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Focus on Private Equity

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Year-End Tax Planning Steps for Private Equity

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The last time the Bush tax cuts were set to expire at the end of 2010, we saw numerous clients scrambling to execute end-of-the-year transactions designed to "lock in" the expiring tax rates. Although the tax rate increases did not come to pass, the cuts are set again to expire on December 31, 2012. This article revisits techniques allowing private equity funds to lock in their capital gains before January 1, 2013.

A Snapshot of the Pending Tax Law Changes

If the rate increases take effect, the current 15 percent federal capital gains rate will rise to 20 percent, and the special 15 percent federal tax rate on dividend income will disappear; thereafter dividend income will be taxed as ordinary income at federal tax rates as high as 39.6 percent. Making matters worse is the special 3.8 percent tax on investment income adopted as part of the Obama 2012 health care legislation, which takes effect in 2013 for taxpayers with more than $250,000 of taxable income. Taking into account this special 3.8 percent tax, the federal tax rate applicable to capital gains recognized after December 31, 2012, will actually become 23.8 percent (a 59 percent increase over the current rate), while the federal tax rate applicable to dividend income will jump to 43.4 percent (an increase of 189 percent over the current rate).

This suggests that closing a sale in 2012 rather than in 2013 could have a significant impact on the after-tax returns realized by a private equity fund's investors. To illustrate, say a private equity fund owns a portfolio company with an equity value today of $100 million, for which its tax basis in the stock is zero. Ignoring state taxes and assuming, for purposes of this example, that the investors are all taxable individuals (*i.e.*, not tax-exempt pension plans or university endowments), a sale of the company in 2013 at a price of $100 million would yield the same after-tax proceeds to the private equity fund investors as a sale of the company in 2012 at a price of $89.6 million. (A sale of the company in 2013 at a price of $100 million will yield to the owners after-tax proceeds of $76.2 million, *i.e.*, $100 million x [1 - .238]. In order to realize the same after-tax proceeds on a sale in 2012, the price need only be $89,647,059, *i.e.*, $89,647,059 x [1 - .15].)

Clearly these changes could have a meaningful impact on valuations and the timing of exits over the next year.

Next Steps for Private Equity

Timing of Exits and Liquidity Events

Private equity owners should consider realizing a capital gain from a sale of a portfolio company or taking a dividend from one of their portfolio companies in 2012 rather than 2013. This is obviously easier said than done—a host of non-tax-driven reasons may make this impractical. However, the potential impact of the tax changes on after-tax proceeds, as illustrated above, should be taken into account.

For private equity buyers, such changes may present an opportunity to acquire companies at lower valuations from sellers sensitive to the concerns raised above.

"Last-Minute" Alternatives

If practicalities prevent end-of-the-year liquidity events, alternative transactions may be available to lock in 2012 tax rates:

- *Borrow and pay a dividend prior to the end of the year.* For owners looking at exits in the next year, the portfolio company could borrow funds (no more than 80–90 percent of what would be the low end of an anticipated sale price in 2013) and pay that amount out as a dividend to its owners before the end of the year, thereby locking in the 2012 tax rates on that dividend. Then, upon a sale the following year, only the excess of the sale price over the amount of debt outstanding would be taxed to the owners at the potentially higher 2013 rates. This technique would result in 80 percent of the owners' gain being taxed at the current 2012 tax rates.
- *Distribute promissory notes prior to the end of the year.* If borrowing to fund a dividend is not practical, the same tax result could be achieved by simply having the portfolio company pay a dividend to its owners in the form of company promissory notes issued in 2012. To give the portfolio company the greatest flexibility with respect to paying off the notes, they could be structured as long-term (*e.g.*, five-year) notes with an acceleration in the event of a sale of the company. When the company is sold next year, the stock would be sold for the difference between the sale price and the debt, with the buyer assuming and paying off the promissory notes previously issued to the owners. As a result, the owners would ultimately net the same sales proceeds from the transaction, but the debt payoff portion of the proceeds would be

taxed in 2012 at the more favorable tax rates with the remaining portion being subject to potentially higher 2013 rates. Note, however, that this technique carries with it the risk of the business not being sold the following year and the owners nevertheless having to pay the tax (albeit at the 2012 tax rates) on their receipt of the promissory notes. For that reason, this technique will work best where there is a relatively high degree of certainty of a sale being consummated in 2013 or where the company can afford to pay out to the owners an amount in cash at least equal to the tax payable on the dividend.

The Applicability of Dodd-Frank Derivatives Provisions to Portfolio Companies

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This article (current as of September 21, 2012) highlights key Dodd-Frank Act provisions that are applicable to portfolio companies that are derivatives users. Most portfolio companies will be regulated as "end users" under Dodd-Frank; this summary does not relate to portfolio companies that are swap dealers or major swap participants, or to investments in public companies (all of which are subject to further regulation).

Evolving Regulations. Although key recordkeeping rules are already in effect, many Dodd-Frank regulations will be issued or phased in later in 2012 and in 2013.

Broad Applicability. The regulations apply to portfolio companies engaging in "swaps." Swaps are defined broadly under new extensive regulations; however, neither commodity futures contracts nor sales for future delivery intended to be physically settled are swaps.

Recordkeeping and Reporting Compliance. Portfolio companies must make records accessible to regulators, and those records must be kept for five years after each trade terminates. Most reporting will be done by swap dealers and major swap participants, but swaps between two end users will require an agreement as to which end user will be responsible for the reporting.

Position Limits. For designated energy, metal and agricultural commodity products, including futures, options on futures, and swaps on these designated products (except for exempt *bona fide* hedges), position limit rules have been finalized and will be imposed starting October 12, 2012, or in 2013.

Clearing Requirements and Commercial End User Exemption. Private equity firms entering into interest rate swaps for initial financings and refinancings must be careful as to which corporate entity will enter into those swaps. All swaps must now be "cleared" if a central clearing counterparty (Derivatives Clearing Organization) is willing to accept the swaps for clearing. However, an end user that is not a "financial entity" (note that a private equity fund itself is a "financial entity") is eligible for an exemption from clearing those swaps that it enters into only to hedge its "commercial risk." Also, only "eligible contract participants" (for a corporation with more than $10 million in assets and $1 million in net worth, or more than $1 million in net worth and engaging in commercial hedging) can enter into over-the-counter (OTC) swap transactions. An end user still can choose, in its sole discretion, to have its trades cleared.

Documentation. Dodd-Frank rules are also changing how swap transactions are documented. Regulations require the types of collateral that can be taken (and with what "haircuts"), and swap dealers face extensive requirements as to how much collateral they must obtain when entering into OTC trades. Although these requirements may not apply in trades with exempt commercial end users, dealers may attempt to impose them as "best practices." End users (such as portfolio companies) also must make additional representations to their swap dealers, requiring more recordkeeping and due diligence. While there have been efforts toward standardization of documents, such as the International Swaps and Derivatives Association (ISDA) "protocol" that can be entered into by end users and dealers to supply required representations and information needed by dealers for compliance with U.S. Commodity Futures Trading Commission Business Conduct Rules, such measures have yet to be widely implemented. We are continuing to monitor best practices on behalf of our clients and friends in the private equity community.

OF INTEREST

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- McDermott Advises JWC Acquisition SPAC on $500 Million Business Combination with The Tile Shop
- Life Sciences Private Equity Dealmaking Symposium, Chicago, October 10
- Healthcare Private Equity Symposium, Miami, March 20-21

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