



**24th Annual
San Jose State University
High Technology Tax Institute**

**Selected Federal Tax and M&A
Developments**

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INTRODUCTION

- The last 12 months have seen relatively few significant technical developments in the federal tax area
- M&A activity in the technology sector, while down from 2007 levels, remained relatively strong in 2008
 - In the absence of a robust private financing or IPO market, the only available outlet for privately funded companies may be acquisition, typically by well-funded private companies or public companies

TOPICS

1. Federal Tax Update (Slides 3-8)
2. Section 409A Update (Slides 9-13)
3. M&A Scenarios (Slides 14-48)
 - Disposition of Subsidiary Stock-Proposed Section 336(e) Regulations
 - Tax-Free Spin offs in the High Technology Sector
PLR 200830005
 - Two-Step Mergers – Invitrogen/Applied Biosystems
 - Restricted Consideration in the Acquisition of a Private Company – Rev. Rul. 2007-49 and the Cap Gemini cases
 - Sale of Assets by Distressed Tech Company

BONUS DEPRECIATION ALTERNATIVE

- Housing Assistance Tax Act (PL 110-289; 7/30/08)
- Added §168(k)(4) for corporations that do not benefit from or prefer not to claim bonus depreciation
- Elect to accelerate AMT and research credit carryforwards from years beg before 1/1/06
 - No bonus depreciation may be claimed
 - Must use SL on eligible property for regular tax and AMT
 - Accelerated credit amount treated as refundable
- Add'l guidance – Rev. Proc. 2008-65 (10/14/08)

§§ 195, 248 AND 709 GUIDANCE

- Prop, Temp and Final regs
- Deemed election
 - Simplification!
- If prefer to capitalize, make election to do so
- Clarifies what is a change in method if miss an amount or err on when business begins
- For amounts paid or incurred after 9/8/08

ISO/AMT/MTC RELIEF

- Tax Extenders and AMT Relief Act of 2008 (P.L. 110-343, 10/3/08)
- §53(e) and (f)
- For individuals who exercised ISOs, large AMT liabilities, large MTCs they may never be able to use, and stock tanked
- Relief for AMT owed for TY ending before 2008
- Accelerate the MTC

INDEPENDENT CONTRACTOR STATUS

- There are 3 bills pending in Congress to modify the safe harbor of worker classification which was enacted as Section 530 of the Revenue Reconciliation Act of 1978
- H.R. 5804, S. 2044 and H.R. 6111
- In general, these proposal would make it more difficult to rely on the Section 530 safe harbor

CSX Corp. v. US

- 2008 US Court of Appeals for the Federal Circuit decision held that payments during a reduction in force are subject to FICA taxes (i.e., denying CSX's claim that they were supplemental unemployment benefit payments)
- It is expected that CSX will not appeal the decision
- Apparently the IRS is dealing with 50,000 claims from other employers on this issue – all of which the IRS will apparently deny
- Query: could modifications to the program result in the payments qualifying as non-FICA taxable supplemental unemployment benefit payments?

PUBLICLY TRADED COMPANIES AND SECTION 83(b) ELECTIONS

- In the old days, publicly traded companies did not sell unvested stock to employees at anything close to the fair market value of the stock
- In the old days, the conventional wisdom was that employees receiving unvested publicly traded stock for “free” should not file a Section 83(b) election
- Note Cypress Semiconductor’s tender offer dated August 22, 2008 to allow employees holding RSUs to exchange them for restricted stock for the express purpose of allowing them to file a Section 83(b) election and thereby “accelerate the measurement and recognition of your taxes”

SECTION 409A

- Fewer significant developments in 2008 than prior years
 - Documentary compliance required by 12/31/08 (Notice 2007-86 (October 22, 2007))
 - ▶ Must be reduced to writing
 - ▶ For amendments requiring Compensation Committee approval, the effective deadline may be earlier than 12/31/2008
 - ▶ Hope for a further extension of the deadline is fading
 - Transitional rules permitting amendments to deferred compensation plans to modify deferral timing (subject to the “anti-push-out, pull-in” rule) expires 12/31/08

SECTION 409A

- **Fewer significant developments in 2008 than prior years (continued)**
 - **New rules for off-shore companies who are not US taxpayers**
 - **W-2 Box 12 reporting requirements**
 - ▶ **Code Y reporting for 2008 W-2's will likely be delayed**
 - ▶ **Code Z reporting for 2008 W-2's will likely be required**
 - **Proposed regulations on how to calculate Section 409A taxes are expected “in the relatively near future”**
 - **Notice 2007-100 corrections program for unintentional 409A operating failures**
 - **Discounted options (other than options granted to certain Section 16ers) can be “fixed” (i.e., cured of their 409A potential taint) through 12/31/08**

TREATMENT OF POTENTIALLY DISCOUNTED OPTIONS

- **FACT PATTERN:** Assume that you are negotiating to acquire a privately held company. The target has been regularly granting options that are supposed to be incentive stock options; however, you are worried that the options are discounted (i.e., have an exercise price that is less than the value of the stock on the date the option was granted). The acquisition will not close until after 12/31/2008. What are your choices?

