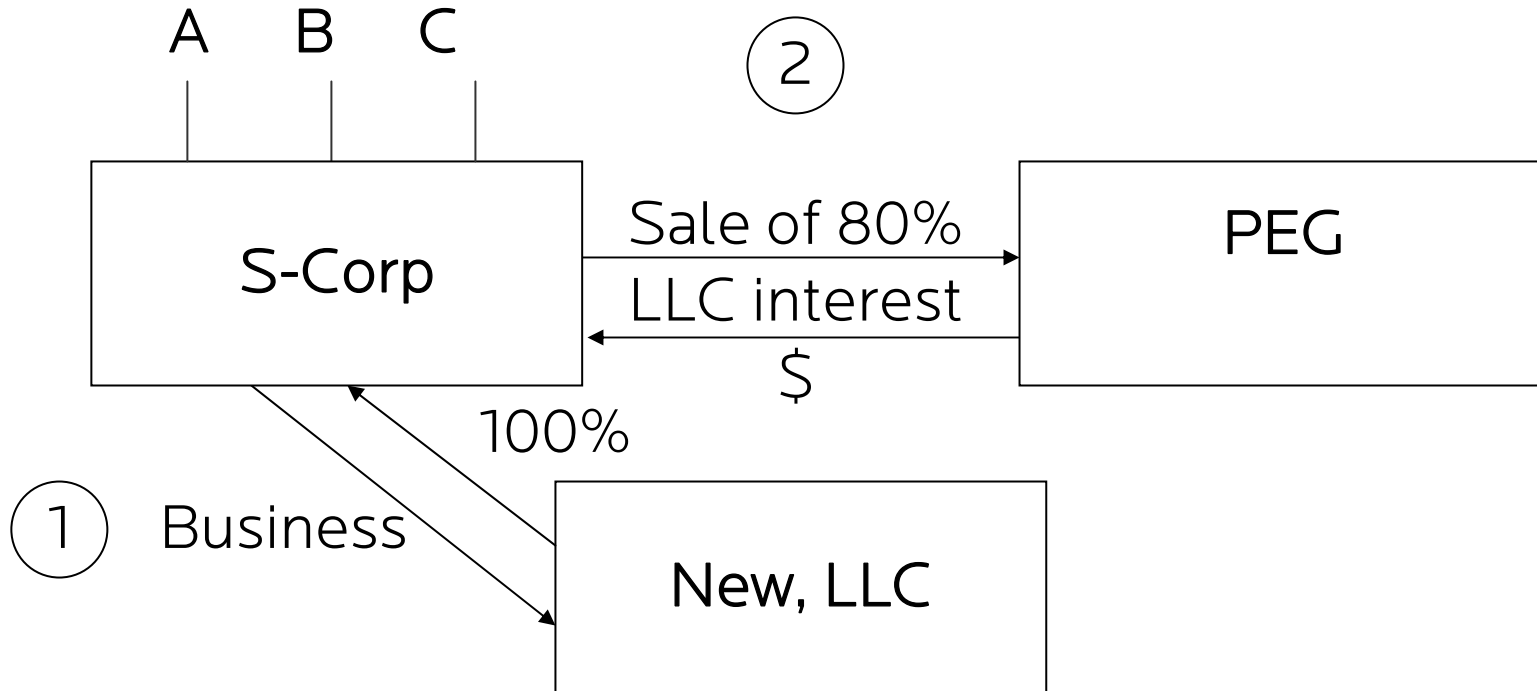
LLC Transaction Planning Issues

- Drop Down LLC Planning
- Rev. Rule 2008-18 for an “easy” drop down
- 704(c) Allocation Method
- Anti-Churning Rules
- Holding Period Issues
- LOI Hot Points

