

Creative Uses of Partnerships in Acquisitions, Dispositions, and PE Planning

Eric Sloan
Gibson, Dunn & Crutcher LLP

Harvard Law School
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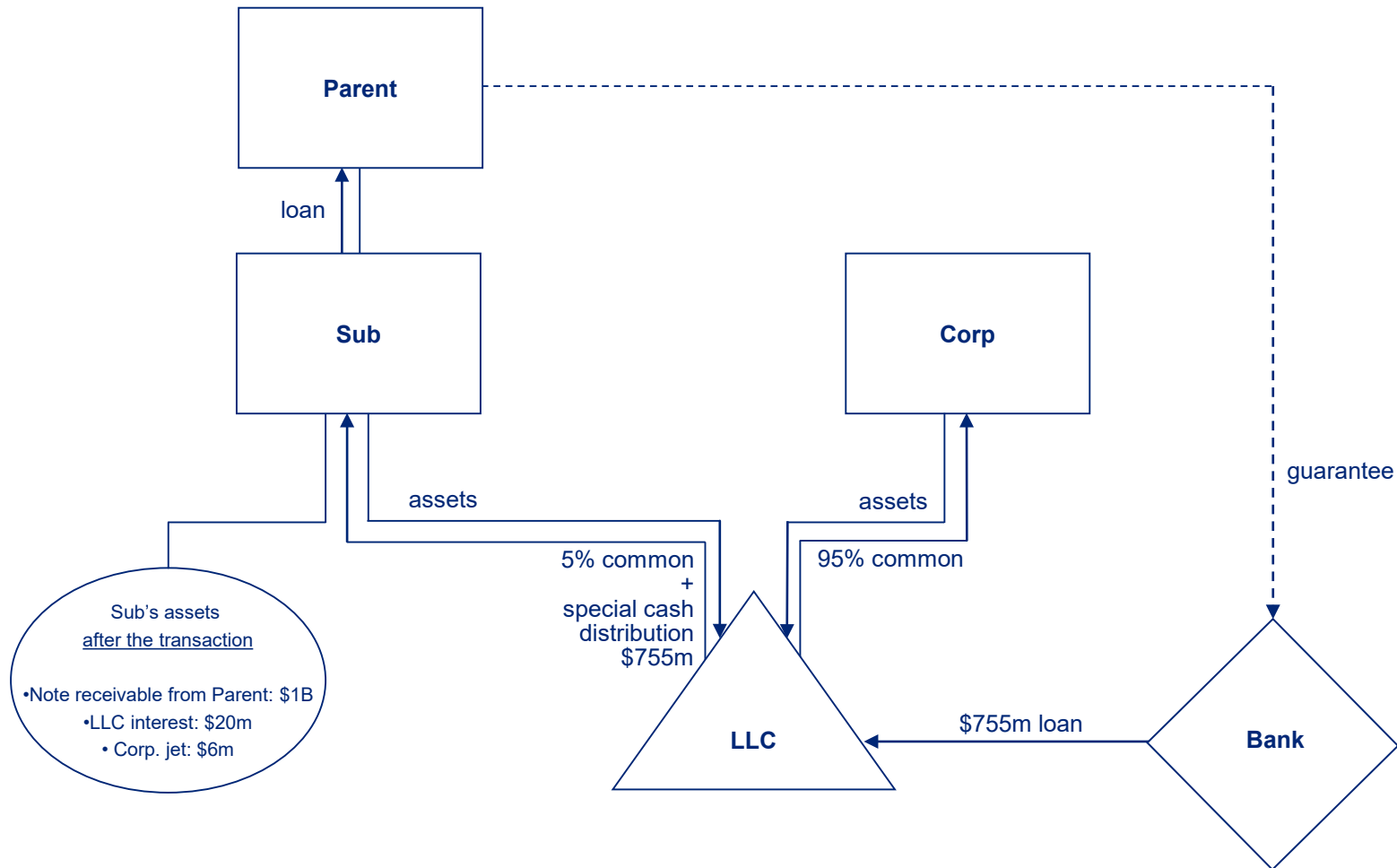
Agenda

1. Acquisition and Disposition: Navigating The Disguised Sale Rules
2. Private Equity
 - A. Topside Planning
 - B. Making an Investment
 - C. Exiting an Investment (Sales and IPOs)

Statutory and Regulatory Outline

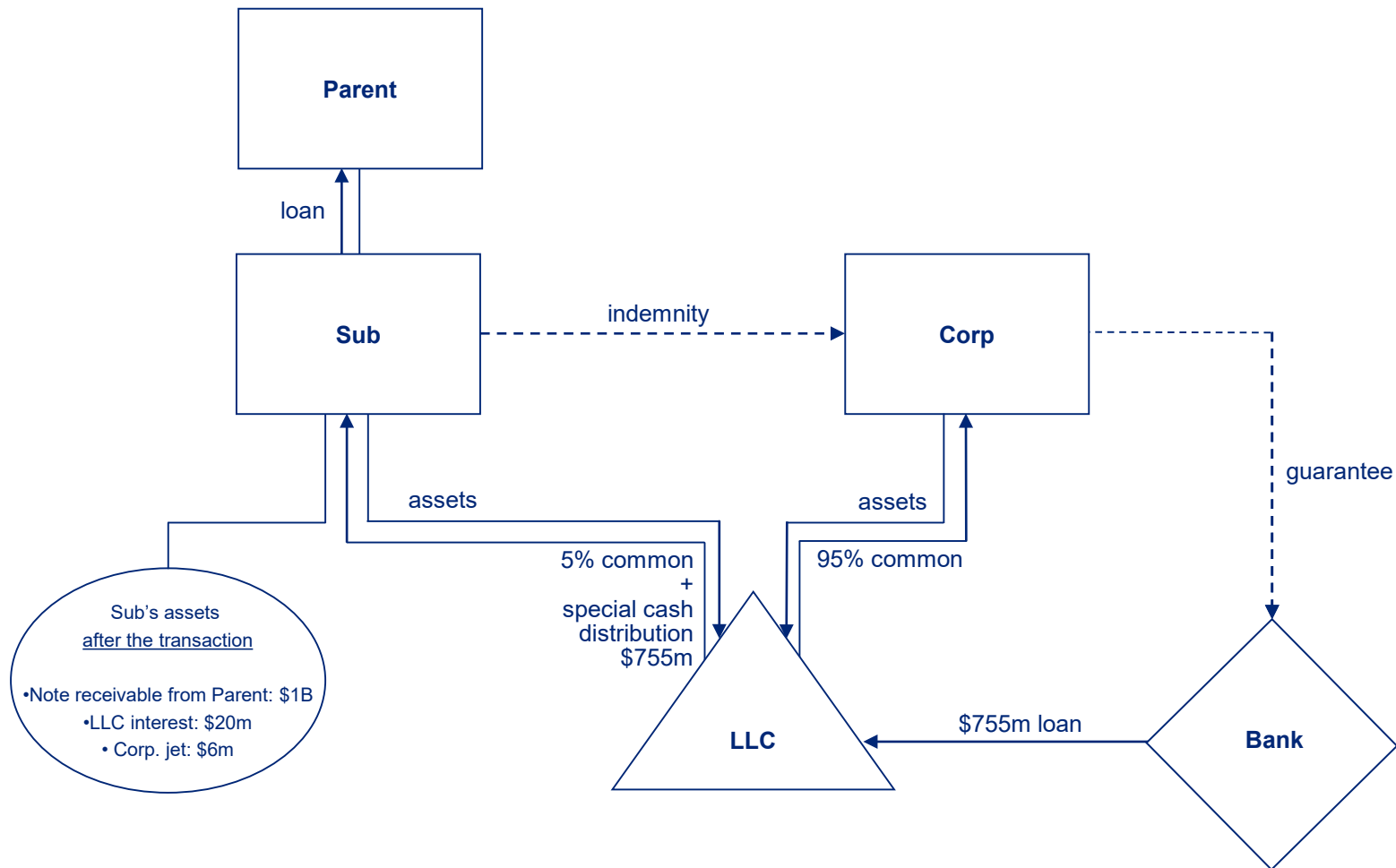
- The Code – § 707(a)(2)(B)
- The Regulations
 - Reg. § 1.707-3 (sales by partners to partnerships)
 - Reg. § 1.707-4 (distribution safe harbors)
 - Reg. § 1.707-5 (impact of liabilities and debt-financed distributions)
 - Reg. § 1.707-6 (sales by partnerships to partners, or Reg. § 1.707-3 in reverse)
 - Reg. § 1.707-7 (oops, strike that)
 - Reg. § 1.707-8 (disclosure rules)
 - Reg. § 1.707-9 (effective dates)

Traditional Leveraged Partnership



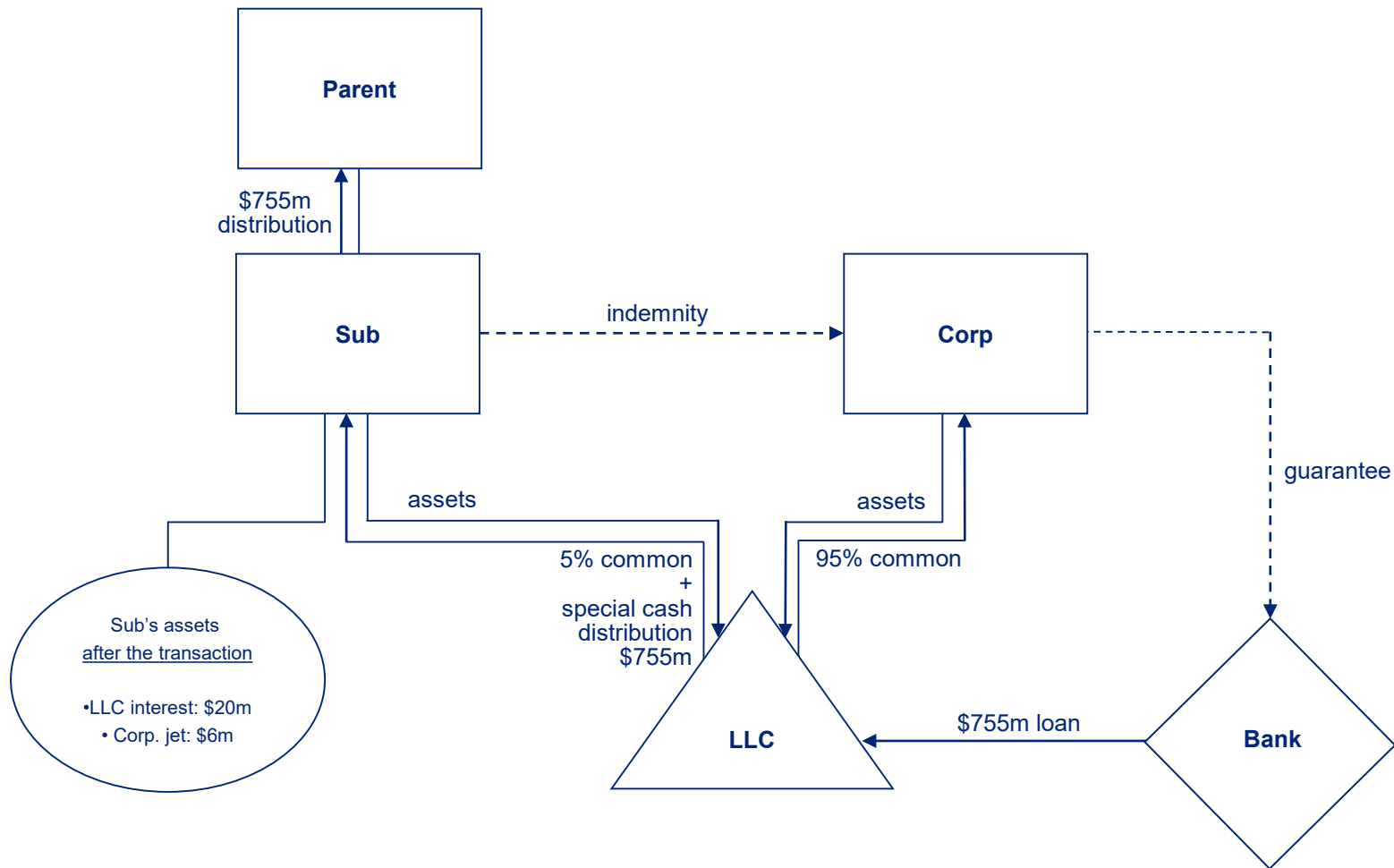
- LLC borrows money from Bank; Parent guarantees the borrowing
- Parent's guaranty is designed to ensure that the liability is allocated to Sub
- LLC distributes loan proceeds to Sub
- Sub should not recognize gain under either the disguised sale or basis rules if respected as structured

Traditional Leveraged Partnership—Indemnity Structure

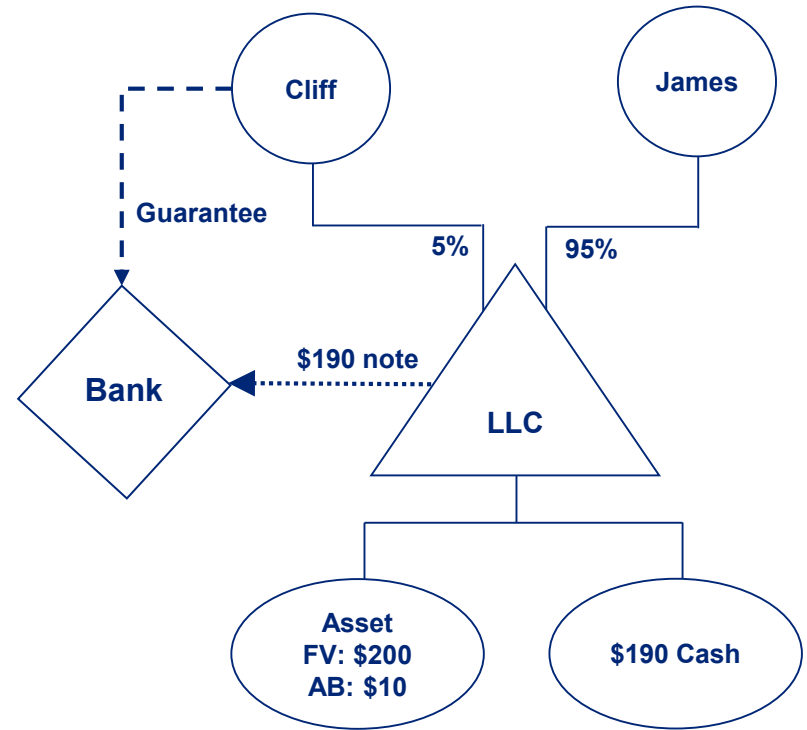
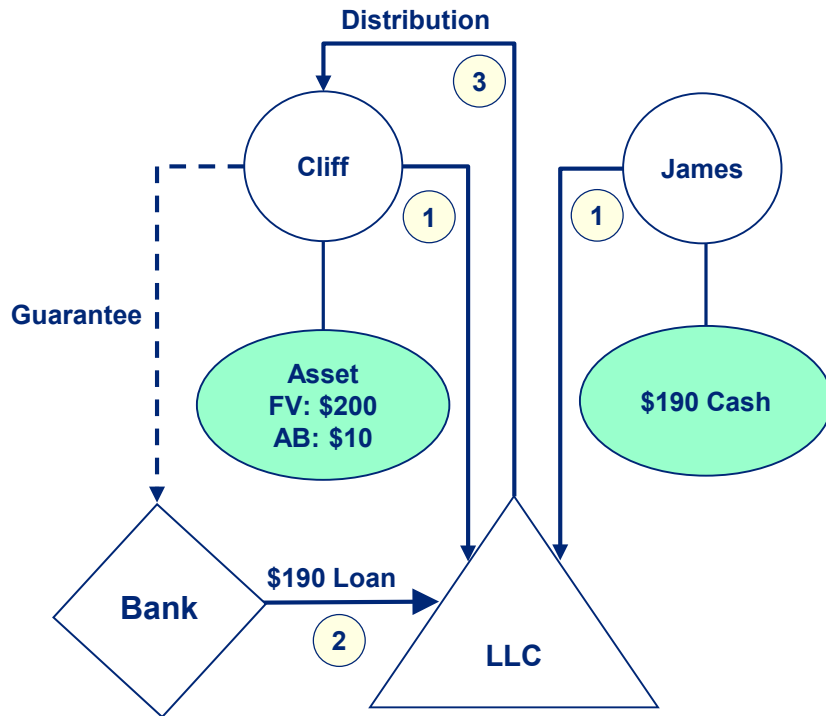


- Bank cannot proceed directly against Sub

Leveraged Partnership (Canal Corp.)



