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Tax Structuring: Considerations for PEG-Backed Companies Throughout the Life Cycle

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Tax Landscape

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Income Tax Comparison (Current Law)

	C Corporation	S Corporation	Partnership
Lowest Top Marginal Tax Rates	X		
Section 199A Deduction		X	X
No Tax on Dividends		X	X
Taxable Income Increases Basis in Equity		X	X
Transaction Flexibility			X

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Comparison of Tax Proposals

	Current	President Trump*	Joe Biden*
Corporate Tax Rate	21%	Statements that he favors decrease to 20% but no formal proposal	Increase to 28% 15% minimum tax on book income of companies with U.S. net income of >$100M but no U.S. income tax
Depreciation	100% immediate expensing through 2022, then phased down each year through 2026 to 20%	Statements indicate consideration to extend or expand bonus depreciation but no formal proposal	No specific proposal – may be affected by minimum tax noted above

*Based on information available through the date of this presentation. Subject to change.

	Current	President Trump*	Joe Biden*
Individuals – Ordinary Income Tax Rate	Top rate of 37% through 2025	FY 2019 through 2021 budget blueprints assume permanent extension of law but no formal proposal	Restore top rate to 39.6%
Individuals – Capital Gains/Dividends	20% rate on LTCG and qualified dividends Additional 3.8% NIIT for individuals with income >$200K and joint filers with income >$250K	Has expressed interest in capital gains relief but no formal proposal	Tax LTCG and dividends at ordinary income rates for those with taxable income >$1M

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		Current		President Trump*		Joe Biden*
Carried Interests		Treated as LTCG if held more than 3 years		Has indicated that he wants to end favorable treatment but no formal proposal		Tax at ordinary rates
Pass-through Income		Generally, taxed at owner's individual rate with a 20% deduction under IRC §199A for domestic business profits through 2025		Unclear if he intends to make permanent		Phase out IRC §199A deduction for filers with taxable income >$400K

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Structuring Considerations

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Tax Structuring

Issues of Consideration:

a. Type of acquisition - i.e., asset or stock deal
b. Choice of entity to acquire Target – i.e., corporation, S corporation, LLC, partnership
c. Will transaction be taxable or tax-free to Sellers
d. Is it possible and what benefit is there in a step-up in the tax basis of the Target's assets – i.e., asset purchase or IRC §338 election vs. stock purchase
e. Placement of Target within Buyer's current structure – i.e., merge with existing entities, leave as a new subsidiary, bifurcate US and foreign entities
f. Future cash tax analysis
g. Issues associated with Seller's roll-over – i.e., retained on-going ownership
h. Financing issues – use of on-hand cash, related party or third party debt; future interest deductions (e.g., IRC §163(j))
i. Exit strategies – consider future disposition of Target tax efficiently

Form of Acquisition/Transaction

- Asset Acquisitions
  - Taxable Asset Acquisition
  - Forward Cash Merger
- Stock Acquisitions
  - Taxable Stock Acquisitions
  - Reverse Subsidiary Cash Merger
  - Section 338 and 336(e) elections – Treating stock acquisition as an asset acquisition
- Merger
  - Statutory Merger
  - Forward Triangular Merger
  - Reverse Triangular Merger
- Joint Venture

Taxes Imposed On The Transaction

The structure of the transaction is important

- Stock vs. asset
- Sales and use tax generally imposed on tangible personal property
- Business vs nonbusiness income
- Real estate transfer taxes on real property sales or controlling interest transfer sale
- International
  - ➢ Impacts global structure and worldwide effective tax rate
  - ➢ Local country income tax and indirect tax implications, including stamp tax on change in ownership

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Taxable Asset Acquisition

- Seller (Target)
  - ➢ Gain/Loss from asset sale
    - Purchase Price (consideration + liabilities) less transaction costs and basis
    - Ordinary vs. Capital
    - Installment Sale & Contingent Consideration
  - ➢ Target Corp may liquidate (CG to T s/hs, 2 levels of tax)
  - ➢ Target (if P\S or S corp, the T s/hs 1 level of tax)
- Buyer
  - ➢ Assets stepped up to FMV
  - ➢ Does not acquire target attributes
  - ➢ Does not acquire target accounting methods
  - ➢ May involve costly fees for transfer of assets (new titles, etc.)

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Taxable Asset Acquisition - Basis

- Basis measured by purchase price, liabilities assumed, and transaction costs
  - Contingent Consideration
  - Liabilities Assumed (need to analyze)
- Purchase Price Allocation: tension between buyer and seller
  - Seller character issues: ordinary income v. capital gain
  - Buyer wants assets that are recovered sooner, e.g. inventory
- Reported on Form 8594
  - What does the agreement say?

