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Focus on Private Equity

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Welcome to the inaugural issue of McDermott Will & Emery's *Focus on Private Equity*. We intend for this publication to serve as a vehicle for the regular communication of some of our thoughts and insights on topics of interest to our clients and other friends active in the private equity community.

Key Tax Considerations for Private Equity Acquisitions

By Thomas P. Ward, Partner, Chicago, U.S. & International Tax Practice Group

Careful attention to tax considerations during the course of acquisition transactions can help secure opportunities to protect and enhance value for private equity funds. While there are numerous tax issues to consider in any transaction, below are some key considerations.

Identifying Structuring Opportunities Through Tax Elections

338(h)(10) Elections for Qualified Targets

An election under Section 338(h)(10) of the Internal Revenue Code allows a corporate buyer to acquire stock while realizing the tax benefits of an asset purchase if the target is (i) a member of a consolidated group (or a non-consolidated selling affiliate) or (ii) an S corporation, and the private equity fund's corporate buyer acquires a minimum percentage of the target's stock by vote and value (after excluding any non-voting, non-convertible preferred stock) within a defined acquisition period. However, in certain circumstances a Section 338(h)(10) election may cause the seller to incur additional taxes due to the difference between the inside and outside bases in its shares. As a result, to secure cooperation from the seller, it is important for private equity funds and their counsel to identify such opportunities early in a transaction—often at the letter of intent phase—to secure the benefits of a 338(h)(10) election without having to agree to concessions later in the transaction.

Section 754 Elections for Tax Partnerships

A buyer of less than all of the equity in a target taxed as a partnership can realize the tax benefits of an asset purchase through a Section 754 election made by the target. A Section 754 election allows the partnership to adjust the basis of its assets to reflect the difference between the private equity fund's basis for the purchased equity and the private equity fund's proportionate share of the adjusted basis of all target partnership property. If a Section 754 election for the target partnership is not already in place, then it should be made on the federal tax return of the target partnership (*i.e.*, Form 1065) for the tax year of the acquisition.

Structuring Rollover Equity

To ensure that management incentives are properly aligned, attention should be given to the value attributed to the management rollover amount when the target owners are to receive "rollover equity" in the post-acquisition tax partnership. The contribution value (if any) attributed to the rollover amount can have unexpected tax consequences. If the private equity fund is entitled to return of its investment before rollover equity participates, attributing contribution value to the rollover equity may have the unintended consequence of causing tax losses to be allocated to the rollover equity owners rather than to the private equity fund.

Transaction Tax Benefits

Many transactions present the opportunity for the target company to recognize tax savings as a result of the costs, incurred compensation-related deductions (including from option cancellation payments, deferred compensation, and stay and bonus plans) and payment of professional fees. However, the allocation of the benefits between

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the buyer and seller of the business is not always intuitive. With the advice of tax counsel, attention should be given to structuring payments in a tax-efficient manner and to allocating transaction tax benefits in the purchase agreement.

Anti-Churning Rules

Attention should be paid to "anti-churning" rules in order to avoid potentially significant and often needless reductions in the buyer's after-tax cash flow. If the target business was in existence on or before August 10, 1993, and after the transaction the target owners own (or a related party owns) more than 20 percent of the equity of the buyer, goodwill and going concern value of the target may not be amortizable by the buyer as a result of the "anti-churning rules." Moreover, if the buyer is a limited liability company or the corporate acquirer is owned by a limited liability company, the anti-churning rules can be an issue even where the target owners hold, after the transaction, 20 percent or less of the limited liability company.

Key Employee Benefit Considerations for Private Equity Acquisitions

By Maureen O'Brien, Partner, Chicago, Employee Benefits, Compensation, Labor & Employment Practice Group

Legal review of employee benefit plan issues represents a key opportunity for private equity funds to protect and enhance the value of their investments. Below are some important considerations to bear in mind when structuring and negotiating transactions.

Potential Areas of Non-Compliance

Dealing with historical benefit plan non-compliance can be costly and distracting to a new management team. An effective review of a target company's employee benefit plans can foster a successful execution of a fund's business plan by reducing ongoing risks, saving costs, helping to ensure a smooth transition for employees, and better positioning portfolio companies for future add-on acquisitions and the private equity fund's eventual exit.

Potential Areas of Joint and Several Liability

Certain employee benefit plans carry unfunded liabilities that are joint and several liabilities of the sponsoring employee or participating employer and each member of that employer's "controlled group." The controlled group generally consists of all entities, whether or not incorporated, that are connected through common ownership of 80 percent or more by vote or value. Under some theories, the entire private equity fund and its portfolio companies may be deemed to be part of the controlled group and thus jointly and severally liable for such liabilities.

Single-Employer Plans

Single-employer defined benefit pension plans often carry significant unfunded termination liabilities that can adversely affect the plan sponsor's balance sheet. Private equity funds should be cautious of rules that impose joint and several liabilities for unfunded termination liabilities and annual minimum funding contributions among members of the controlled group.

Multi-Employer Plans

A private equity fund acquiring a direct or indirect interest in 80 percent or more of the target may be liable for any withdrawal liability or missed contributions. Many U.S. multi-employer defined benefit pension plans assess significant liabilities against employers that cease participation in such plans (referred to as "withdrawal liability"). A key consideration for multi-employer plans is identifying and managing potential (and often significant) withdrawal liabilities in due diligence. In addition, multi-employer defined benefit pension plan liabilities can be deemed to be joint and several liabilities of the entire controlled group. Further, in an asset transaction, withdrawal liability is automatically triggered and assessed on the seller and its controlled group. Private equity buyers should be aware that sellers sometimes may seek to shift such burdens to the buyer in the purchase agreement.

Positioning for the Future – Structuring the Post-Acquisition Entity

The definitive purchase agreement should contain provisions to manage the benefit plan obligations of the private equity fund and its target. After closing, acquisition targets typically must establish and administer new employee benefit plans. This is particularly relevant in carve-out scenarios where the target had been participating in the employee benefit plans of a much larger parent company. Proper documentation and corporate governance is key to ensuring compliance with relevant rules and regulations. In particular, sellers often seek to require that buyers replicate current employee benefit plans at the seller. However, a replication of such plans may not make business sense for the size and cash flow of the target. In the welfare area, the most costly plans to establish are retiree welfare benefit plans. In the pension area, typically defined contribution, rather than defined benefit, plans are established.

Questions concerning the information contained in this newsletter may be directed to your regular McDermott Will & Emery lawyer or you can contact the Firm at privateequity@mwe.com.

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