Leveraged Partnership—Back to Basics



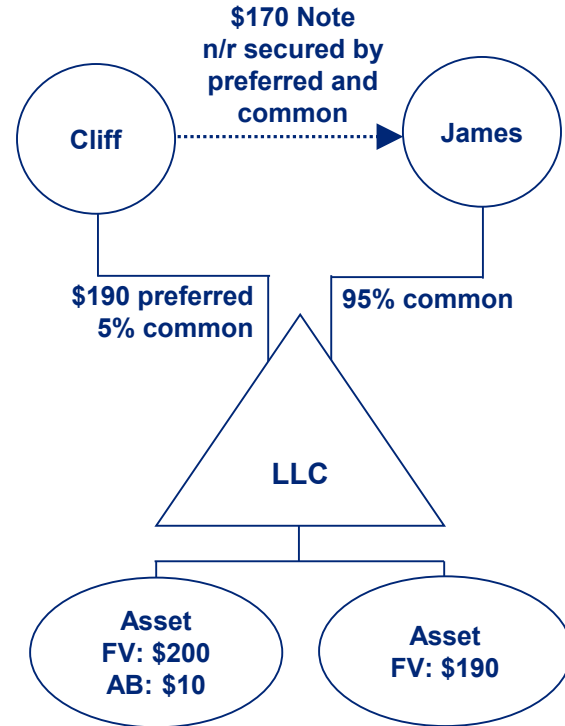
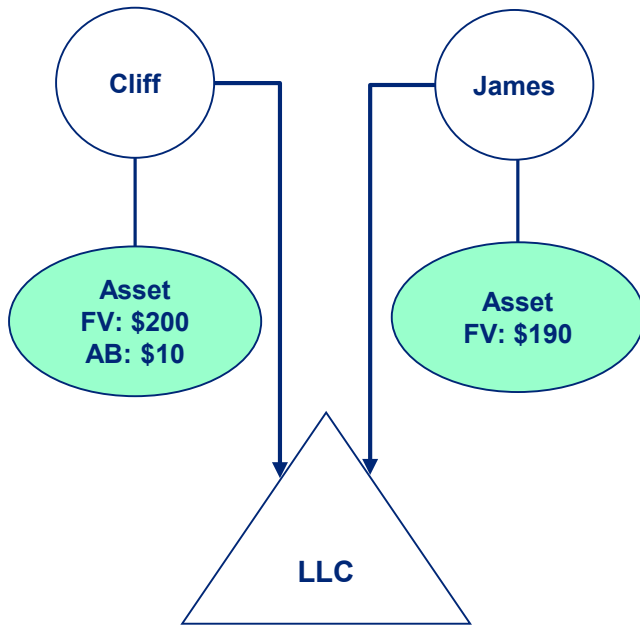
Steps

1. Contribution by Cliff and James.
2. Lending by Bank.
3. Distribution to Cliff.

Note

Works well if James has assets to combine with Cliff's and if Bank financing is available on acceptable terms.

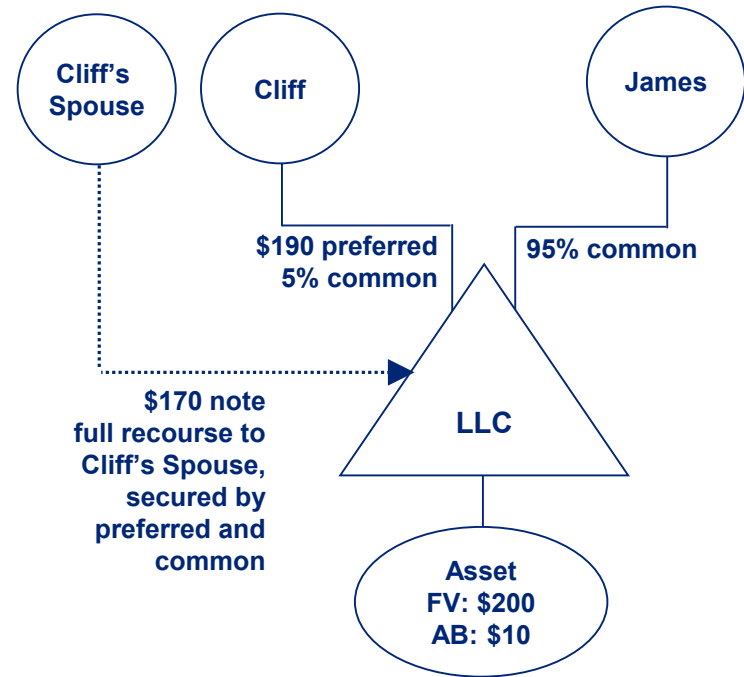
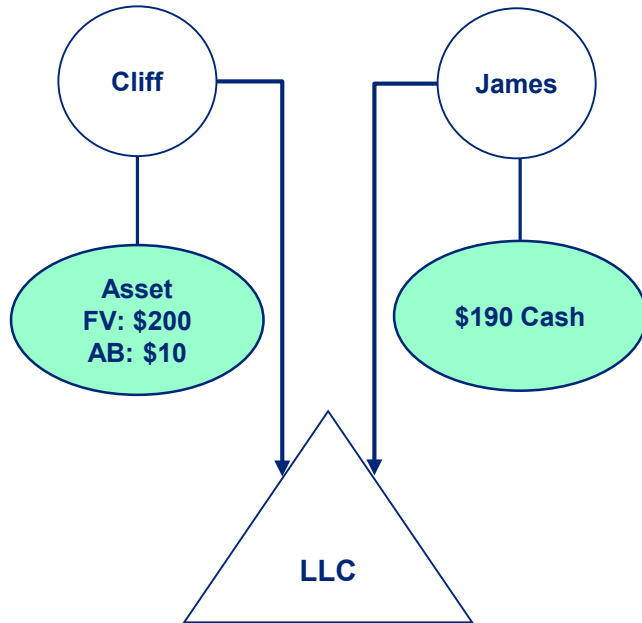
Over-the-Top Loan



Considerations

1. Will the form be respected?
2. Alternative: A bank lends part (with James lending the rest to Cliff).
 - Can LLC Guarantee repayment? *Cf. G-I Holdings Inc.*

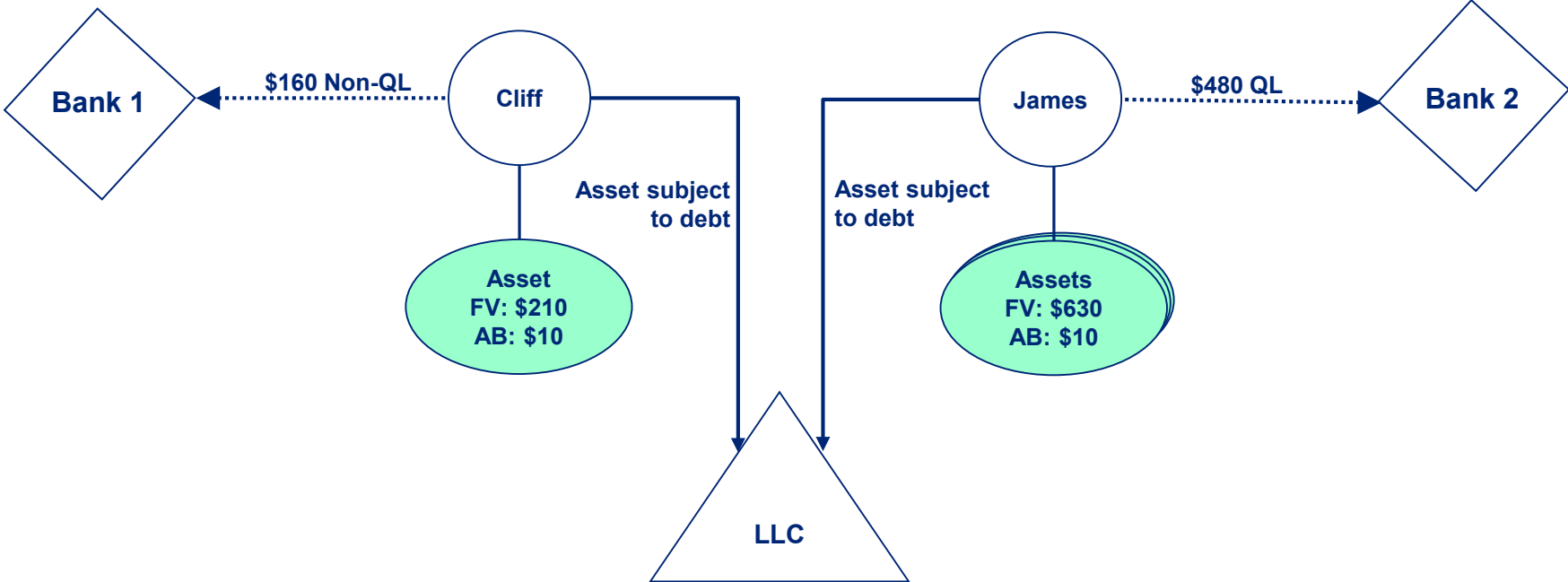
Loan Up



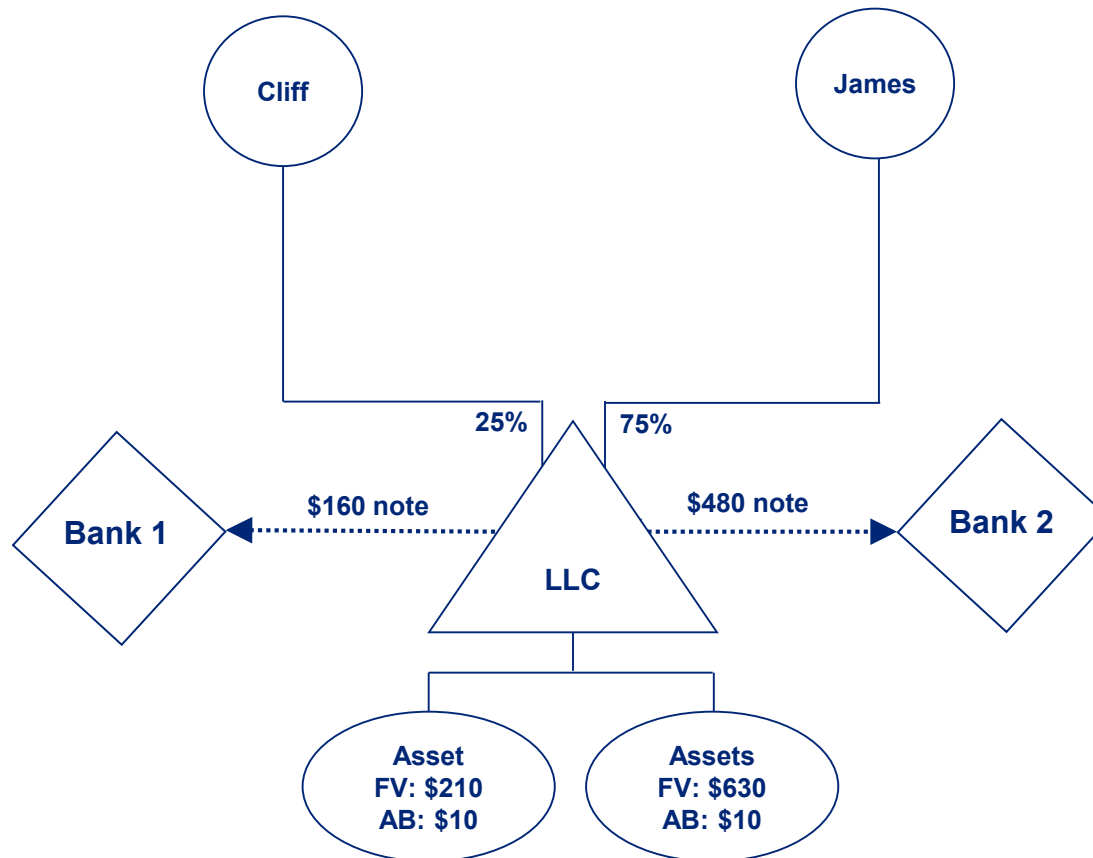
Considerations

1. Why would you do this? Because James has only cash to contribute.
2. Cliff's Spouse must have the wherewithal to repay the loan.
3. What if loan were made to Cliff directly?
4. Could increase amount of note to \$190.

Liability Netting Rule (Part 1/2)



Liability Netting Rule (Part 2/2)



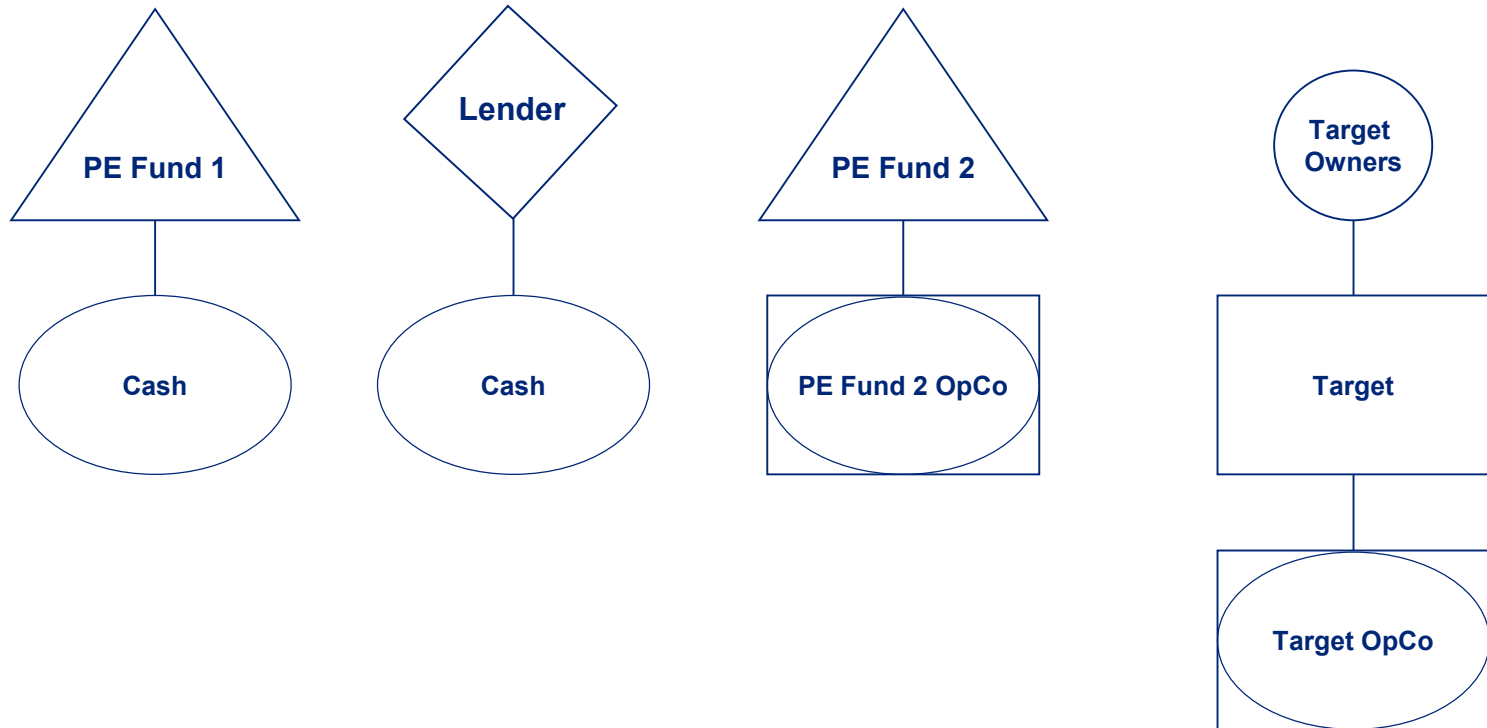
Note

The reduction of Cliff's share of his \$160 note (i.e., 75 percent of \$160 = \$120) is offset by the 25 percent of James's \$480 note that Cliff will get (25 percent of \$480 = \$120). See Reg. § 1.707-5(a)(4).