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Taxable Asset Acquisition - Basis Allocation Classes

Class I – Cash, demand deposits

Class II – Marketable securities, CDs

Class III – Accounts receivable

Class IV – Inventory

Class V – Identifiable assets not in some other class (e.g., equipment and real estate)

Class VI – §197 intangibles other than goodwill, going concern value

Class VII – Goodwill, going concern value

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Taxable Stock Acquisition

- Seller – Capital Gain to Target Shareholder
  - Negotiations with Target Shareholder
  - Exception: Non-compete agreements
- Buyer – Cost basis in target stock
  - Target asset basis unchanged
  - Target tax attributes remain intact
  - Target accounting methods remain intact
  - Advanced (Rev. Proc. 2004-34)
  - Liabilities of target are acquired
  - Non-Compete allocation is amortizable as IRC §197 asset
  - IRC §338

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Taxable Stock Acquisition - When Does §338(h)(10) or §336(e) Make Sense?

- When gain on sale of stock is similar compared to deemed sale of assets, i.e. target inside basis equals outside basis
- When buyer is willing to pay a premium to step-up basis, i.e. buyer has appetite for deductions
- When target has NOL's that can be used to offset gain on deemed asset sale
- When C corp target is wholly owned
- When S corp target shareholders sell 100%
- No significant BIG tax under IRC §1374

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What Are The Proceeds (Cash, Stock, Property, Mix)?

- Tax-free intent?
- Rollover of equity
- Notes
  - Seller notes
  - IRC §453B(h) trap on distribution of installment obligations to S corp shareholders on liquidation
- Earnouts
  - Consideration of installment sale rules and basis deferral
- Escrow
- Purchase price adjustment mechanics: working capital, debt, etc.

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Vinson&Elkins
Established 1917

EXIT CONSIDERATIONS FOR FLOW-THROUGH PORTFOLIO COMPANIES

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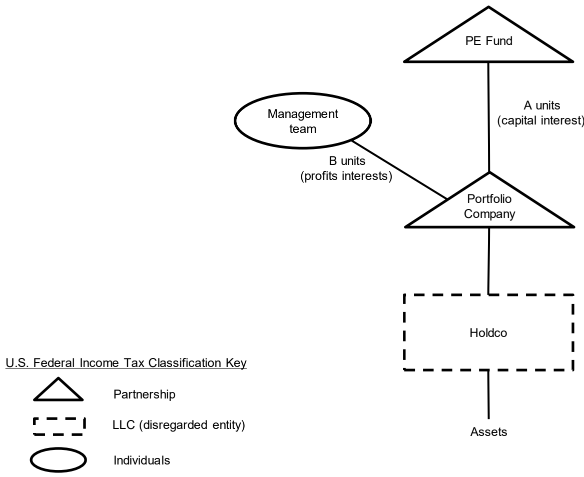
Common Flow-through Portfolio Company Structure (simplified)



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Structuring Alternatives

- Three primary alternatives:
  - Equity holders (PE Fund and management team) sell/transfer their equity interests in the portfolio company
  - Portfolio Company sells its equity interests in Holdco
  - Holdco sells the business assets

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Structuring Alternatives - Continued

- Alternative 1: Equity holders sell/transfer their equity interests in the Portfolio Company
  - Generally treated as a sale/transfer of partnership interests from sellers' perspective for federal income tax purposes
    - Generally treated as resulting in capital gain/loss, except to the extent attributable to recapture and certain other items that are treated as ordinary income items under Section 751 of the Code
    - Fund GP likely subject to the "carried interest rules" on its allocable share of the income attributable to its carried interest in the PE Fund
    - Management may be able to "rollover" some of their interests in a tax-deferred manner
  - Treated as an asset purchase by the buyer for federal income tax purposes (except to the extent of any tax deferred management rollover)
  - Normally not subject to transfer/sales taxes in most jurisdictions (but there are exceptions)

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Structuring Alternatives - Continued

- Alternative 2: Portfolio Company sells its equity interests in Holdco
  - Generally treated as sale by the Portfolio Company of the assets held by Holdco to the buyer for federal income tax purposes
    - Net gain on depreciable assets and real property used in a trade or business and held for more than 1 year ("1231 Properties") generally qualifies for long-term capital gains tax rates (except to the extent of depreciation recapture), and net loss on such properties generally qualifies for ordinary loss treatment
    - Gain on 1231 Properties is not subject to the carried interest rules
    - Normal tax rules apply to capital assets (e.g., goodwill)
  - More difficult for Management to engage in a tax-deferred rollover
  - Normally not subject to transfer/sales taxes in most jurisdictions (but there are exceptions)

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Structuring Alternatives - Continued

- Alternative 3: Holdco sells the assets
  - Generally same federal income tax consequences as described in Alternative 2, above
  - Difficult for Management to engage in a tax-deferred rollover
  - Tangible personal property (and in some jurisdictions, real property) generally subject to transfer/sales taxes unless an occasional sale or other exemption is available
  - Potentially less favorable state income tax consequences due to sourcing/apportionment rules

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Where Do Things Go Wrong?