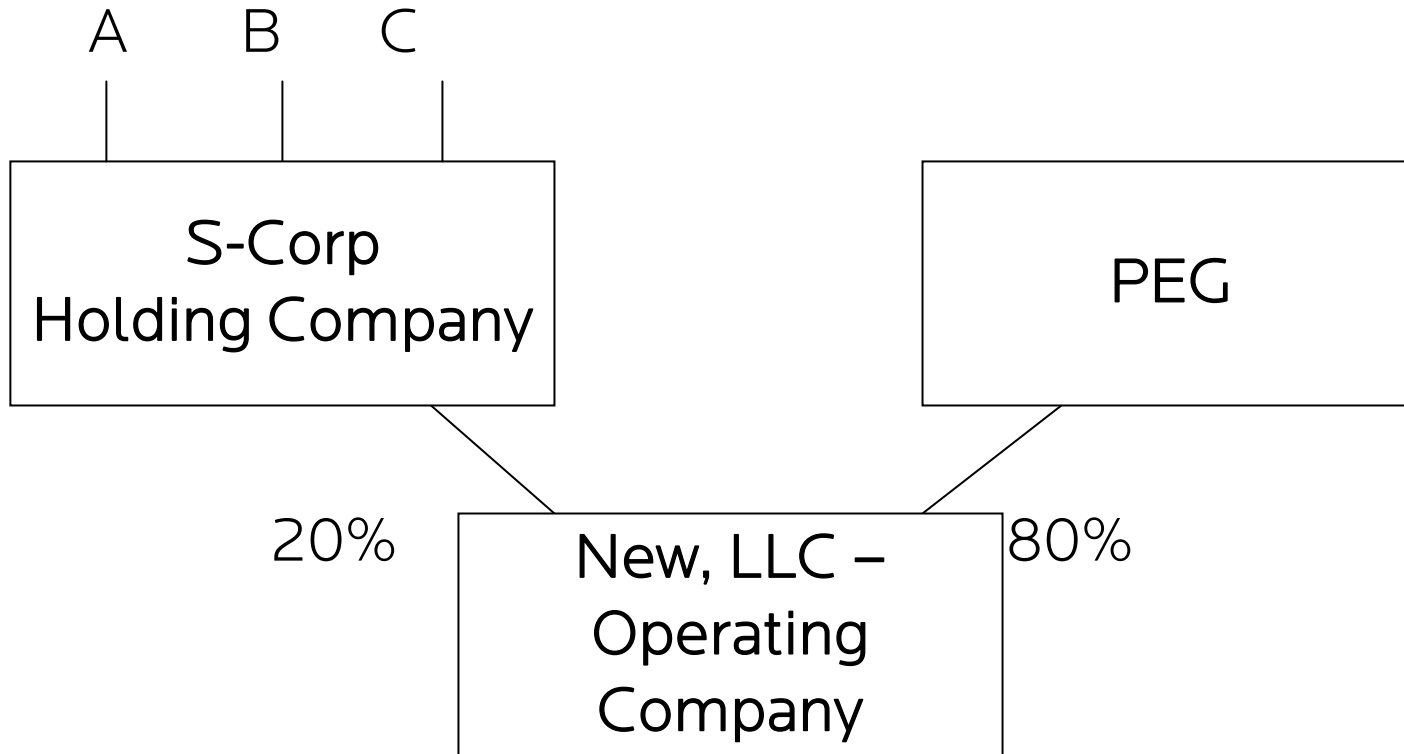
Drop Down LLC Planning

- S corporation sale to a PEG
- PEG requires roll-over of equity
- S corporation shareholders want
 - Tax deferred roll-over
 - Single level of tax on next sale
- PEG wants
 - Step-up in basis
 - Asset deal liability assumption
- Drop Down LLC
 - Tax deferred roll-over
 - Single level of tax on next sale
 - Step-up in basis for PEG
 - Asset deal liability assumption by drop down LLC

Drop Down LLC Planning



Drop Down LLC Planning



- Tax-free rollover of retained equity

Step-Up Issues

- Equity purchase is an asset purchase for tax purposes
- Rev-Rule 99-5
- 754 Election Not Required
- PEG is deemed to buy a pro rata undivided interest in each asset, including goodwill and contribute full basis assets to a new tax partnership
- Seller is deemed to sell undivided interest in each asset and then contribute balance of assets to a new tax partnership
- Need an asset allocation schedule even though an equity deal