Qualification of LBO Debt

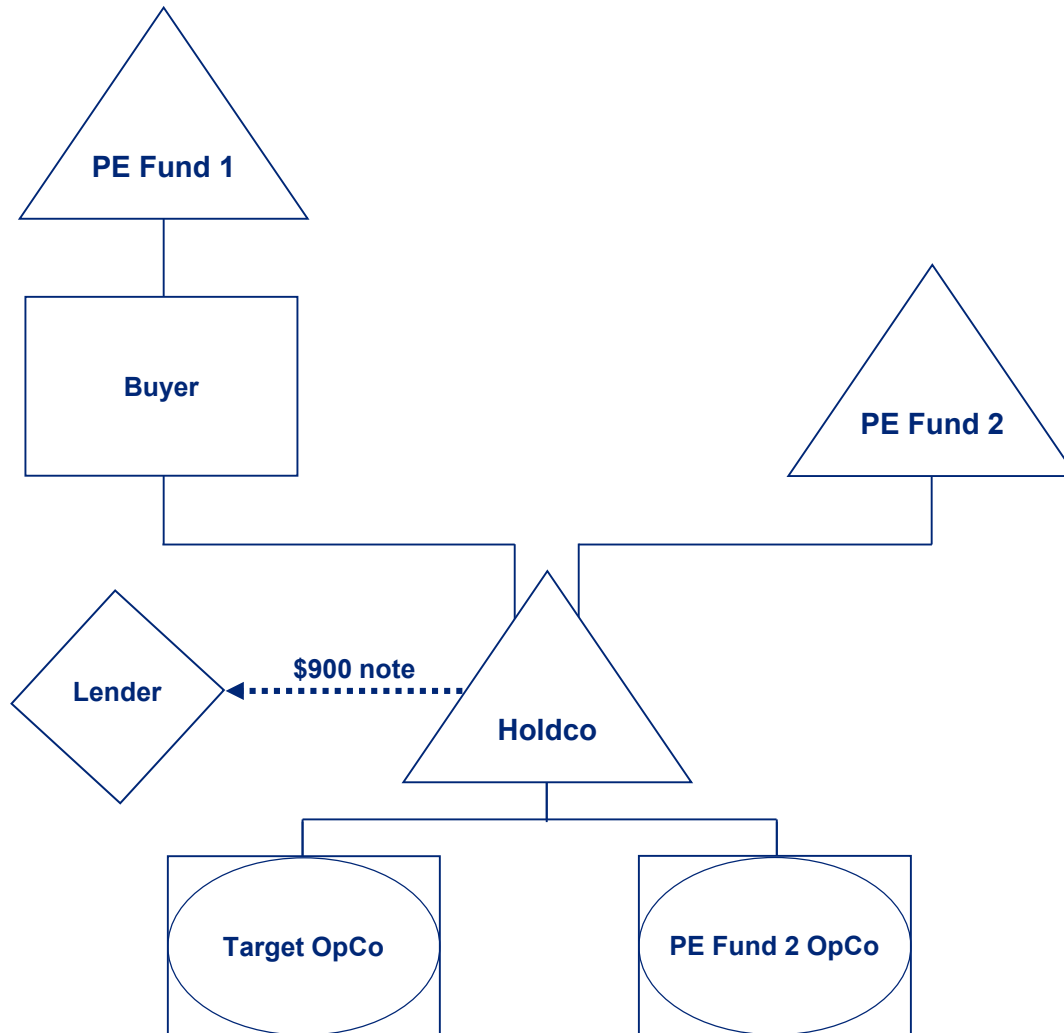
Reg. § 1.707-5(a)(6)(i)(C) and the Magic of Tracing

Structure Before Acquisition of Target



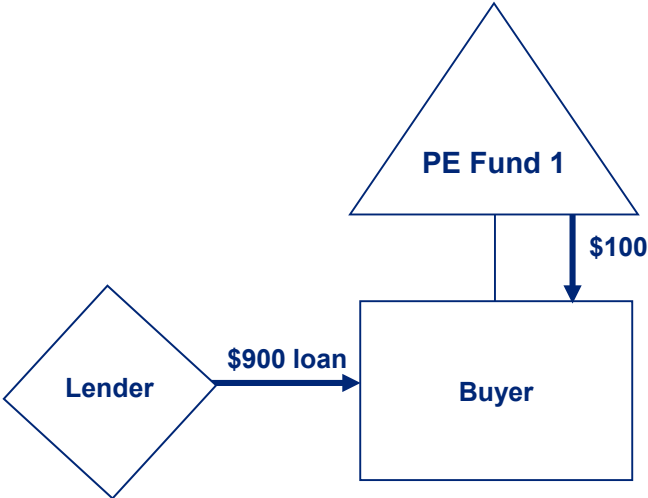
1. PE Fund 1 has cash.
2. Bank has cash.
3. PE Fund 2 owns a business.
4. Target has a business.

End Structure — Preview

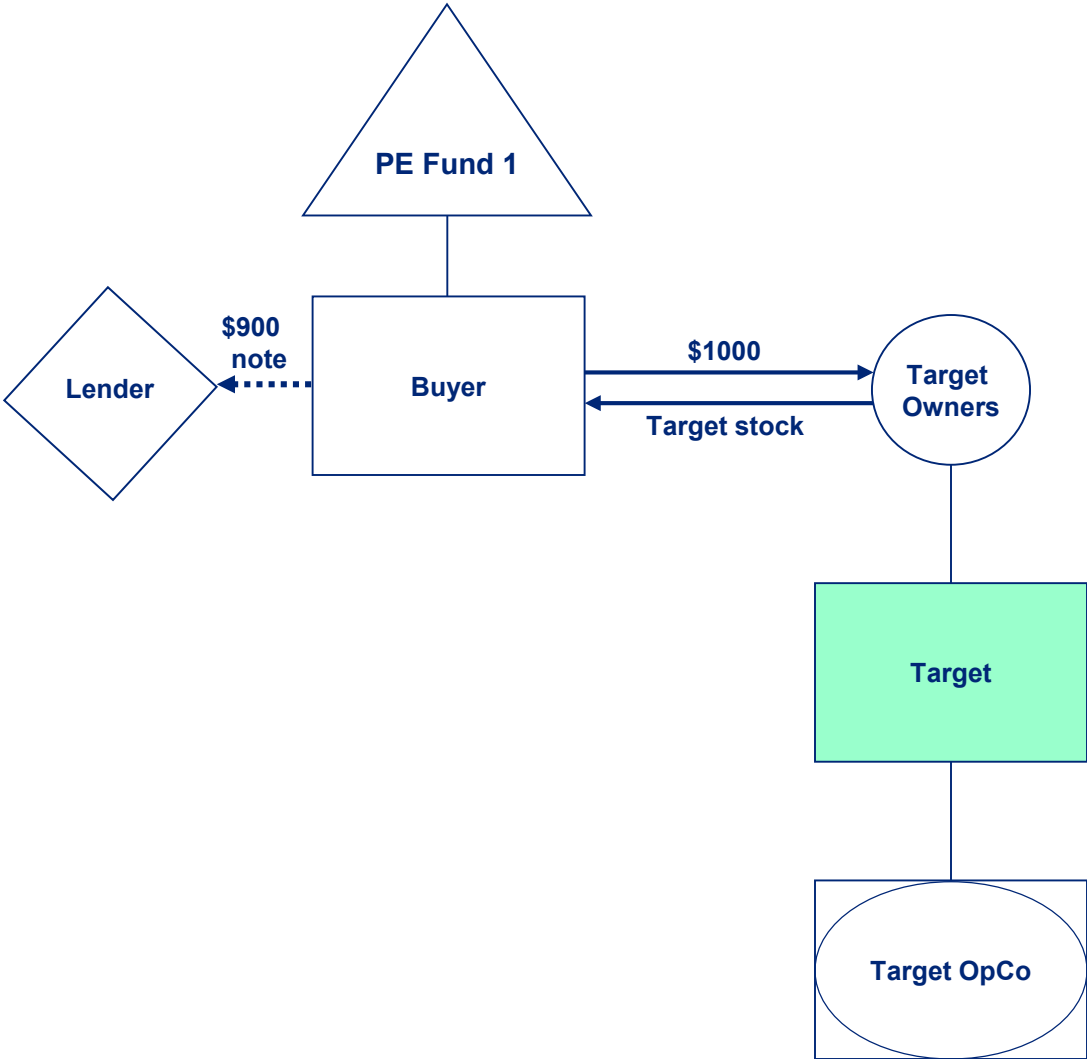


- How did we do this without triggering gain under the disguised sale rules?

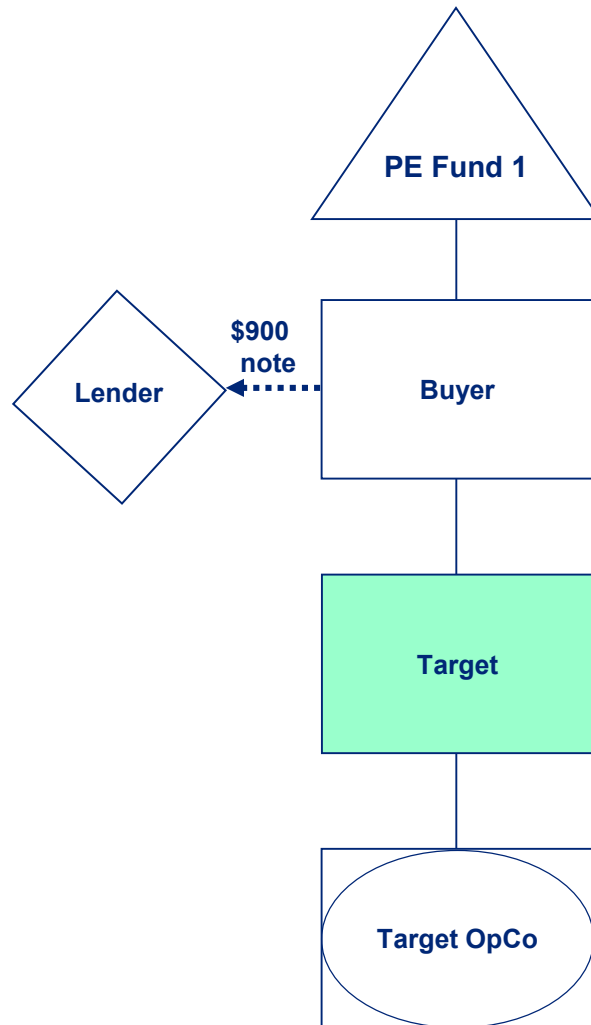
Formation and Capitalization of Buyer



Buyer Purchases Target Stock

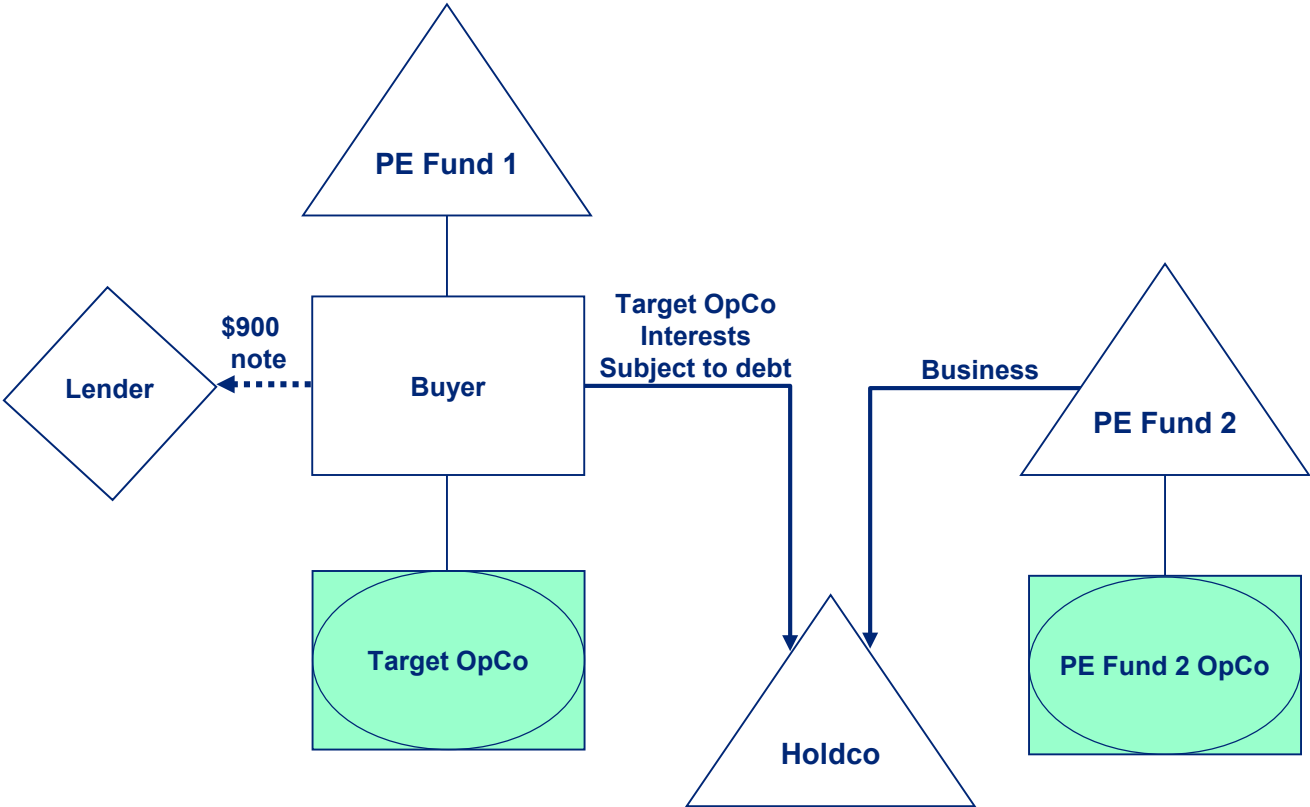


Target Liquidates

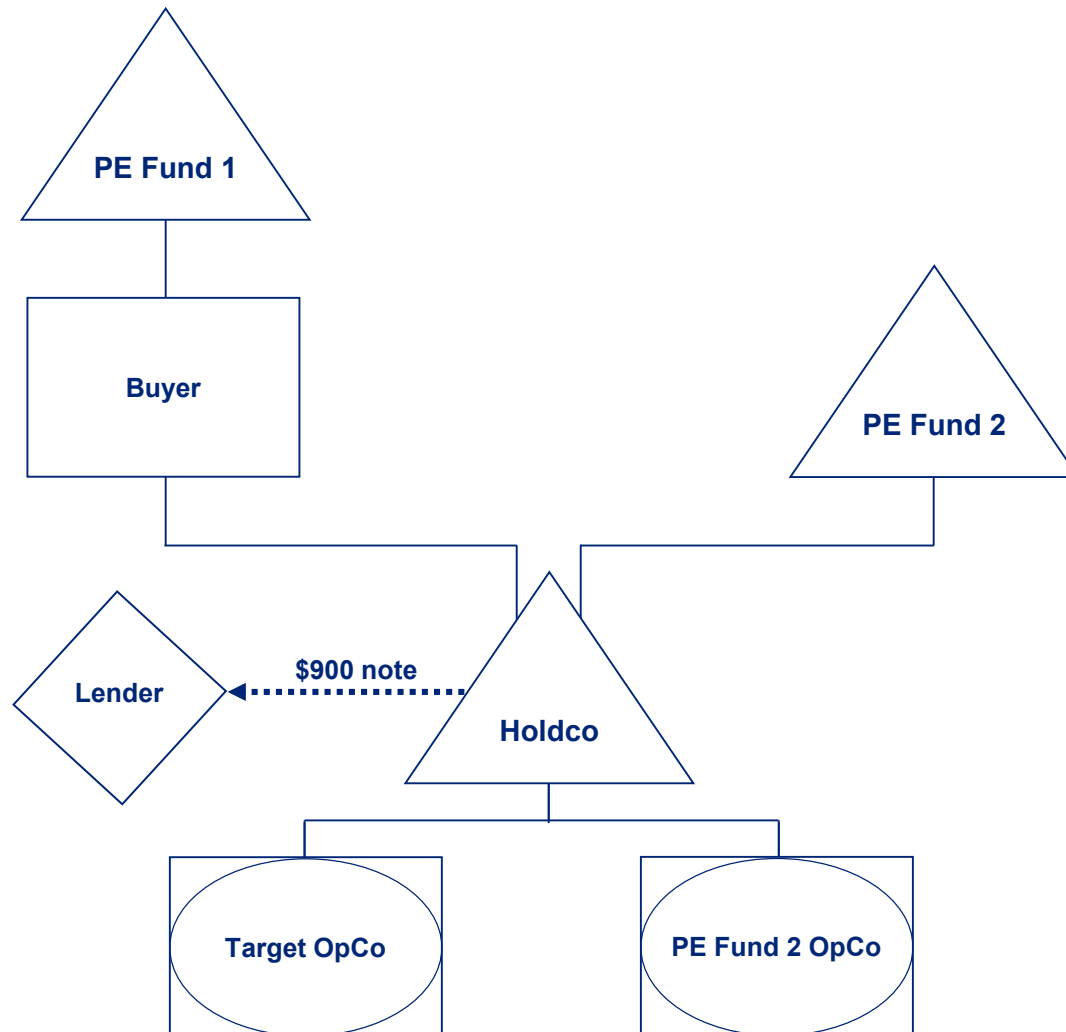


- Reg. § 1.707-5(a)(6)(i) (and Temp. Reg. § 1.163-8T(j)).
- What if Target operates its business directly?