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Issues Can Crop Up Anywhere

a. Unplanned tax costs of the transaction
   - Deferred Revenue
   - IRC §197(f)(9) anti-churning rules apply to a business that existed prior to 1994
   - IRC §382 limitations
   - Excess loss accounts
   - Treas. Reg. § 1.1502-36(d) – "unified losses"

b. Unidentified successor liability (e.g., LLC previously taxed as a corporation)

c. Assume issues will go undetected

d. Being unprepared for the tax diligence process

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Issues Can Crop Up Anywhere

e. Many buyers accrue for uncertain tax issues based on the merits of the issues, not based on detection risk by tax administration agencies
f. Selling price can change based on risks and costs that come to light during the deal
g. Buyers tend to conservatively estimate high exposure for uncertain tax positions
h. Failure to adequately review the purchase agreement

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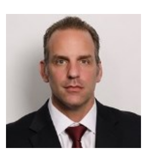

Harry Costin is a Managing Director at Moss Adams' Transaction Services. He has worked at both the Big Four firms and middle market public accounting firms serving large and mid-cap corporate and private equity clients in acquisitions, mergers and dispositions. He has more than 24 years experience in public accounting, serving clients in a broad range of industries, including hospitality, agriculture, manufacturing and distribution, energy, retail and consumer products, telecommunications, media and entertainment, technology, and pharmaceutical / biotech.

Harry typically focuses on acquisitions and divestitures including tax due diligence, tax structuring, analyzing the tax assumptions in a client's transaction model, and reviewing the tax aspects of relevant transaction documents such as sale and purchase agreements. He also advises clients on reorganizations, operational initiatives and other corporate led projects.

Harry received his B.A. and M.P.A from the University of Texas at Austin. He is a member of the American Institute of CPAs and is a licensed CPA in both Texas and Virginia.

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Lori Mettille is a Tax Partner at Moss Adams. She began her career at a Big Four firm and spent two years as director of tax in private industry.

Lori has practiced public accounting since 1999. She specializes in business taxation for corporations and partnerships, primarily in the energy and manufacturing and distribution industries. Lori focuses in areas unique to private equity investments, including maintenance of IRC Section 704(b) capital accounts, targeted capital computations, and IRC Section 704(c) considerations. She has an additional focus in ASC 740 accounting for income taxes.

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Todd advises clients on the tax aspects of complex domestic and cross-border transactions, including mergers and acquisitions, partnership and other joint venture arrangements, capital markets and private financing transactions, spin-offs, and bankruptcy and insolvency restructurings. He has extensive experience in planning and structuring transactions involving natural resources (including joint ventures to exploit wet and dry shale plays), alternative energy, technology, and health care. In addition, Todd has represented numerous private equity funds, master limited partnerships (MLPs), real estate investment trusts (REITs), and other pooled investment vehicles in connection with capital formations, acquisitions, and divestitures.

Select Experience

- Concho Resources in its $1.625 billion acquisition of oil and gas assets from Reliance Energy.
- TPG Capital in its $1.8 billion acquisition of natural gas properties in Wyoming's Jonah field from Encana Corporation.
- Trafigura AG in the sale of a majority stake in its Corpus Christi Terminal and associated Eagle Ford assets in South Texas, and related joint ownership arrangements .
- Apollo Global Management in a $500 million equity commitment to CSV Midstream Solutions, which pursues the construction and operation of midstream facilities in the Western Canadian Sedimentary Basin.
- Mitsui & Co., Ltd. in its agreement with DuPont to purchase DuPont's global Kocide and ManKocide copper fungicide assets.
- CONSOL Energy, Inc. in Marcellus shale and Utica shale joint venture transactions with Noble Energy, Inc. valued at approximately $4 billion.
- SandRidge Energy in $1.12 billion sale of its Gulf of Mexico offshore and Gulf Coast assets to Fieldwood Energy, LLC.
- Austin Ventures in its acquisition of SAM, Inc., a surveying, mapping and engineering company.
- Lime Rock Partners in the $118.5 million line of equity commitment to Battlecat Oil & Gas, an exploration and production company focused on South Texas.