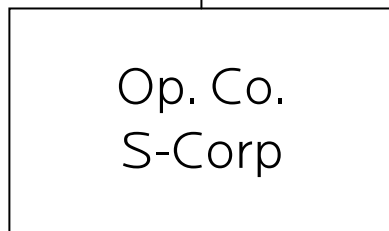
Drop Down LLC Planning and Revenue Rule 2008-18

- Drop Down is usually formed by contributing assets
- May be difficult for certain assets and may require significant third party consents and/or license issues
- Drop down can be accomplished without an actual asset transfer
- Contribute stock to a new holding corporation
- Operating company elects to be taxed as qualified subchapter S subsidiary
- Holding company sets up a wholly-owned LLC
- Operating company is merged into LLC
- F reorganization for initial stock contribution, same S-Corp per Rev. Rule 2008-18
- Watch the liabilities that go with the merger

Drop Down LLC Planning and F Reorganization

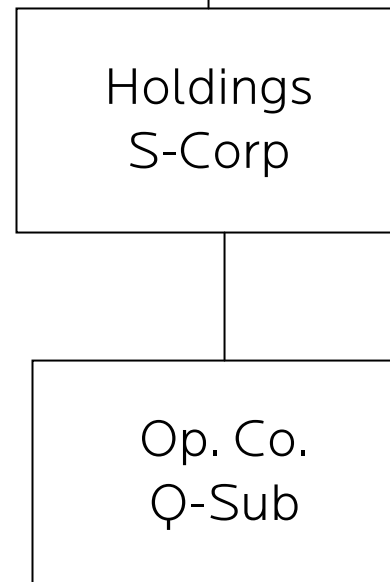
STEP 1

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STEP 2

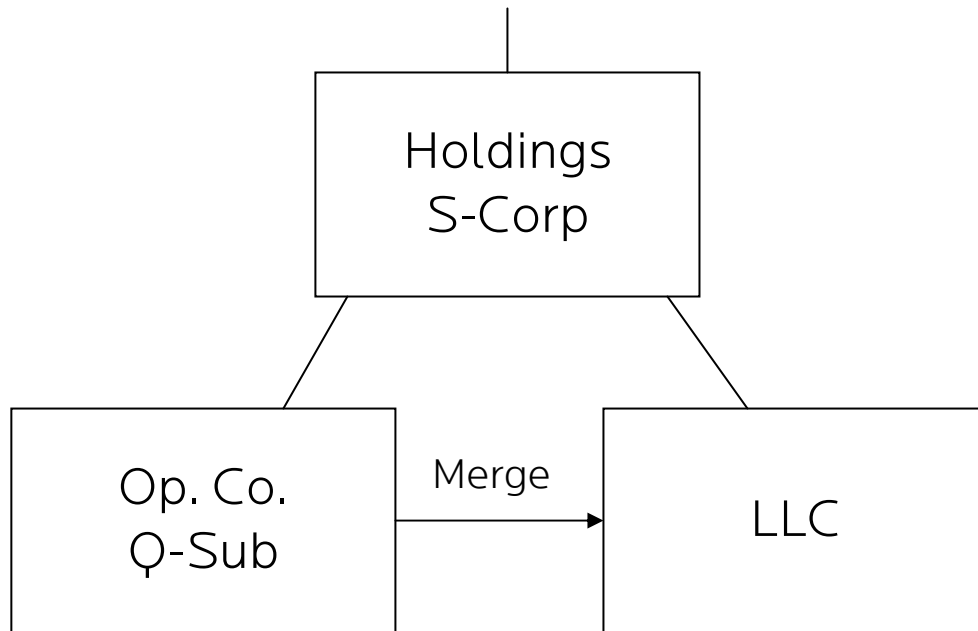
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Drop Down LLC Planning and F Reorganization