Formation of Target Holdco



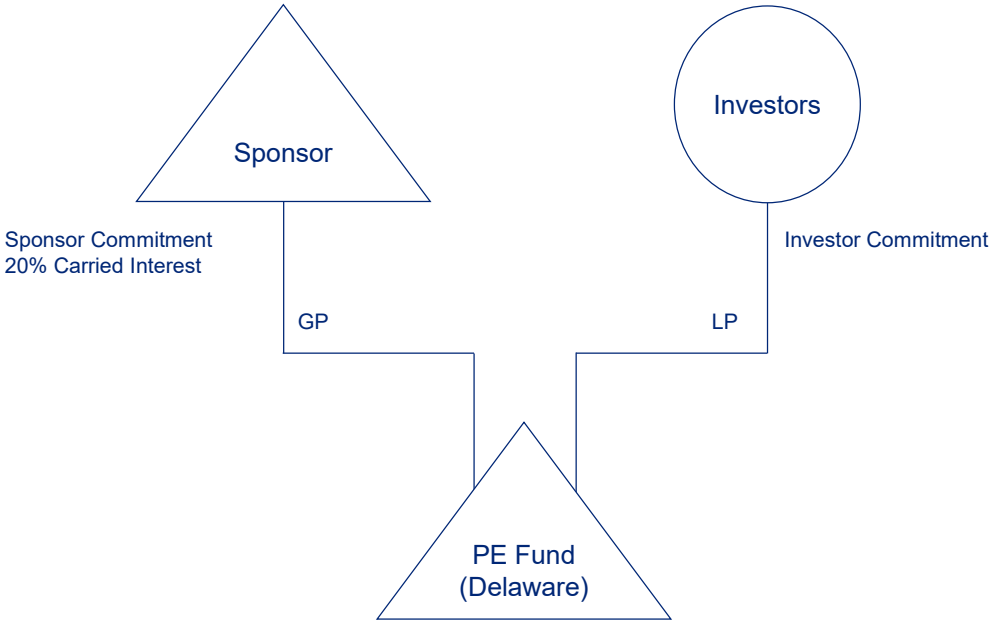
End Structure



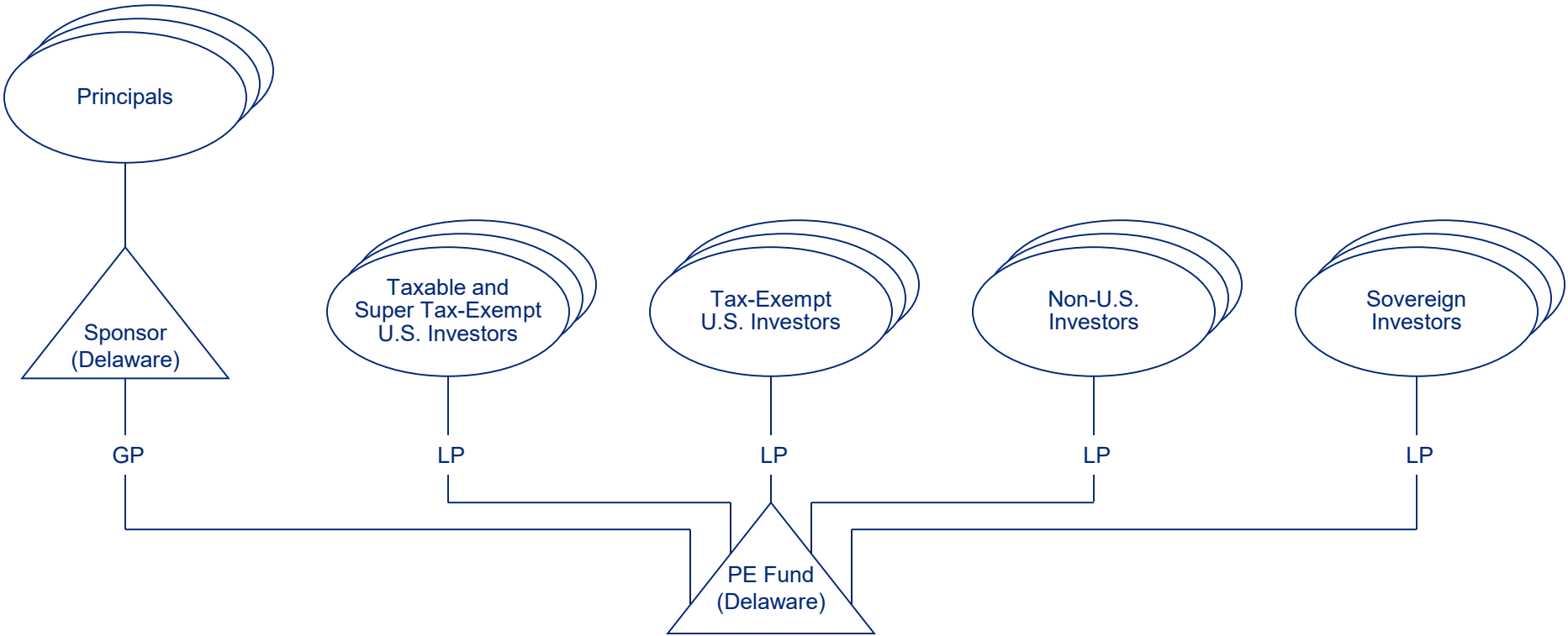
- Can Target OpCo and PE Fund 2 OpCo guarantee the note payable to Lender?

Private Equity

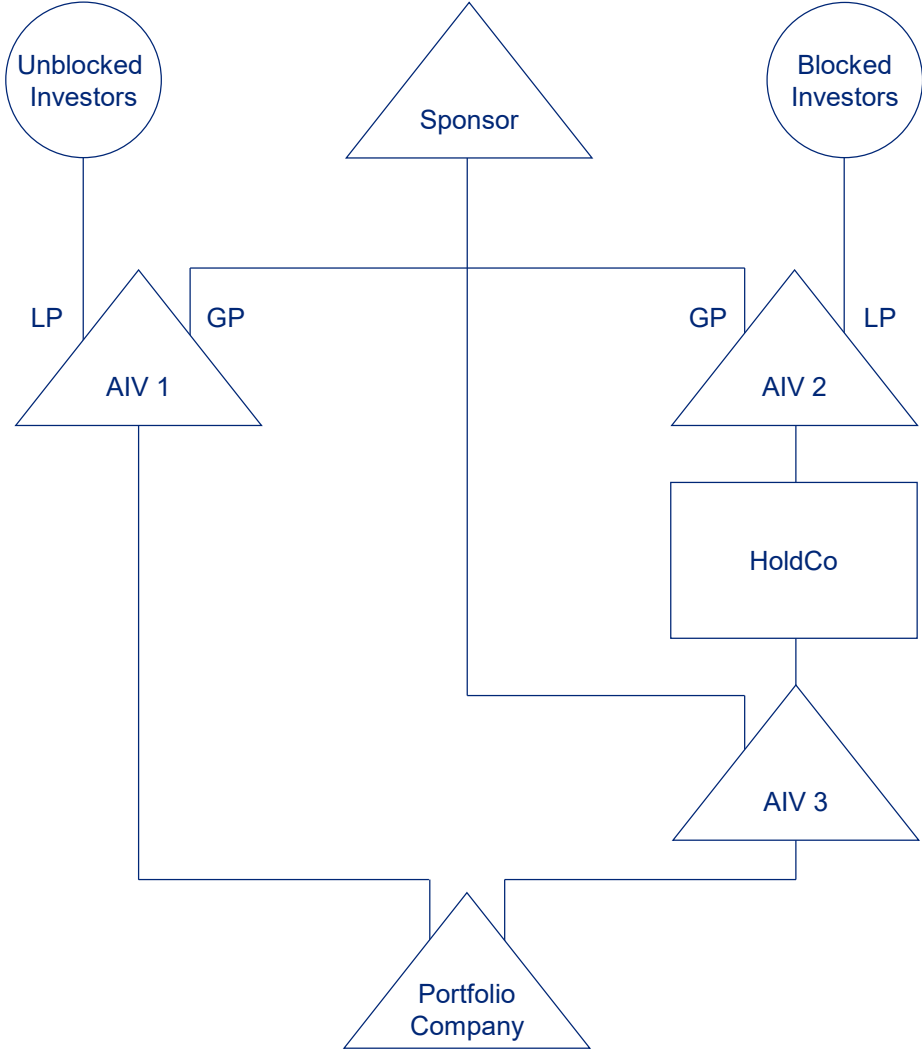
Simplified Overview Structure



Simplified Topside Structure (Part 1/2)



Simplified PE Topside Structure (Part 2/2)

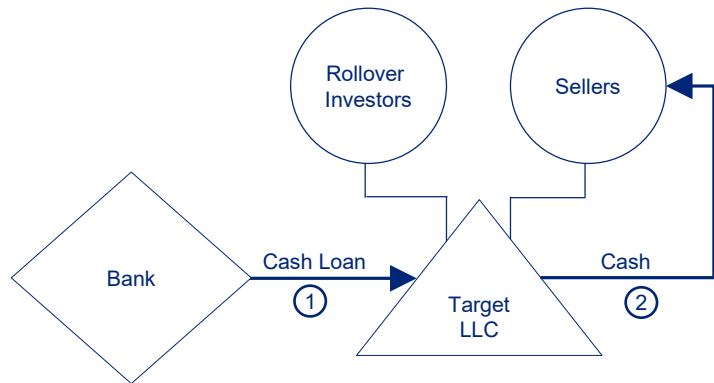


PE: Acquisitions

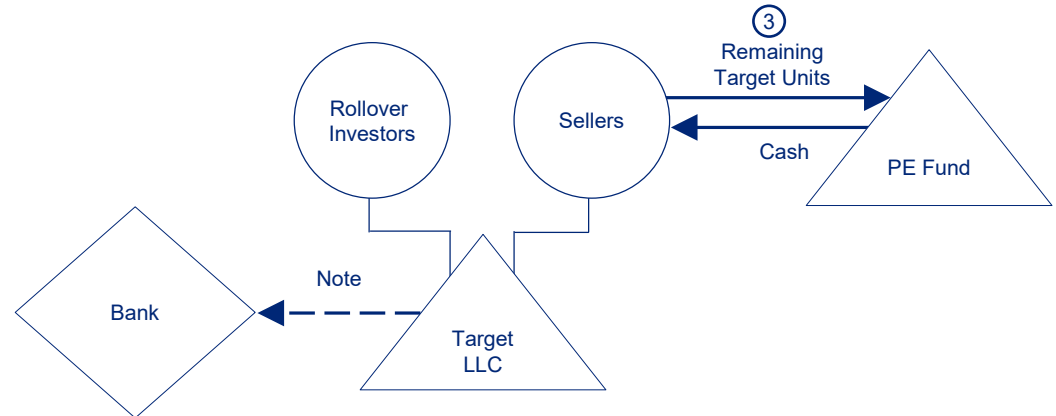
Acquiring Partnerships

Acquisition with Rollover

Partial Redemption of Sellers' Units



Sale of Remainder of Sellers' Units



Basic transaction

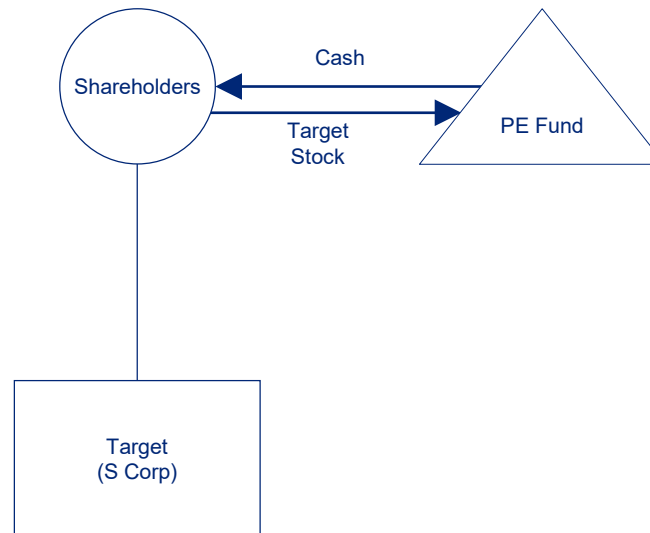
1. Target borrows from Bank.
2. Target distributes the borrowed cash to Sellers in partial redemption of their units.
3. PE Fund buys Sellers' remaining units.

Considerations

1. What if Rollover Investors want to get some cash?
2. Does the order of the steps matter?
3. Disguised sale of partnership interest?

Acquiring S Corporations

Alternative 1: No Asset Step Up



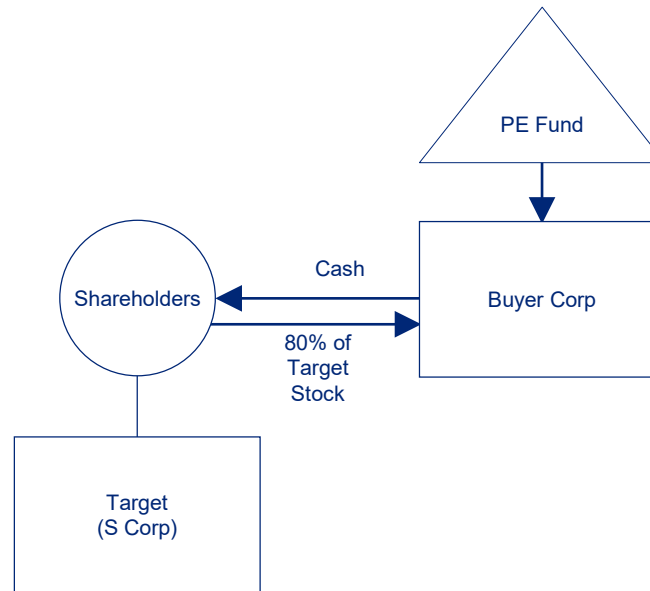
Basic transaction

PE Fund buys Target stock from Target's shareholders.

Consequences

No **asset basis** step up for the stock purchase.

Alternative 2: § 338(h)(10) Election



Basic transaction

1. PE Fund forms Buyer Corp, which buys stock of Target from Target's shareholders.
2. Shareholders and Buyer Corp make a § 338(h)(10) election to treat Target as having sold all of its assets at FMV.

