



# Private Equity Alert

## Special Edition July 28, 2009

### Weil News

- Chambers recommended 9 of our private equity partners in its National rankings in the *2009 Chambers USA Guide to Leading Business Lawyers*, including David Duffell, Doug Warner, Glenn West and James Westra in the category of Private Equity Buyouts, Shukie Grossman, Jonathon Soler, Jeffrey Tabak and Barry Wolf in the category of Private Equity Fund Formation and Joe Basile in the category of Hedge Funds
- Chambers also recommended 5 of our private equity partners in its Massachusetts rankings in the *2009 Chambers USA Guide to Leading Business Lawyers*, including Marilyn French, Steve Peck, Kevin Sullivan and James Westra in the category of Private Equity Buyouts and David Kreisler in the category of Private Equity Fund Formation
- Chambers also recommended 3 of our private equity partners in the Texas rankings in the *2009 Chambers USA Guide to Leading Business Lawyers*, including Mike Saslaw, Jay Tabor and Glenn West in the category of Corporate/M&A.
- Weil Gotshal advised HM Capital in connection with its acquisition of an interest in Earthbound Farms
- Weil Gotshal advised Showtime Arabia and its parent Kipco Group in connection with its merger with Orbit Group, creating the leading pay-TV platform in the Middle East and North Africa
- Weil Gotshal advised OMERS Private Equity in connection with its proposed acquisition of railroad track and maintenance equipment manufacturer Nordco

## Proposed Tax Legislation May Affect Taxation of Profits Interests Issued to Management—Preemptive Action May Be Appropriate

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Granting “profits interests” in a limited liability company (“LLC”)<sup>1</sup> that wholly owns a corporate portfolio company has been a popular alternative to the issuance of corporate stock options that has been used by private equity funds to compensate the management teams of their acquired corporate portfolio companies. A profits interest is an equity interest in an LLC that entitles the holder to share in future appreciation of the LLC. This article discusses proposed legislative changes to the tax treatment of such profits interests and the adverse consequences this legislation could have to management.

Private equity funds have used LLCs to acquire corporate portfolio companies and have had the LLCs issue profits interests to management as equity compensation. The use of LLC profits interests as executive compensation has been popular among management as an alternative to the receipt of corporate stock options because profits interests, in general, are not taxable upon receipt and may give rise to preferential long-term capital gains upon disposition, while stock options give rise to ordinary income. This structure has imbedded within it a tax cost – the inability of the portfolio company to claim any tax deduction for the appreciation in value of the profits interest or profits paid to the executive.

Although the receipt of a corporate stock option in a private equity transaction is also not taxable to the recipient, the holder of a corporate stock option will have compensation income, taxable at ordinary income rates, upon the exercise of the stock option in an amount equal to the “spread” between the fair market value of the stock underlying the option and the option’s exercise price, and the employer will receive a corresponding tax deduction.

Legislation that initially had targeted only the preferential long-term capital gains tax treatment of “carried interests” and similar interests issued to private equity and other similar investment professionals has been much talked about, including in the July 2007 issue of the *Private Equity Alert*. On April 2, 2009, Representative Sander Levin (D-Mich.) introduced H.R. 1935 (the “Proposed Legislation”), which expanded on prior legislative proposals directed at the taxation of carried interests and has the potential to impact a variety of other arrangements. The Proposed Legislation would treat as ordinary income, net income with respect to an “investment services partnership interest.” In addition, such income would be included in the calculation of the holder’s self-employment tax.

An investment services partnership interest is defined very broadly and, depending upon the nature of the services provided, may include, in addition to carried interests typically held by private equity and other similar investment professionals, the typical profits interest issued to management in an LLC that owns stock of a corporate portfolio company. More recently, in May 2009, the Treasury Department issued its General Explanation of the Administration's Revenue Proposals, which describes the Administration's Fiscal Year 2010 budget proposals (the "Obama Proposal"). Although the General Explanation provided very little detail, the Obama Proposal would subject a profits interest recipient's share of income in respect of a "services partnership interest" to tax as ordinary income regardless of the character of the income of the LLC. A services partnership interest is defined as a carried interest held by a person who provides services to the partnership, without regard to the nature of the services provided.

Notably, the Proposed Legislation would tax all dispositions of an investment services partnership interest at ordinary income tax rates, even if the disposition transaction otherwise would be nontaxable. For example, ordinarily the incorporation or liquidation of an LLC in connection with an IPO, two commonly used methods to take a portfolio company public, would be a nontaxable transaction. Under the Proposed Legislation, effecting an IPO using either of these methods would produce taxable income to holders of the transferred or liquidated investment services partnership interests, even though the holders may not receive any cash in the IPO.

If the Proposed Legislation were enacted or if it were expanded to include the Obama Proposal, it could subject all of a portfolio company's management's gains in the LLC profits interests that they currently hold to tax at ordinary income rates. For example, assume that in 2006 (*i.e.*, long before the effective date of the Proposed Legislation), a private equity sponsor contributed \$100 million to an LLC for the LLC to

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acquire a corporate target. In connection with the transaction, the LLC issued to management profits interests entitling them to 10% of the profits of the LLC as equity compensation. Assume further that by the effective date of the Proposed Legislation, the value of the corporation had appreciated to \$200 million. If, after the effective date of the Proposed Legislation, the LLC were to incorporate in connection with an IPO at a valuation of \$200 million, the \$10 million of built-in gain attributable to the profits interests would be taxable to the profits interest holders at ordinary income tax rates (and would be included in their calculation of their self-employment tax) even though such gain would have been attributable to portfolio company

appreciation for periods prior to the effective date of the Proposed Legislation. This taxable gain would represent "phantom income" since the holders most likely would not receive any cash in such transaction with which to pay any resulting tax.

In view of these consequences, it may be desirable for the owners of these types of LLCs to consider the possibility of restructuring prior to the effective date of the Proposed Legislation (or any other legislation that may change the tax treatment of profits interests). Although the effective date of the Proposed Legislation presumably would be the date of its enactment, and the Obama Proposal only would be effective for tax years beginning after December 31, 2010, in the current revenue raising environment it is conceivable that, if enacted, a bill may be effective retroactive to as early as its introduction in Congress. For this reason, LLC owners considering the possibility of restructuring should begin exploring the alternatives with their advisors expeditiously.

The opportunities available for private equity portfolio companies and their management to benefit from restructuring will vary depending upon their particular circumstances. If you wish to discuss the opportunities, if any, available under your particular circumstances, please contact Michael Nissan ([michael.nissan@weil.com](mailto:michael.nissan@weil.com) or 212-310-8169) or Martin Pollack ([martin.pollack@weil.com](mailto:martin.pollack@weil.com) or 212-310-8461) or your Weil Gotshal relationship partner.

<sup>1</sup> The federal income tax treatment of a profits interest issued by an LLC that is taxable as a partnership for US federal income tax purposes is identical to that of a profits interest issued by a partnership.

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