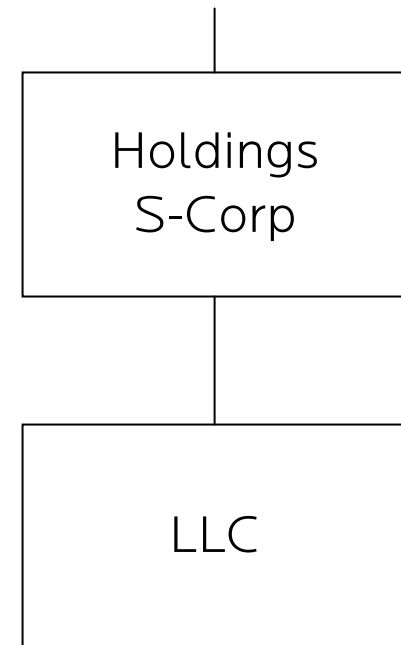
STEP 3

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STEP 4

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704(c) Issues

- PEG wants 100% of amortizable goodwill from purchase price
- 704(c) allows three different methods to address book/tax difference on roll-over assets from S corporation
- Issues on which method to use
- Issues on tax distribution provisions

704(c) Issues

- Assumptions
 - Taxable income before amortization \$8M
 - 30M of amortizable goodwill; all from PEG's new investment
 - 15 year amortization period or \$2M per year deduction
 - Remedial allocation of \$500K per annum
 - Tax rate 40%
 - Income generally allocated pro rata between PEG (75%) & B (25%)

704(c) Issues – Traditional Method

704(c) Using Traditional Method without Curative Allocation

| | <u>PEG</u> | <u>S-Corp</u> | <u>Total</u> |
|---|------------------|------------------|------------------|
| Taxable income before amortization | 6,000,000 | 2,000,000 | 8,000,000 |
| Amortization | (1,500,000) | (500,000) | (2,000,000) |
| Allocable Taxable Income | <u>4,500,000</u> | <u>1,500,000</u> | <u>6,000,000</u> |
| Required Tax Distribution on Taxable Income | 1,800,000 | 600,000 | 2,400,000 |

704(c) Issues – Remedial Method

| | <u>PEG</u> | <u>S-Corp</u> | <u>Total</u> |
|--|------------------|------------------|------------------|
| Taxable income before amortization | 6,000,000 | 2,000,000 | 8,000,000 |
| Amortization | (1,500,000) | (500,000) | (2,000,000) |
| Remedial Allocation | (500,000) | 500,000 | – |
| Allocable Taxable Income | <u>4,000,000</u> | <u>2,000,000</u> | <u>6,000,000</u> |
| Actual Tax Liability to IRS/State | 1,600,000 | 800,000 | 2,400,000 |
| Tax Distribution on Taxable Income (including remedial allocation) | 1,600,000 | 800,000 | 2,400,000 |
| Tax Distributions if Remedial Allocations Not Taken into Account | <u>1,800,000</u> | <u>600,000</u> | <u>2,400,000</u> |
| Over/Under Distribution | 200,000 | (200,000) | |