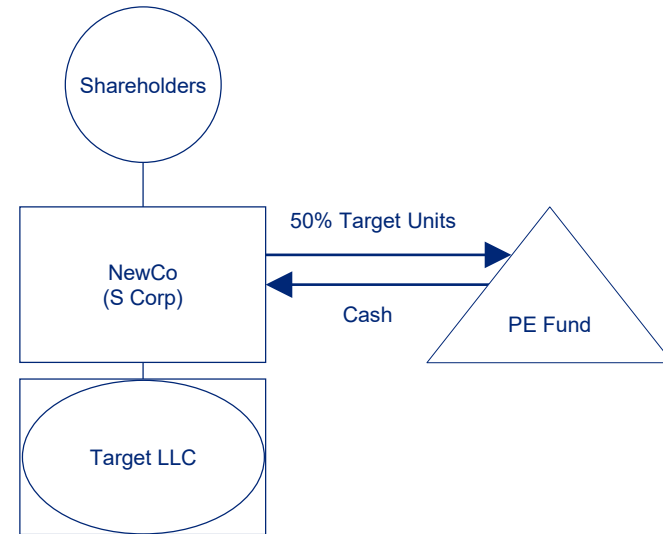
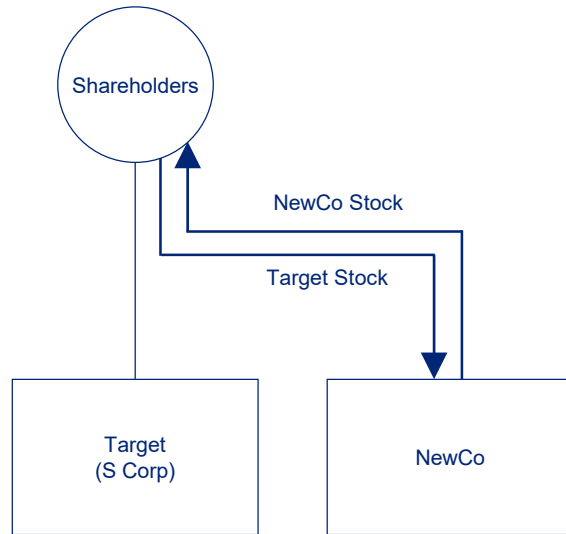
Main tax issues to consider

1. § 1374 BIG tax
2. Inside/ outside basis differences
3. Character differences
4. State tax differences
5. Impact if not S Corp
6. Too much gain is triggered
7. Section 336(e)

Consequences

1. Target is taxed on deemed sales of its assets subject to liabilities to Buyer Corp, followed by a deemed liquidation. Deemed liquidation generally does not result in additional tax.
2. Key is convincing Target Shareholders to accommodate a step-up transaction.

Alternative 3: F Reorganization and 99-5 transaction



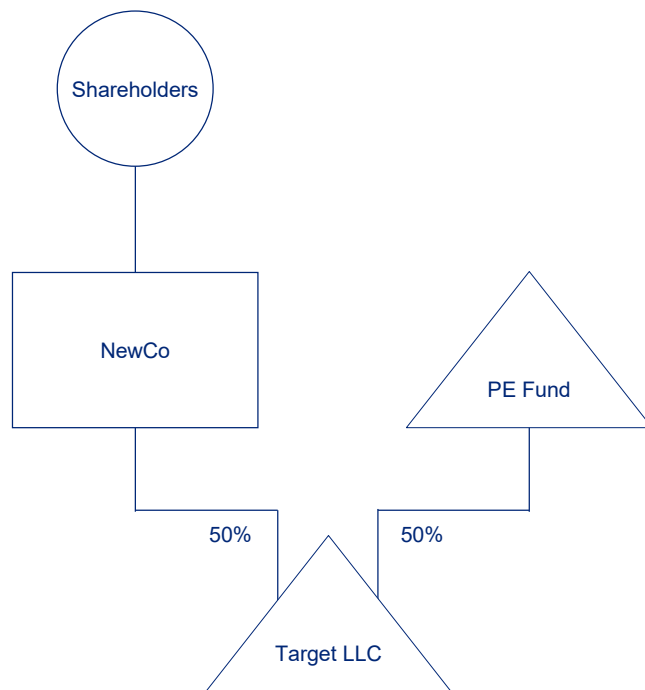
Basic transaction

1. Target Shareholders form NewCo, a domestic corporation, and contribute all of the stock of Target to NewCo in exchange for all of the stock of NewCo.
2. Target converts into an LLC, a disregarded entity.
3. PE Fund buys all of the Target LLC units from NewCo.

Consequences

1. The first two steps should be treated as a tax-free reorganization pursuant to § 368(a)(1)(F).
2. NewCo does not have to make a new S election pursuant to Rev. Rul. 64-250.
3. Same tax consequences for PE Fund as Alternatives 2 and 3.
4. Perhaps different consequences to Target Shareholders (inside/outside basis differences).
5. If S Corp bad, trigger gain, but get step up.

Alternative 4: F Reorganization and 99-5 transaction (*cont'd*)



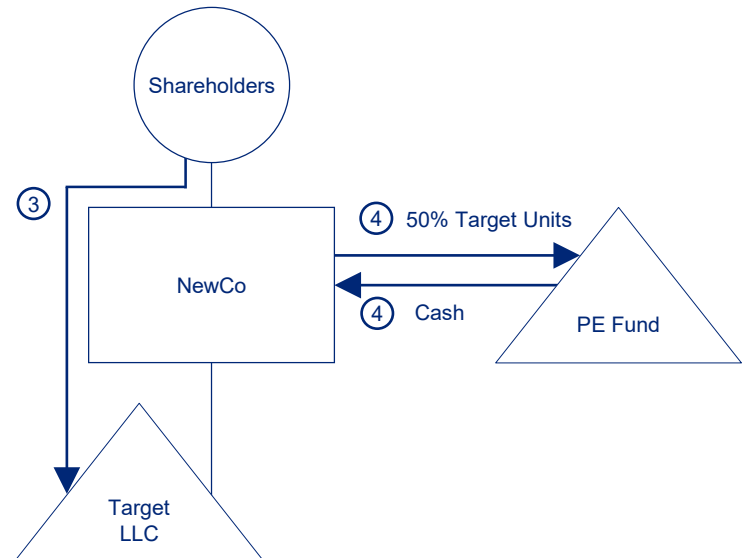
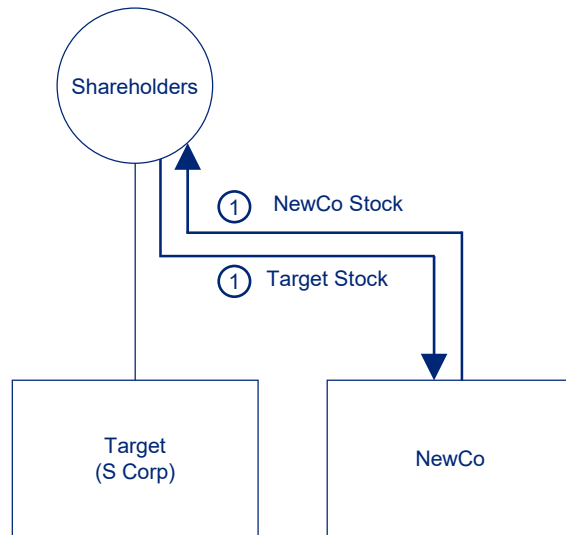
Consequences

1. The first two steps should be treated as a tax-free reorganization pursuant to § 368(a)(1)(F).
2. PE Fund's purchase of 50% of Target shares is treated as the purchase of a 50% interest in each of the Target's assets followed by a contribution of Target's assets to Target LLC under Rev. Rul. 99-5, *Situation 1*.

Considerations

1. Book/tax disparity for assets deemed contributed by NewCo.
2. Anti-churning.

Alternative 5: F Reorganization/Interest Purchase



Basic transaction

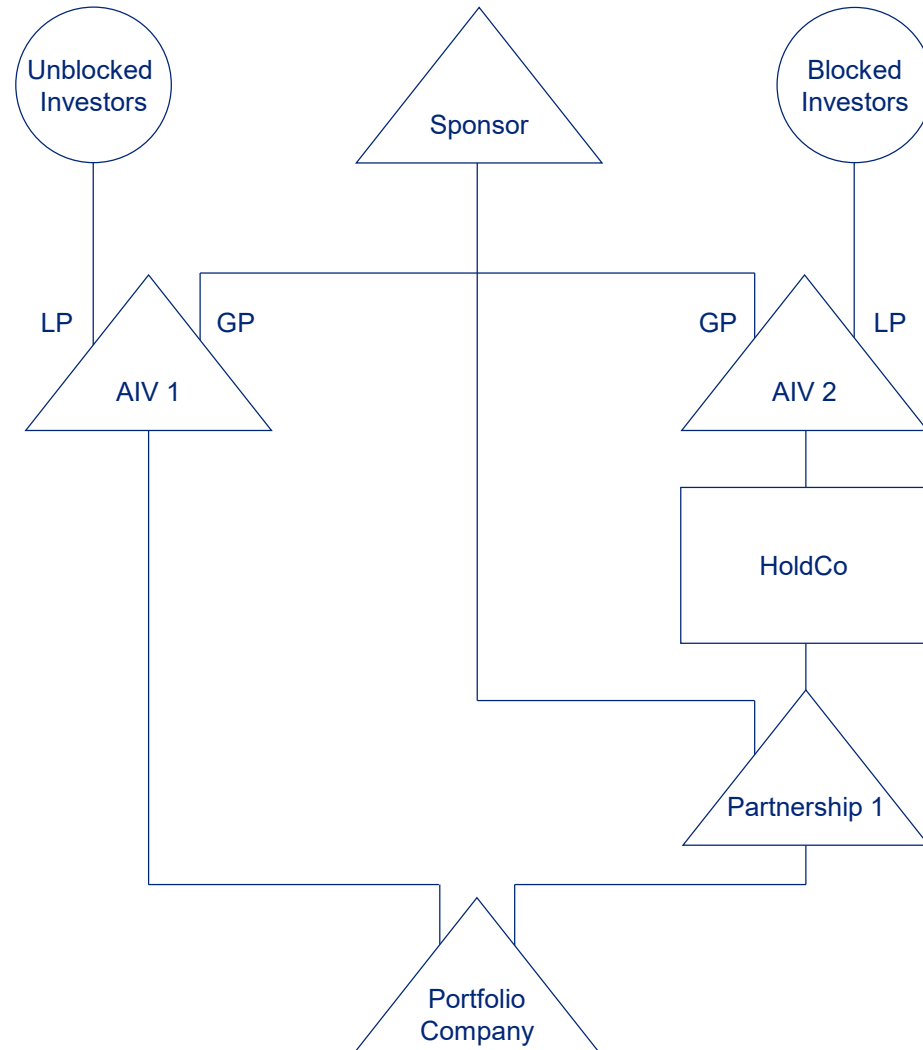
1. Shareholders form NewCo, a domestic corporation, and contribute all of the stock of Target to NewCo in exchange for all of the stock of NewCo.
2. Target converts into an LLC, a disregarded entity.
3. Shareholders contribute cash to Target LLC in exchange for membership interests.
4. PE Fund buys 50 percent of Target LLC units from NewCo.

Considerations

1. Purchase of interests vs. assets.
2. Will form be respected?
3. Anti-churning.
4. If debt at Target LLC, disguised sale?

Exit from Partnership Investments: Sales

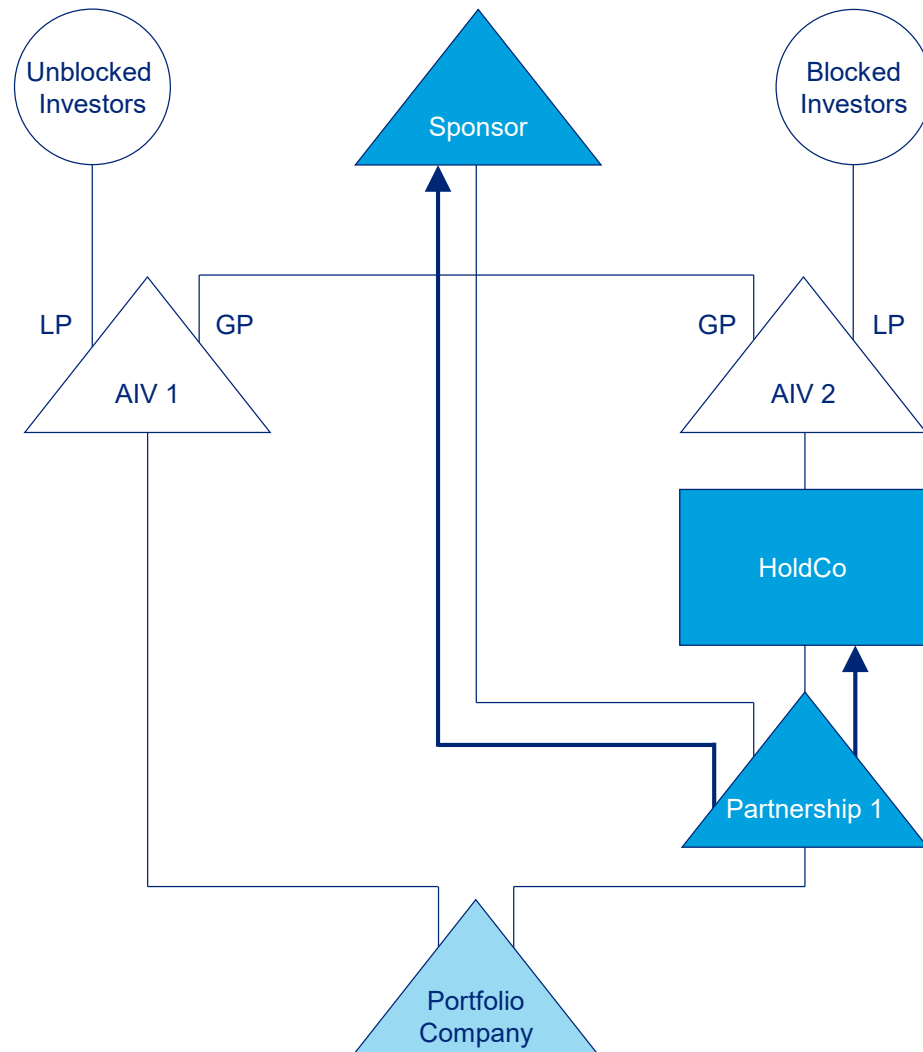
Sale of Typical PE Investment in an Operating Partnership



Objective

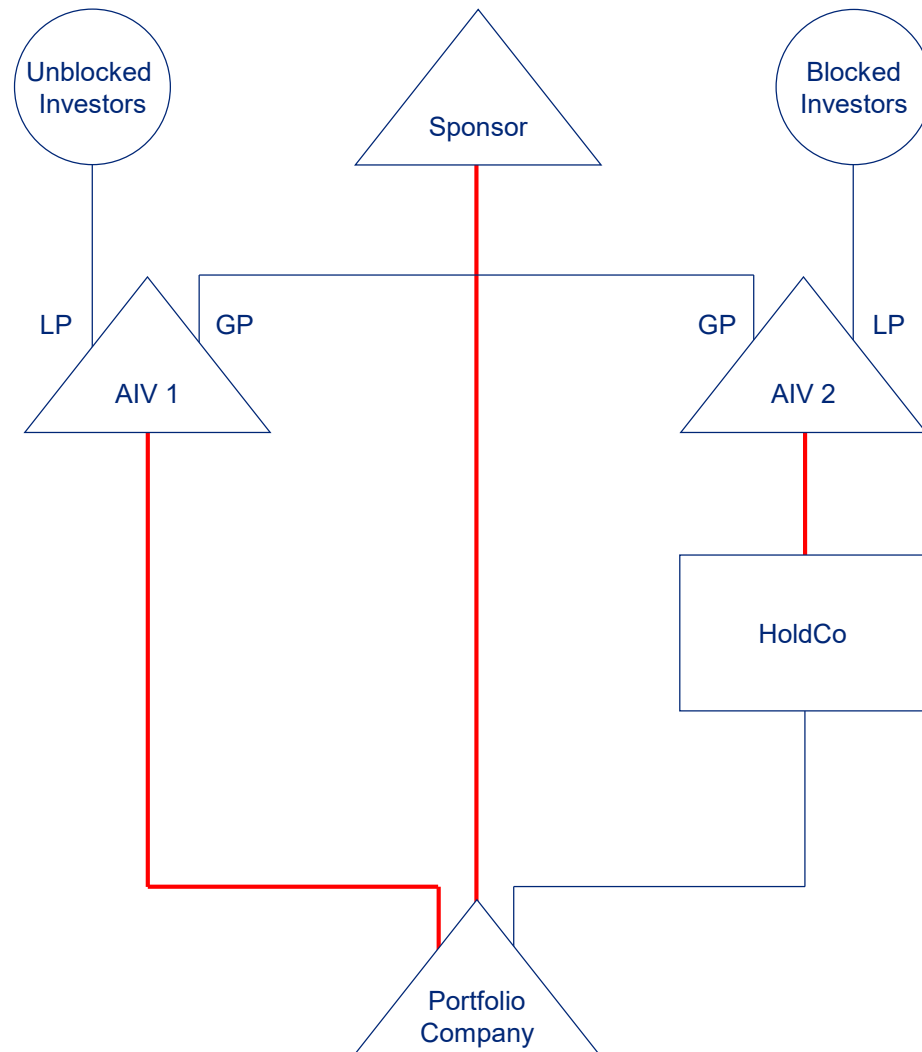
PE wants to sell Portfolio Company.