TREATMENT OF POTENTIALLY DISCOUNTED OPTIONS

- If it is still 2008:
 - Have the target upward reprice the options to have an exercise price that is not discounted. The target could promise a bonus payable in 2009 to compensate for the increased exercise price. Decide whether or not to treat the options as ISO. Otherwise proceed as if the options are not discounted.
 - Have the target amend the options to be exercisable only in connection with a change in control (as defined in Section 409A) or separation from service. Cash out the options at the closing.

TREATMENT OF POTENTIALLY DISCOUNTED OPTIONS

- It is after 12/31/2008:
 - Do not assume or cash out the options. Insist that the options be exercised pre-closing with an extended indemnification for failure to withhold. Grant new at-the-money options.
 - Cash out the options at the closing. Apply normal withholding to the cash-out payments. Grant new at-the-money options.
 - Rollover the options using a 409A compliant but not a 424 compliant exchange ratio. The rolled over option will be an NSO. Grant new at-the-money options to reload the lost shares.
 - Rollover the options using a 409A and 424 compliant exchange ratio. Treat the options as ISOs.

TAXABLE DISTRIBUTION OF SUBSIDIARY STOCK

- Technology companies that are not able to take advantage of Section 355 may elect to distribute the stock of a subsidiary (“Sub”) in a taxable transaction
- Under Section 311(b), gain, but not loss, is recognized by the distributing corporation
- In the absence of some cumbersome corporate gymnastics there is no step-up in the basis of Sub’s assets even though gain is recognized at the corporate level
- Techniques to create a basis step-up under current law include purposely failing Section 351 or distributing interests in a single member LLC

TAXABLE DISTRIBUTION OF SUBSIDIARY STOCK SECTION 336(e)

- Section 336(e) was added to the Code in 1986 and provides:

“(e) Certain Stock Sales and Distributions May Be Treated as Asset Transfers.—Under regulations prescribed by the Secretary, if—

(1) a corporation owns stock in another corporation meeting the requirements of section 1504(a)(2), and

(2) such corporation sells, exchanges, or distributes all of such stock,

an election may be made to treat such sale, exchange, or distribution as a disposition of all of the assets of such other corporation, and no gain or loss shall be recognized on the sale, exchange, or distribution of such stock.”

PROPOSED SECTION 336(e) REGULATIONS

- In August 2008, the IRS proposed regulations implementing Section 336(e) of the Code.
- The proposed regulations describe the circumstances under which a sale, exchange or distribution of the stock of a subsidiary by its parent may be treated as an asset sale
- As a general matter, the proposed regulations provide that “the results of a section 336(e) election should coincide with a Section 338(h)(10) election”
- The election may only be made where a Section 338 election is not available

PROPOSED SECTION 336(e) REGULATIONS – Continued

- The proposed regulations currently apply Section 336(e) only to domestic corporations disposing of stock in domestic subsidiaries
- A “disposition” means, any sale, exchange or distribution (e.g. under Section 301), of stock of a domestic corporation and can include a tax-free spin-off that becomes taxable under Section 355(d)(2) or (e)(2)
- A “qualified stock disposition” means any disposition of stock constituting Section 1504(a)(2) control by a domestic corporation over a 12-month disposition period, but does not include a disposition that would constitute a “qualified stock purchase” under Section 338
- Unlike under Section 338, the acquiror need not be a corporation and there may be multiple unrelated acquirors of the stock

PROPOSED SECTION 336(e) REGULATIONS – Continued

- The Section 336(e) election is, unlike a Section 338(h)(10) election, a unilateral election by the disposing corporation
- The basic effect of the election is to treat the qualified stock disposition as a sale of assets by “old target” to an unrelated person in exchange for the Aggregate Deemed Asset Disposition Price
 - All gain is recognized by old target, subject to the installment sale rules
 - Loss is recognized on assets to the extent of the stock sold or exchanged, but not distributed, although the IRS has indicated that losses may be available in a Section 331/336 liquidating distribution where loss would otherwise be recognized
- New Target is then treated as having purchased all of its assets from an unrelated party at the close of the disposition date
- Old Target is deemed, after the sale, to distribute all of its assets to the disposing corporation, in most cases in a liquidation described in Section 332

