RECONSIDERING PRIVATE EQUITY AND VENTURE CAPITAL INVESTMENTS IN LLC PORTFOLIO COMPANIES By: Warren P. Kean*

Private equity and, to a lesser extent, venture capital firms have become increasingly comfortable with investing in portfolio companies that are organized as flow-through tax entities, such as limited liability companies ("LLCs"). The principal reason for this is that LLCs and other entities that are treated as partnerships for tax purposes can enhance the returns and the timing of returns for investors.

LLCs are not subject to federal income taxes and generally are not subject to state income taxes. Instead, the owners are taxed on their respective shares of the LLC's taxable income. As a result, cash that a portfolio company would otherwise use to pay company-level income taxes may be used to deleverage or may be distributed to the company's owners (whether as tax or regular distributions), with a favorable effect on their IRRs. In addition, because distributions from an LLC usually may be made tax free, LLCs are preferable to corporations for recapitalizing a portfolio company with debt, a distinguishing characteristic of LLCs that will become increasingly meaningful as credit markets thaw and become more robust.

Because an LLC portfolio company generally is not subject to U.S. income taxes and because LLCs generally are governed by contract, there is much more flexibility in the manner in which transactions involving these companies may be structured or restructured to adapt to changes and other developments in the business, legal, regulatory, tax, and financial landscapes. For example, unlike shareholders of a corporation that must sell stock to avoid two levels of income tax, members of an LLC generally are indifferent, from a federal income tax perspective, to whether they sell their ownership interests in the company or the company sells its assets. In addition, a tax election is available to allow the buyer of ownership interests in an LLC to receive substantially the same tax treatment had the buyer purchased assets.

As a result, the buyer of an LLC portfolio company generally is able to "step-up" the tax basis of the company's assets to correspond with the purchase price that it pays for the company. This step-up in tax basis usually generates tax deductions, typically over a 15-year period for intangible assets such as goodwill, thereby lowering the buyer's income tax liability and allowing the cash savings to be employed by the buyer for other purposes. This enhanced cash flow for a buyer then may be (and usually is) emphasized in connection with the auction or other sale of the portfolio company to support a higher sales price (often in the range of a half or full turn of EBITDA).

An LLC also yields a better result than a corporation in connection with a failed investment. Losses from an LLC portfolio company usually may be deducted sooner than losses relating to an investment in a corporation. Those losses also may be deducted as ordinary losses, allowing for a 35% federal income, after-tax recovery. In the corporate context, investors typically realize capital losses that, generally speaking, may only be used to reduce their capital gains, and for individuals allow only a 15% federal income, after-tax recovery. Because capital losses generally may be used only to offset capital gains, an investor often must carry them forward for one or more years until the investor recognizes sufficient capital gains to absorb those losses. Moreover, corporate investors have a limited recovery period. They can only carry capital losses back three years and forward five years, otherwise they will expire unused.

Founders and managers who receive a significant part of their compensation in the form of equity incentives often prefer to have portfolio companies organized as LLCs or be organized under an LLC holding company. Using an LLC allows members of management to receive “profits interests” that are taxed more favorably (to both the portfolio company and the executives) than their corporate counterparts (such as stock options and restricted stock). In addition, LLC portfolio companies generally facilitate the founders’ ability to roll over all or part of their ownership interests in their company into a new platform tax free (particularly in connection with roll ups) and to realize the other tax and economic benefits described above.

LLCs have certain disadvantages and shortcomings. The principal disadvantages include (1) tax-exempt investors being subject to tax (unrelated business taxable income tax or UBTI) on their direct or indirect, through tiers of flow-through entities, investment in LLCs; (2) foreign investors having to file U.S. income tax returns and pay U.S. income taxes; (3) investors having to pay state income taxes for the states in which the portfolio company conducts business; (4) the need to convert to a corporation to access the public equity markets; (5) the inability to merge into or otherwise exchange membership interests in an LLC for stock in an acquiring corporation tax free; and (6) the delays LLC structures tend to cause investors in filing their own tax returns. The flexibility of LLCs, however, allows procedures, structures, and techniques to be employed to minimize or eliminate the objectionable aspects of their tax treatment. Being able to structure around those disadvantages, while retaining their advantages, is what makes investing in LLC portfolio companies appealing.

* This article is a digest of a paper that is to be published by Practising Law Institute in two sets of course handbooks: (i) Tax Strategies for Corporate Acquisitions, Spin-offs, Joint Ventures, Financings, Reorganizations & Restructurings, and (ii) Tax Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures and Other Strategic Alliances. A copy of the unabridged text may be obtained by contacting the author at warren.kean@klgates.com.

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