Sale of Typical PE Investment in an Operating Partnership (cont'd)



- Partnership 1 liquidates and distributes its interest in Portfolio Company to HoldCo and Sponsor.
- Necessary? Prudent?

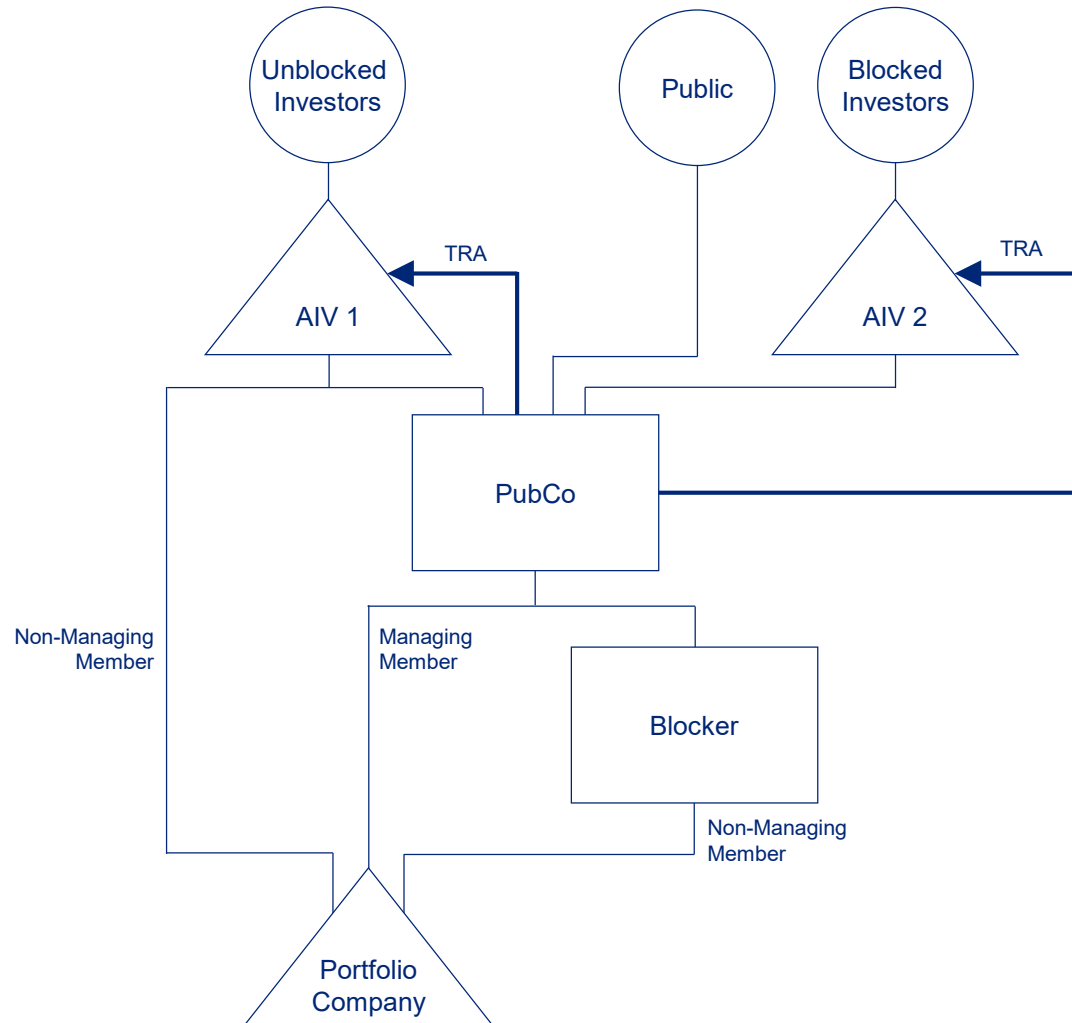
Sale of Typical PE Investment in an Operating Partnership (*cont'd*)



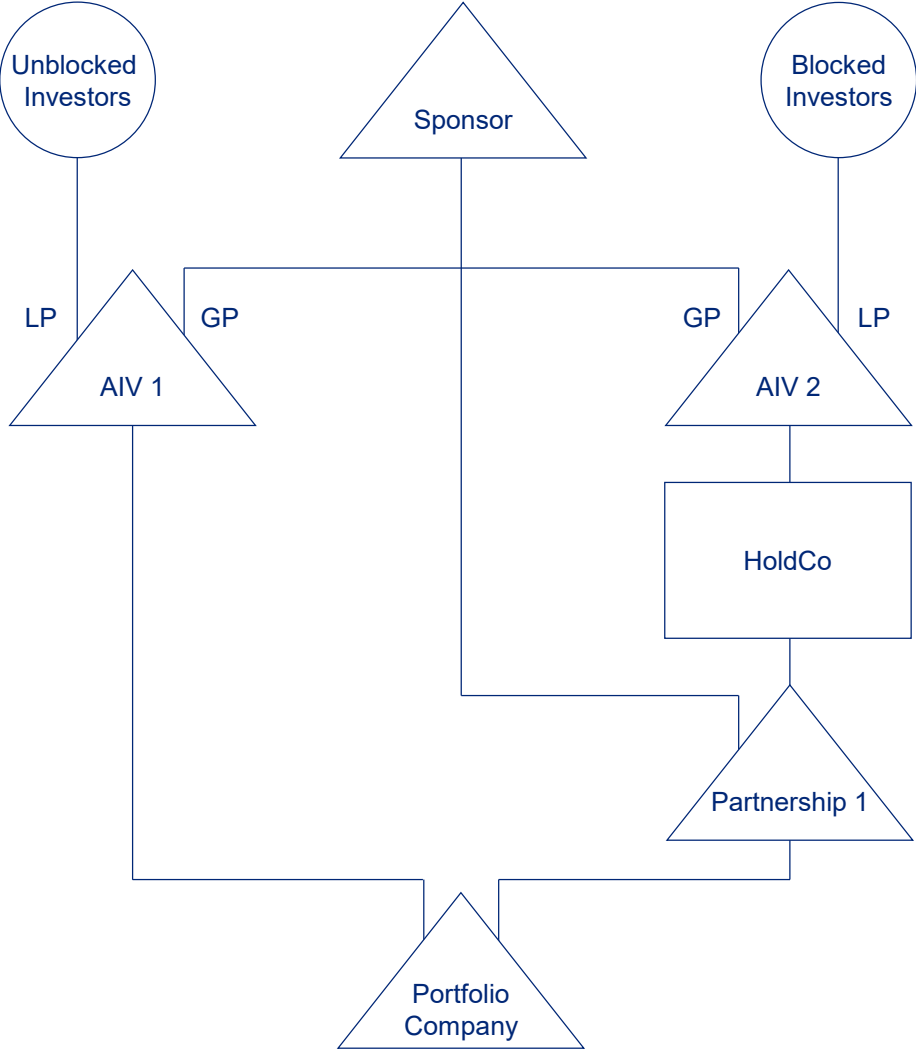
- Sponsor and AIV sell their interests in Portfolio Company; AIV2 sells its shares of HoldCo.

Exit from Partnership Investments: UP-C IPOs

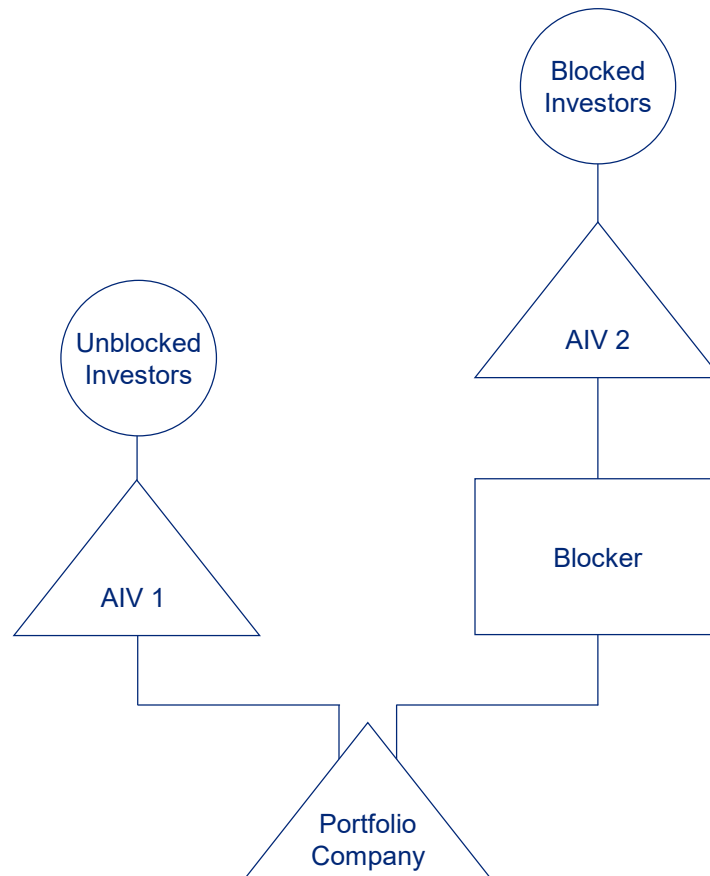
UP-C Structure – Simplified Ending Structure



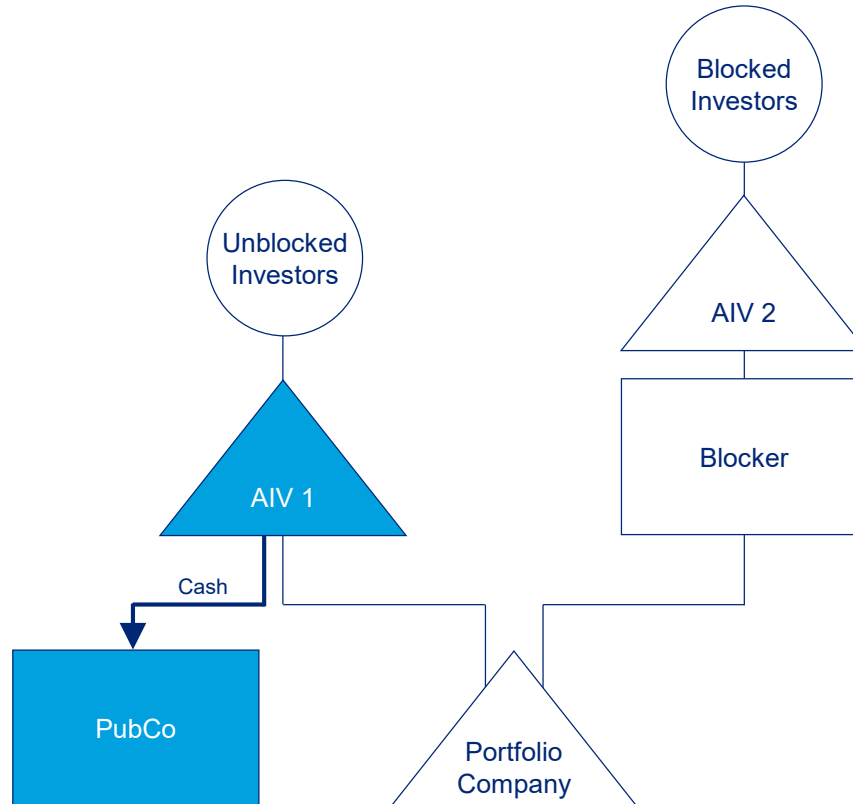
Pre-IPO Structure



Pre-IPO Structure – Simplified

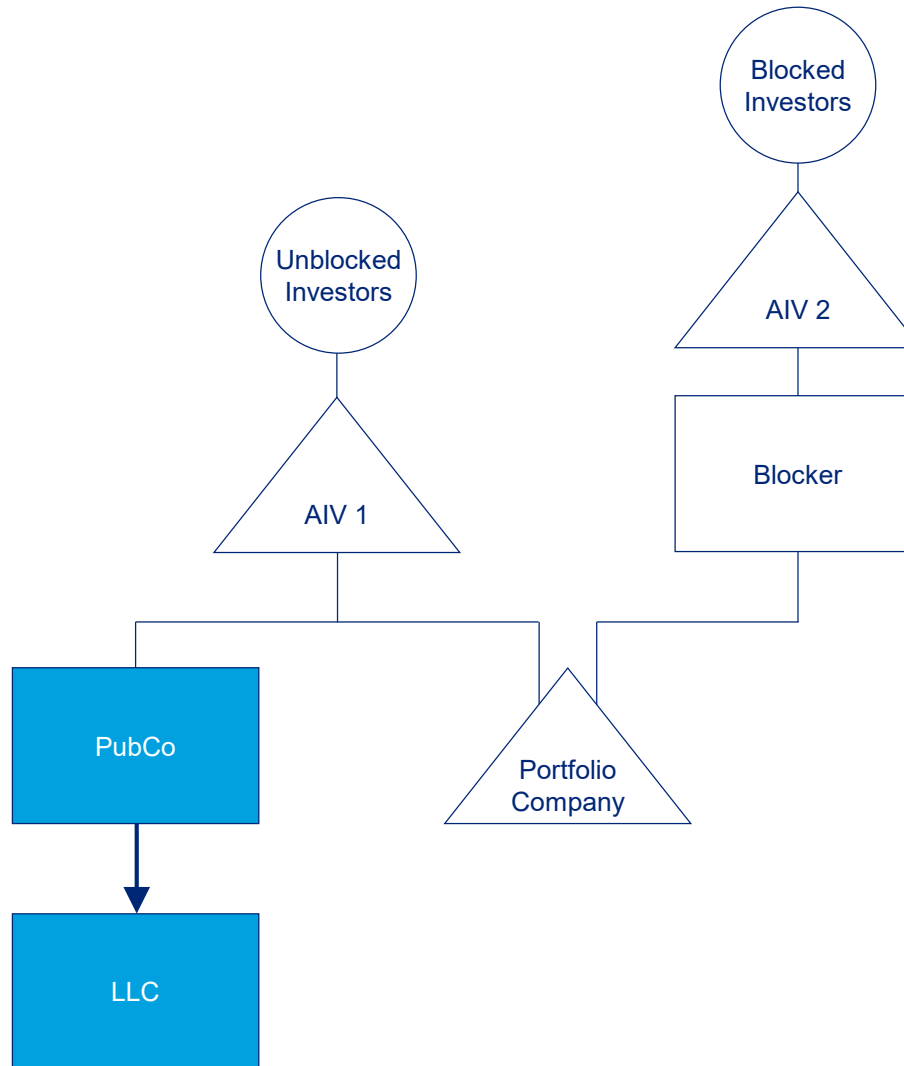


PubCo – Step 1



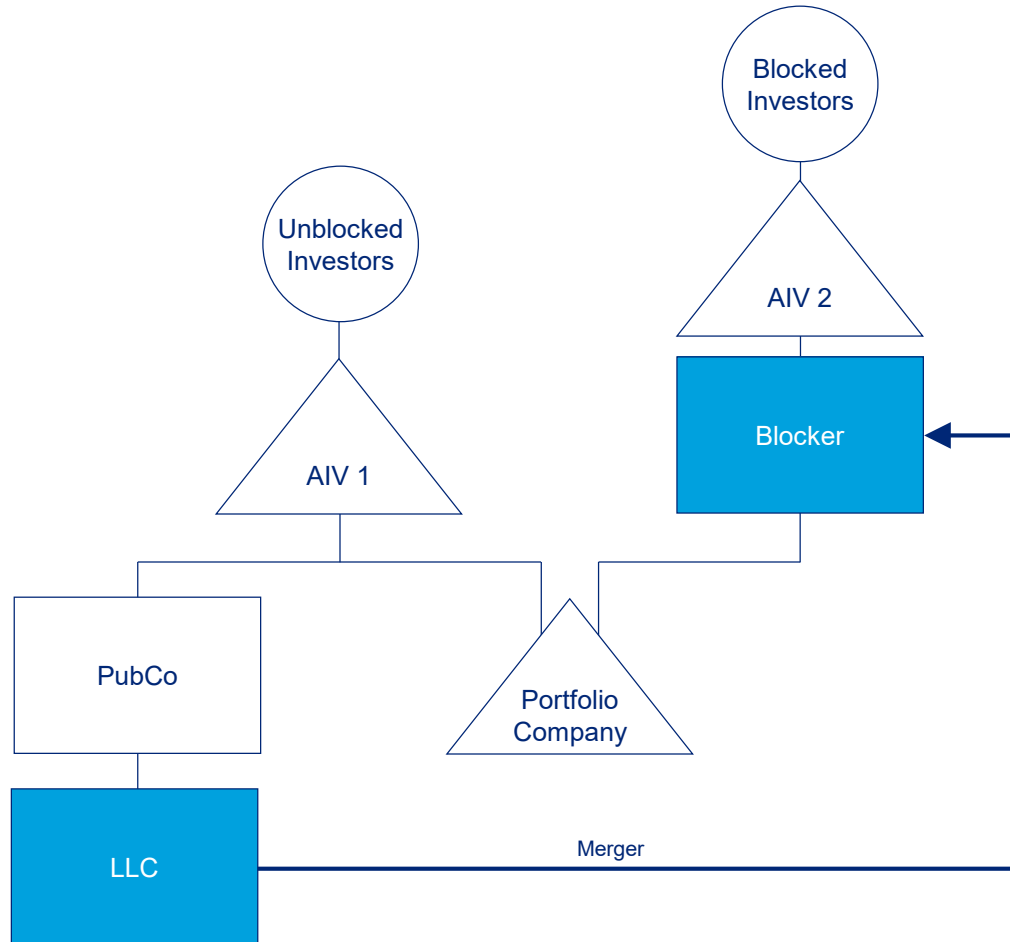
1. AIV 1 forms a corporation that will be the public registrant (“PubCo”). Portfolio Company is recapitalized. The unblocked units are exchangeable for PubCo shares. (See Rev. Rul. 69-265 regarding the exchange right.)