OTHER APPLICATIONS OF SECTION 336(e)

- May be used in connection with purchase of Sub by an unincorporated entity, e.g., an LLC
 - Section 338 requires a corporate purchaser
- Allows for a step-up in the case of spin-off that is taxable at the corporate level under Section 355(d) or (e)
 - Note that the proposed regulations allow for “protective elections,” Section 1.336-2(i)
- Also may have adverse consequences to acquirors, e.g., an election may result in a “step-down” in asset bases
 - Should be reflected in transaction document where relevant

EFFECTIVE DATE OF SECTION 336(e)

- The preamble to the proposed regulations indicates that the regulations when finalized will be the exclusive means by which an election may be made under Section 336(e)
- At least one comment has been submitted arguing that Section 336(e) has been available since enactment and is by its terms applicable in the case of foreign sellers and targets. See Letter from J. Fuller & A. Dranginis, 2008 TNT 195-23 (Sept. 24, 2008)
- In general, the IRS has been very inconsistent in its application of statutory provisions that contemplate further regulatory direction, e.g., on the fundamental question of whether such provisions operate in the absence of such direction

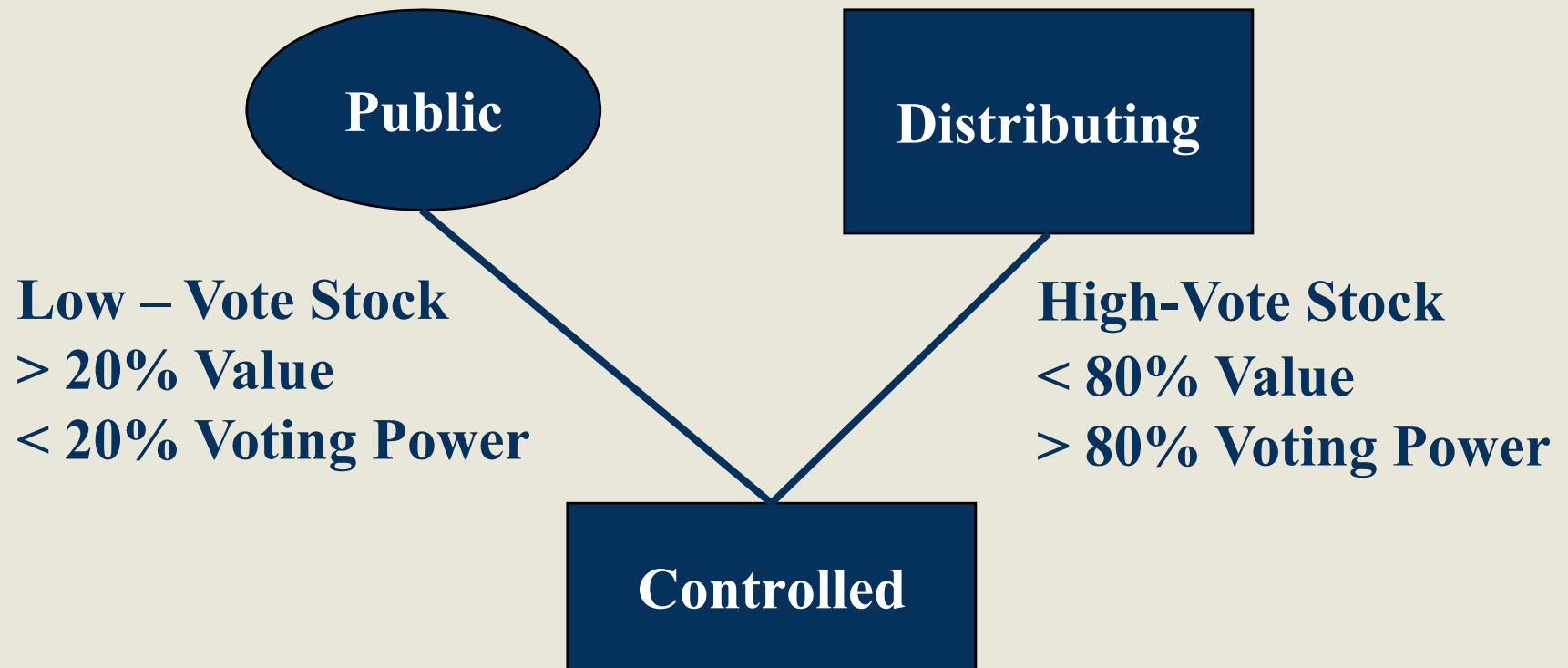
SECTION 355 SPIN-OFFS IN THE HIGH-TECH SECTOR