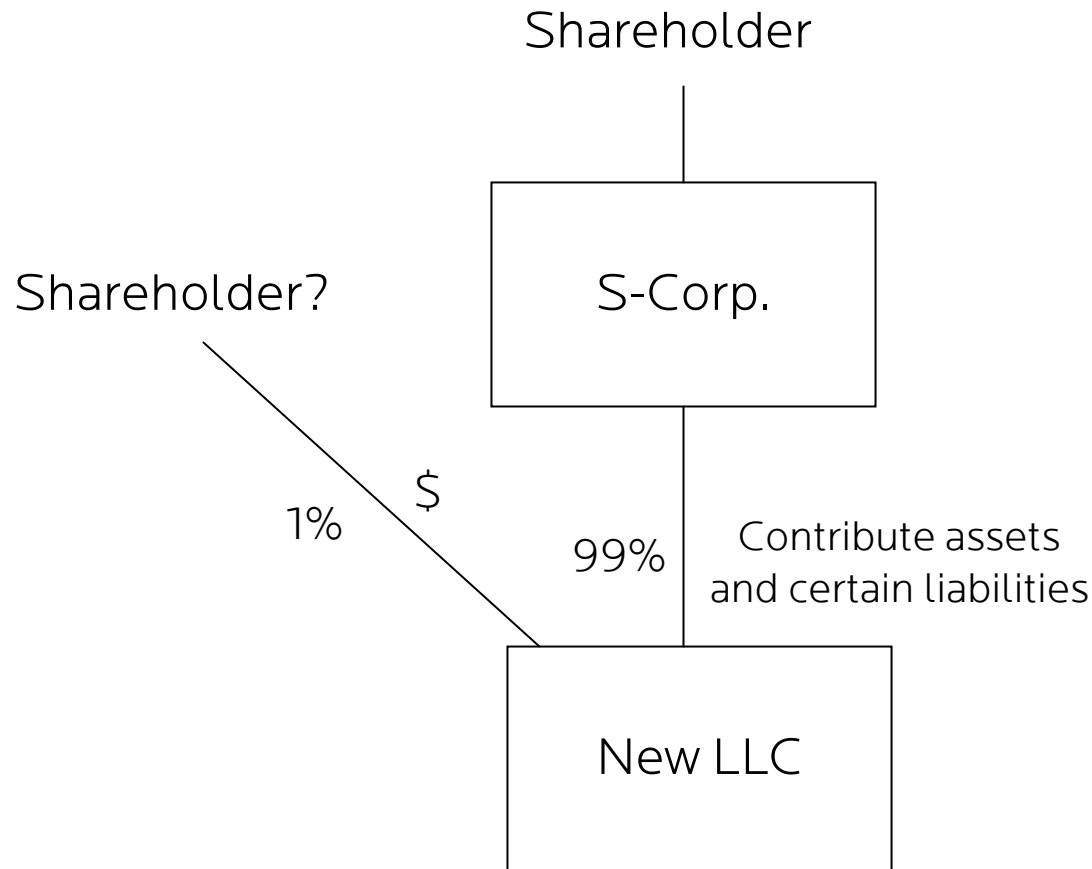
Anti-Churning Rule Planning

- Anti-Churning Rules May Apply to Goodwill if pre-August 10, 1993 tracing
- Get Basis In Goodwill But Not Amortizable
- Not an Issue if 20% or less retained ownership
- Think about at LOI stage – roll-over equity and profits interests
- Representations directly or indirectly towards application of anti-churning rules