PubCo – Step 2



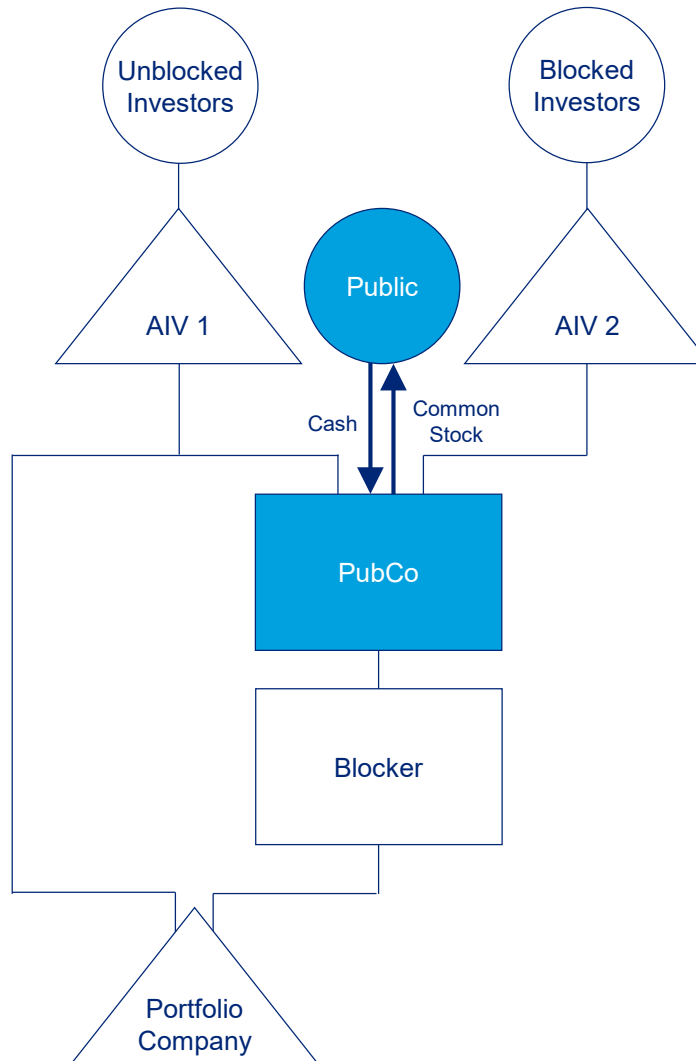
2. PubCo forms LLC and elects to classify it as a corporation for U.S. federal income tax purposes.

PubCo – Step 3



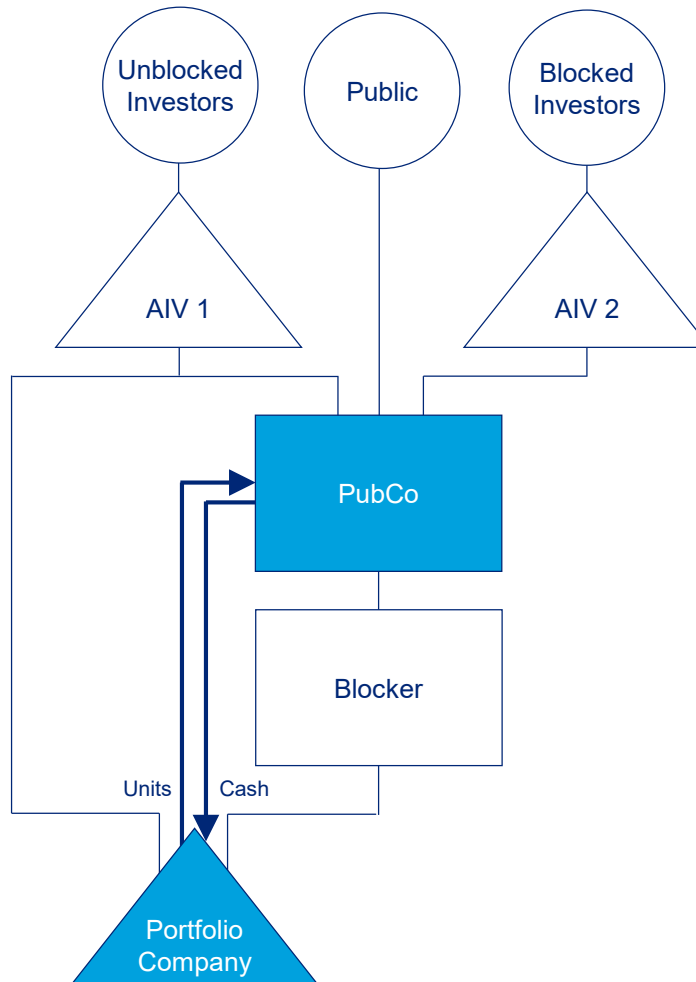
3. LLC merges with and into Blocker. Blocker's shareholders receive PubCo shares and rights under a tax receivable agreement ("TRA") as merger consideration.

PubCo – Step 4



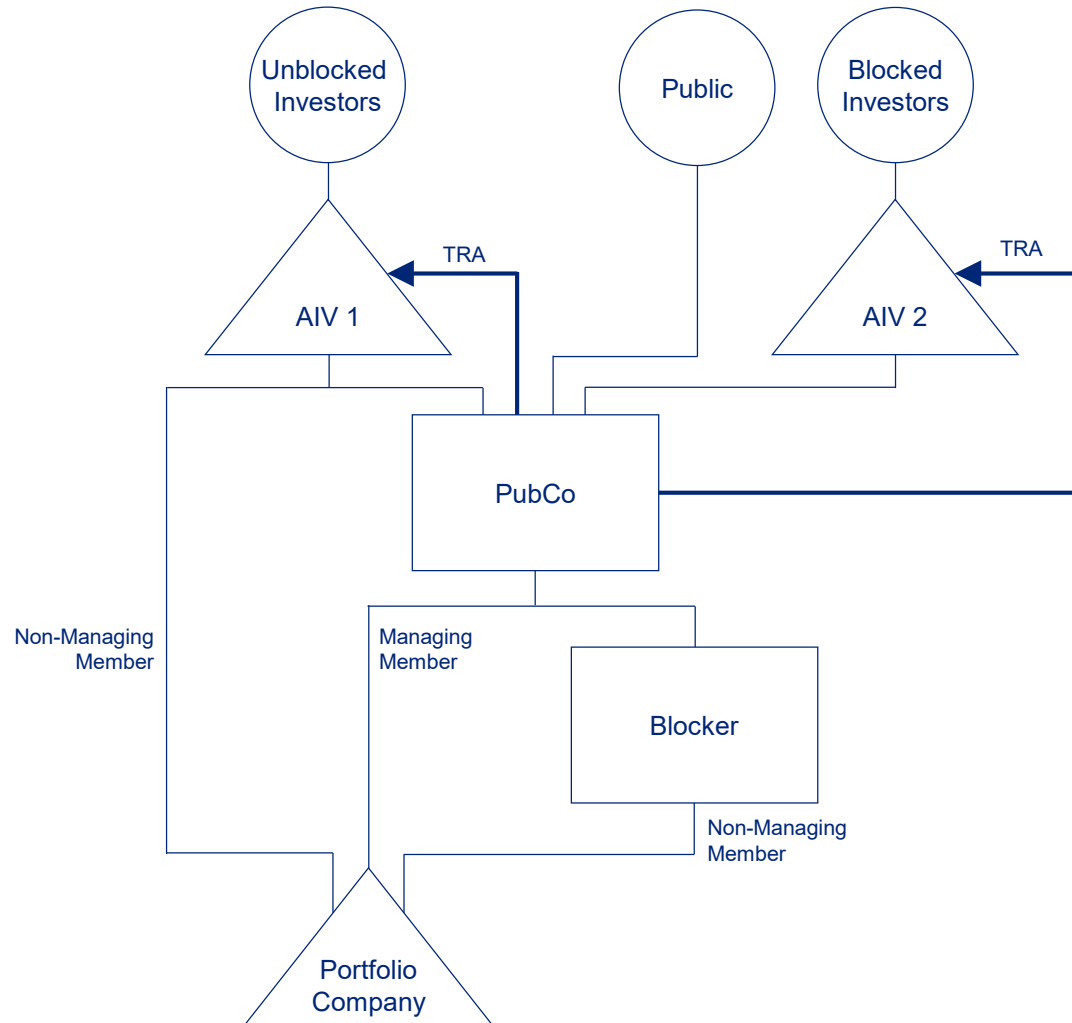
4. PubCo issues stock to the public in an IPO.

PubCo – Step 5



5. PubCo contributes the IPO proceeds to Portfolio Company in exchange for units. Portfolio Company will use the cash for general company purposes (e.g., repayment of existing debt, capital expenditures, acquisitions).

UP-C Final Structure



- From time to time, AIV 1 may exchange Portfolio Company units for PubCo stock and ITRs.

Tax Receivable Agreements

- What is a tax receivable agreement?
 - What attributes are covered?
- "With and Without" calculation
- What is needed?
 - § 754 election
 - § 743(b) adjustment to step up basis.
 - Other tax attributes (*e.g.*, NOLs, credits)
- Financial statement treatment
 - Liability for gross payments
 - Valuation allowance needed?

Characteristics of a TRA

- Depends on nature of transaction that gave rise to TRA
 - Taxable purchase
 - Reorganization
 - Current distribution
- Installment sale
 - Principal and imputed interest
 - Basis recovery
 - Election out
- When does the actual payment occur?

Characteristics of a TRA (*cont'd*)

- Common issues to consider
 - Ordering of multiple exchanges
 - Not enough taxable income
 - Permanent loss of TRA benefit
 - Law changes
 - What is the character of interest on the payment?