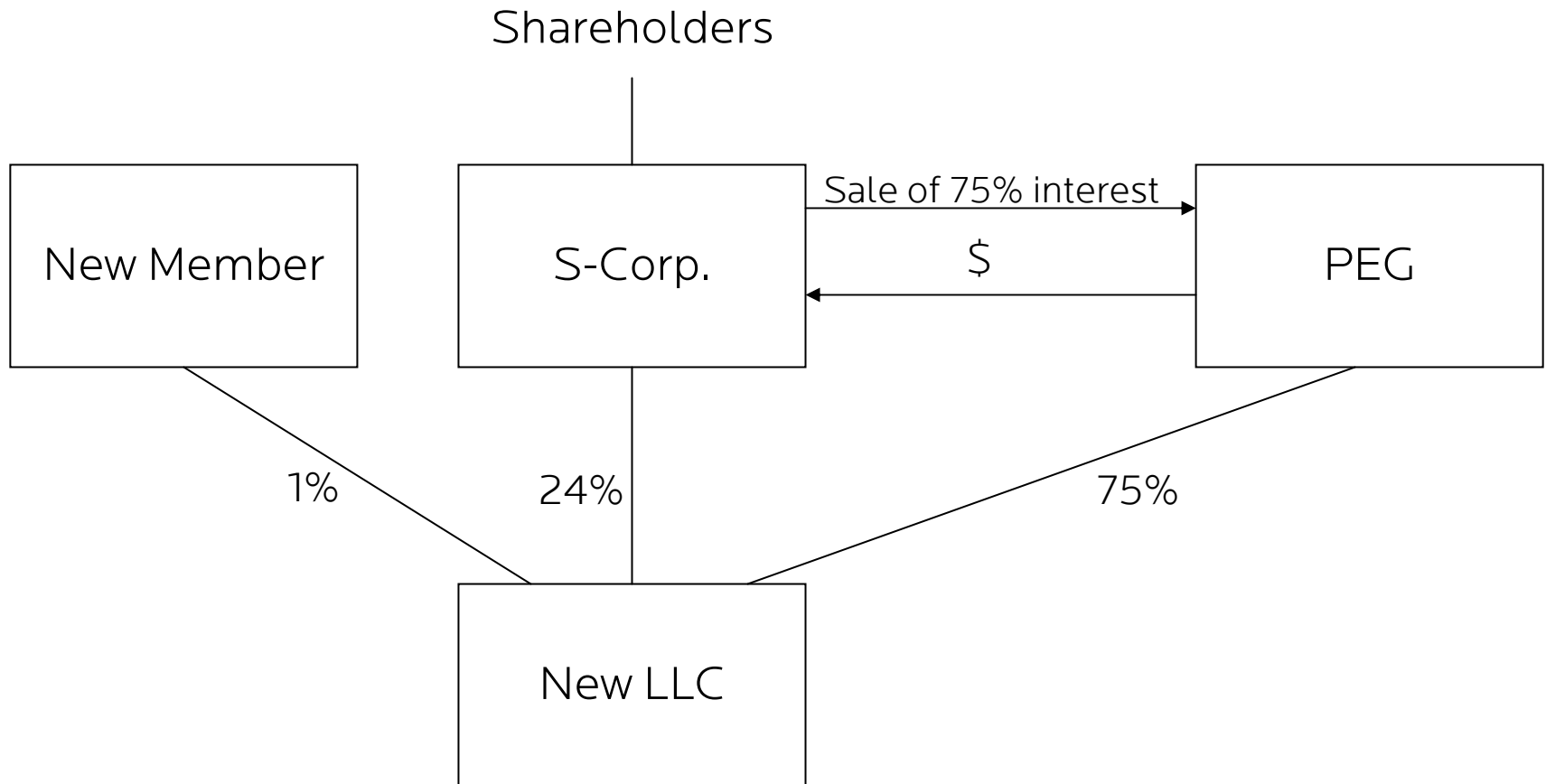
Anti-Churning Rule Planning

- If deal requires more than 20% retained equity, Rev. Rul. 99-5 step-up won't work
- Need to purchase a regarded partnership interest so the step-up comes from a 754 election
- Two member drop down before sale
- Regulation has one year old example
- Separation of time between creation of regarded LLC and the acquisition
- Watch out for impact of holding period rules!

Drop Down LLC with 99% owned LLC – Step 1



Drop Down LLC 99% Owned LLC – Step 2



Watch Out For Holding Period Rules

- Holding Period Rules
 - Tacking for capital assets
 - No tacking for other assets
- Split Holding Period Based on Contributed Assets Can Created Unintended Short Term Capital Gain
- Assumptions
 - Sole assets are \$20M of goodwill and \$10M of cash
 - Sell a 75% partnership interest for 22.5M
 - Sale of a regarded partnership interest
 - Gain is \$15M
 - What is the character of the gain?

Watch Out For Holding Period Rules

- Not the usual “hot asset” issue
- Gain is from sale or exchange of capital asset
- Partnership Holding Period is Bifurcated
- 20/30 Long Term
- 10/30 “Day After”
- Gain is 2/3rd Long Term; 1/3rd Short Term
- \$5M Short Term Gain Right Result?
- Planning Ideas
 - Don’t contribute the assets that taint the holding period

LOI Hot Points

- Detail PEG equity v. roll-over equity
- 704(c) methods either directly or in disguise
- Tax distribution methodology
- Benefit of 754 shield for PEG
- Structure that works for anti-churning rules