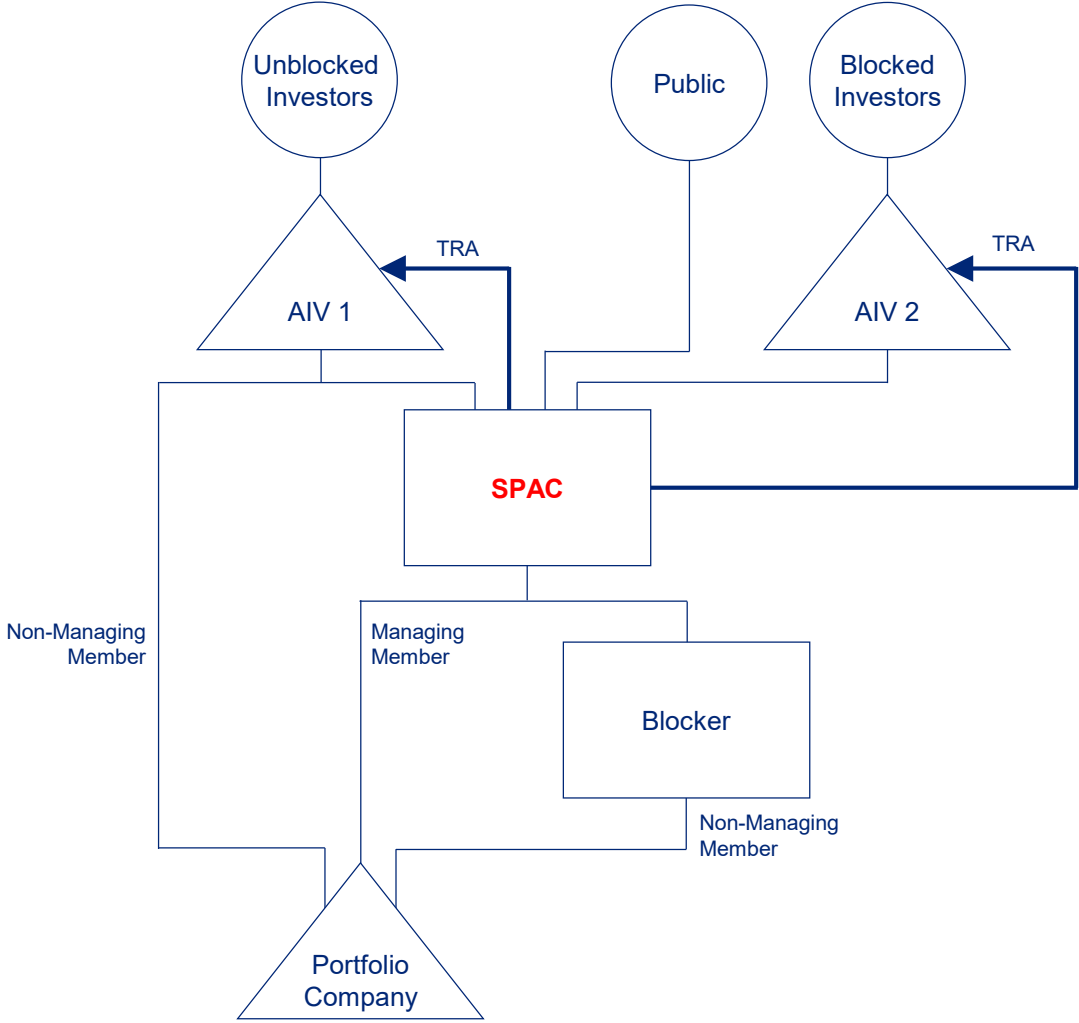
The SPAC UP-C

That's a Whole Lot of Acronyms

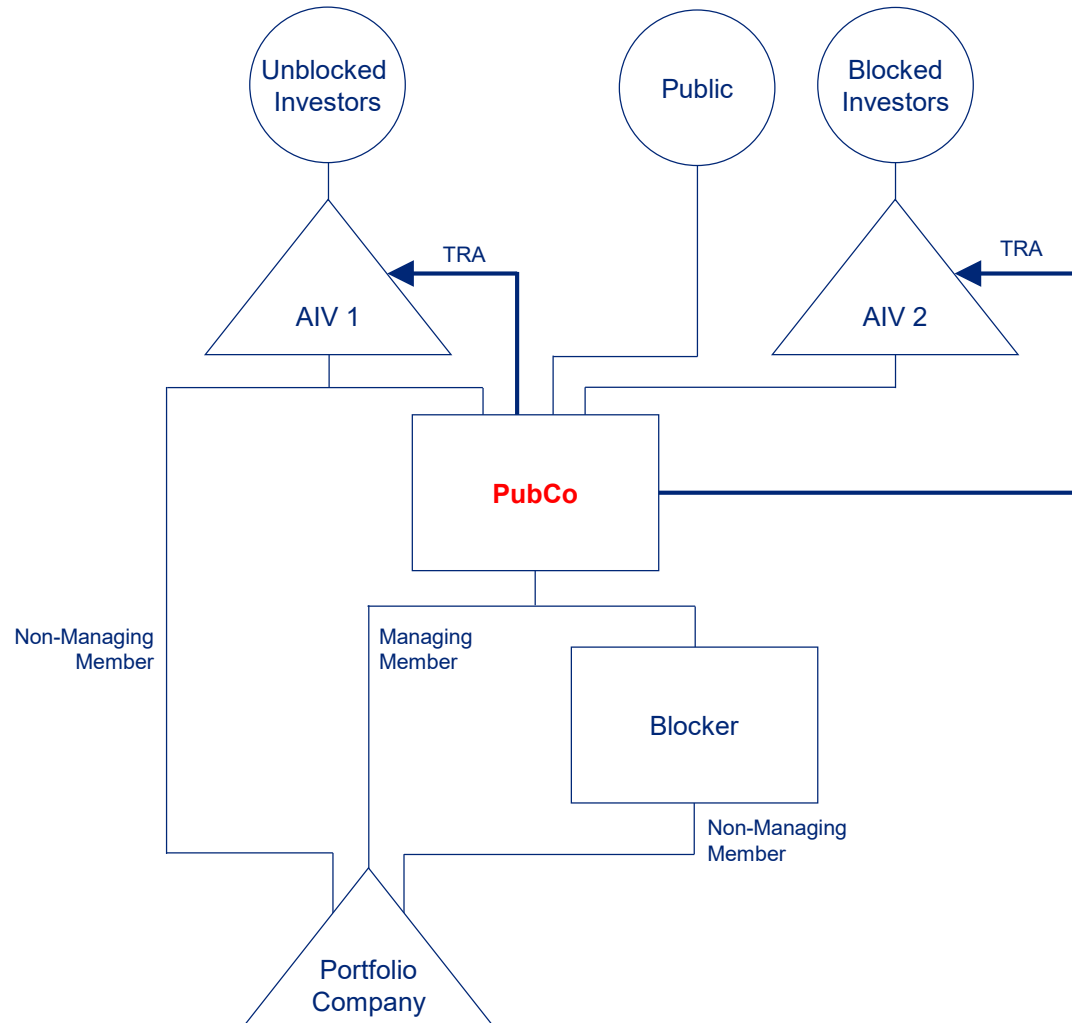
- UP-C (not Up-C, as much as lawyers like to pretend we're bankers)
 - **U**mbrella **P**artnership **C**orporation

- SPAC
 - **S**pecial **P**urpose **A**cquisition **C**ompany
 - Also known a “blank check company”

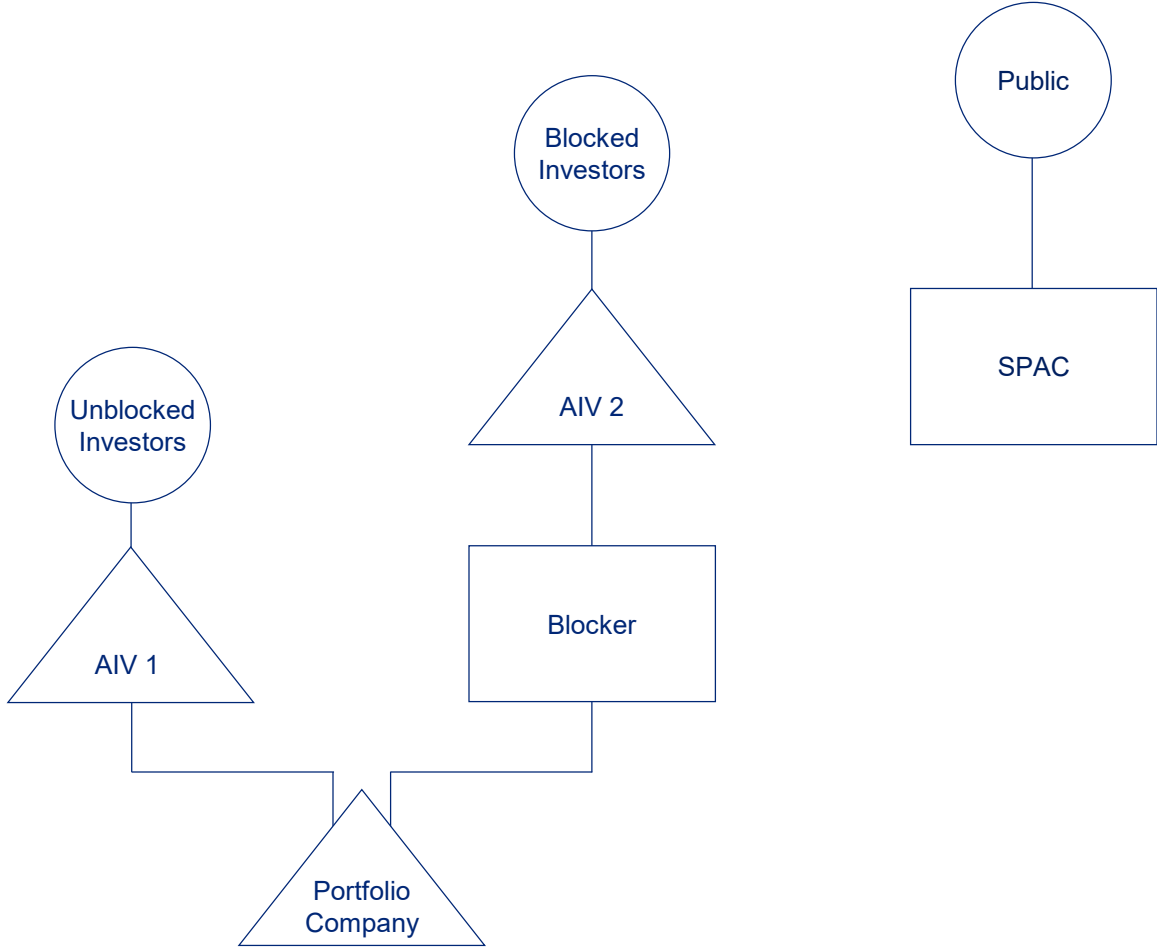
SPAC UP-C Structure – Ending Structure



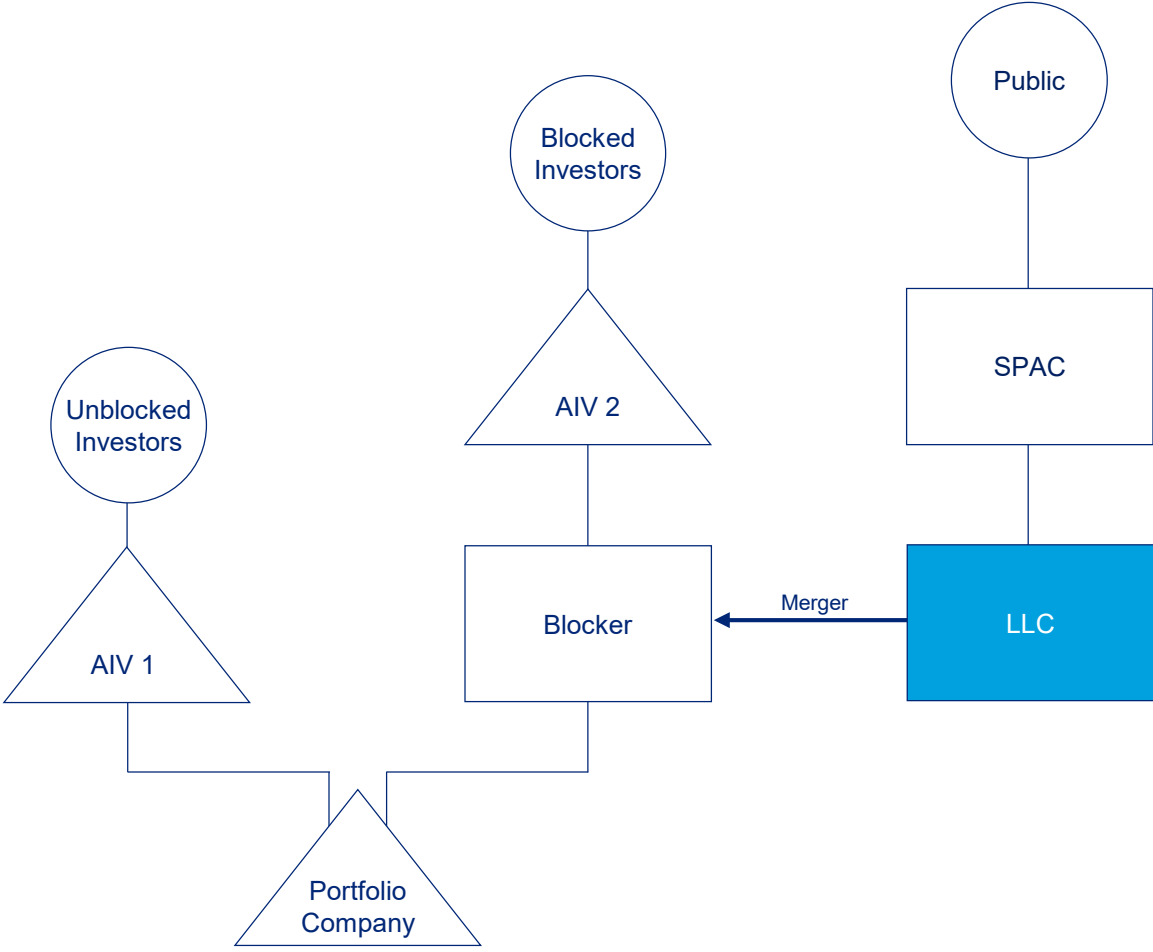
UP-C Final Structure



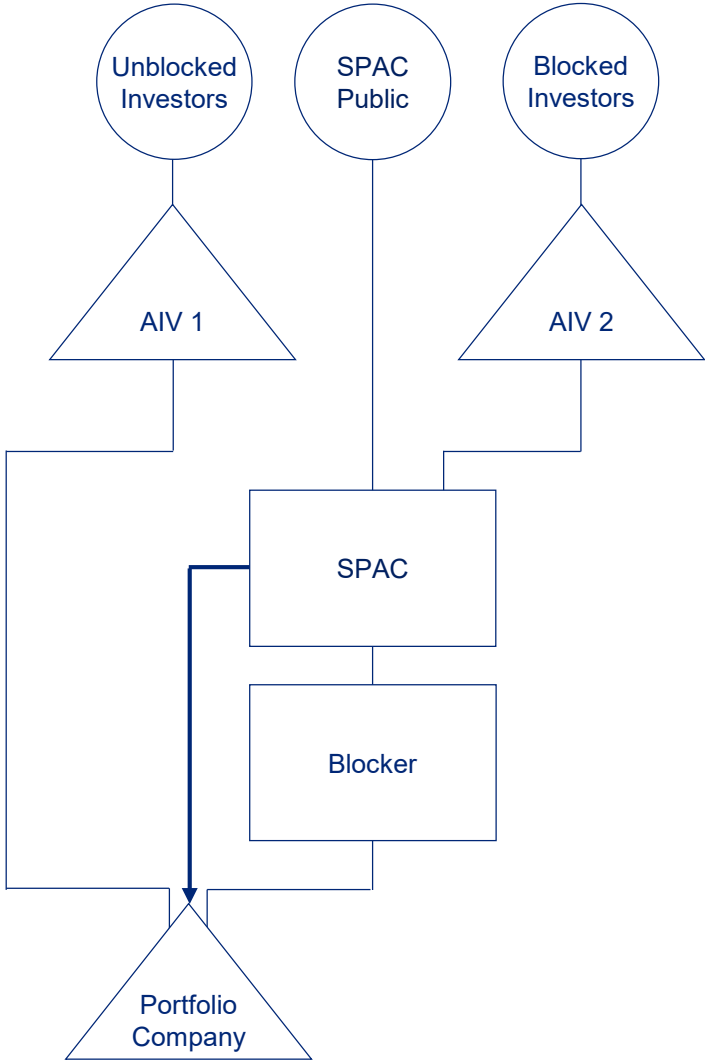
SPAC Transaction Structure – Simplified



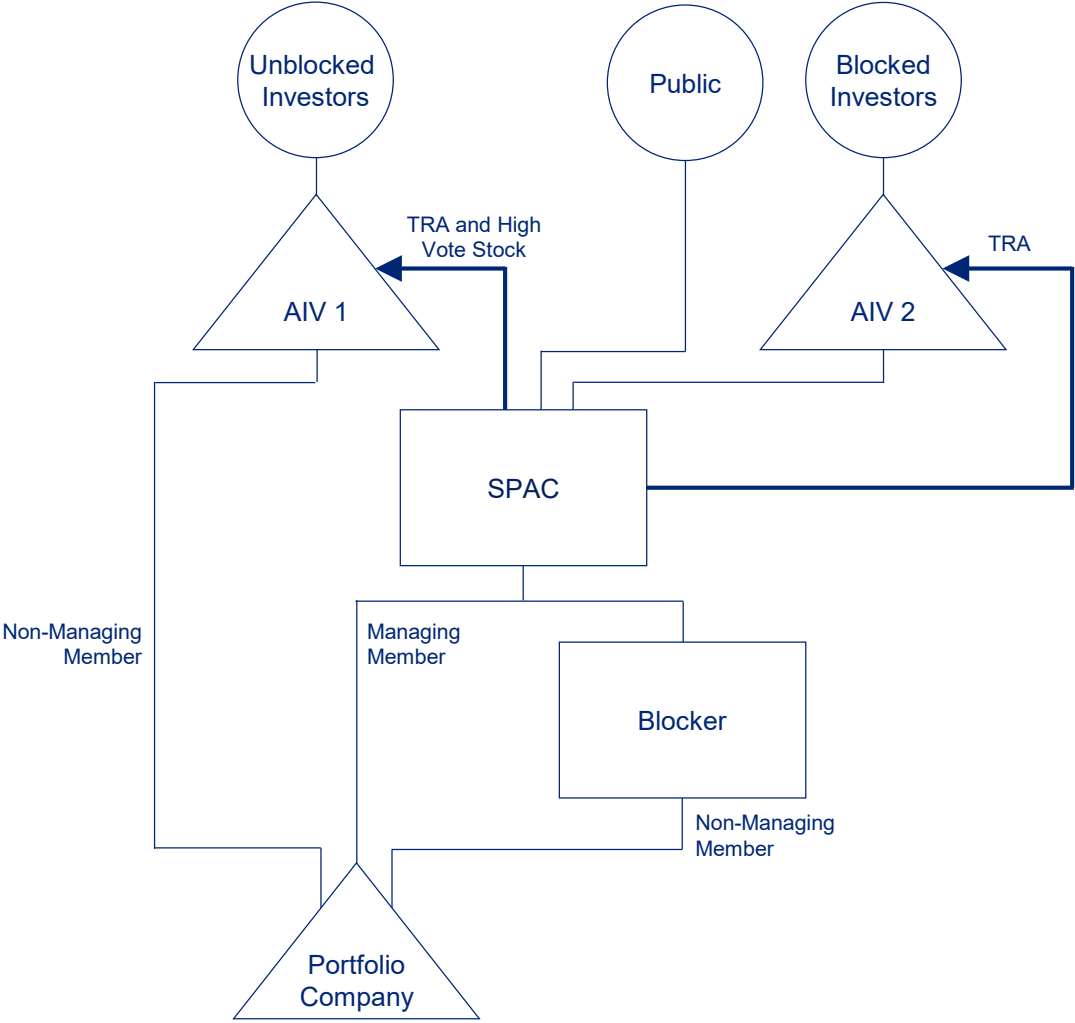
Blocker Merger



Contribution of SPAC Cash to Portfolio Company



TRAs and Issuance of High Vote Stock



SPAC UP-C Structure – Ending Structure