- Silicon Valley has seen some high-profile spin-offs under Section 355
- Tech spin-offs over the past decade include H-P/Agilent, 3-Com/Palm, Adaptec/Roxio, and most recently Applera's spin-off of Celera and Cypress Semiconductor's spin-off of SunPower Corporation
- The technical requirements of Section 355 can be a roadblock

SECTION 355 SPIN-OFFS IN THE HIGH-TECH SECTOR - Continued

- There are significant hurdles under Section 355
- The five-year active business test may be difficult to meet, particularly for companies in the medical device/biotech fields
 - Treas. Reg. Section 1.355-3(b)(2)(ii) requires that an active business “ordinarily must include the collection of income and the payment of expenses”
 - Five years of income is often a limiting factor
- Uncertainty has existed as to how to meet five-year trade or business where a company has grown by acquisition
- May be difficult to meet “control” test where large employee or venture fund ownership of controlled subsidiary

PLR 200830005*



*Ruling may relate to Cypress Semiconductor’s spin-off of SunPower Corporation – See R. Willens “Expansion Doctrine May Have Facilitated Spinoff of SunPower” *Tax Notes* 1341 (Sept. 29, 2008)

FACTS OF PLR 200830005

1. Distributing acquired voting control of Controlled within previous five years
2. Distributing acquired additional stock in Controlled in exchange for cash and contribution of debt
3. Controlled went public and Distributing held less than 80% of Distributing stock by value at the time of the ruling, but more than 80% of the voting power of Controlled thus satisfying Section 368(c) control test

IRS RULING ON TRADE OR BUSINESS

- Acquisition of voting control by Distributing did not cause five-year active business clock to restart regardless of whether transaction was taxable – likely application of expansion doctrine
 - PLR contained several representations regarding the similarity of the products and manufacturing processes of Distributing and Controlled
- Ruling applied the expansion doctrine in the case of an indirect acquisition of a trade or business in the same line of business, i.e., the acquisition of a subsidiary.
Reg. Section 1.355-3(b)(3)(ii)
 - The Proposed Regulations clarify this concept further by explicitly applying the expansion doctrine to the acquisition of a subsidiary by a SAG
 - Potential conflict arises between expansion doctrine and tainted stock rule of Section 355(a)(3)(B)
- More generally, liberal application of the “expansion” doctrine could smooth the path for other high-tech spin offs

TWO-STEP MERGERS INVITROGEN/APPLIED BIOSYSTEMS

- Many high-tech acquisitions are completed under the two-step format described in Rev. Rul. 2001-46, i.e., a stock acquisition through a reverse triangular merger followed by a forward merger
 - The second step merger is often into an LLC
- Typically invoked when the stock/cash mix does not permit a tax-free reverse triangular merger and there exists some potential uncertainty about the qualification of a single step forward merger, e.g., because of issues related to “continuity of interest”

TWO-STEP MERGERS

INVITROGEN/APPLIED BIOSYSTEMS - Continued

- A recent example is Invitrogen's acquisition of Applied Biosystems
- Originally structured as a cash and stock forward merger into an LLC, with tax opinions a condition to closing of the merger
 - A taxable forward merger is treated as an asset sale under Rev. Rul. 69-6
- At the time of the merger agreement the value of the stock component easily met the continuity of interest test
- The price of Invitrogen has dropped so that the parties apparently believe the continuity of interest test may not be met and tax opinions not forthcoming
 - The parties were apparently unable to rely on the “signing date” rule of Treas. Reg. Section 1.368-IT(e)(2) since the merger agreement contained a measure of price protection for the Applied stockholders
- On the eve of closing, the parties amended the merger agreement to provide for a two-step merger and to eliminate the condition that the merger be tax-free to the stockholders while continuing to be tax-free to Applied and Invitrogen
- The public filings also contain a risk factor that the merger may cause the prior spin-off of Celera by Applied Biosystems to be taxable under Section 355(e)

TWO-STEP MERGERS

INVITROGEN/APPLIED BIOSYSTEMS - Continued

- In Rev. Rul. 2008-25, the IRS clarified that if the second step of an integrated two-step transaction is a liquidation rather than a merger the transaction must be tested under Section 368(a)(1)(C) to determine reorganization status
- Since the transaction as a whole failed to qualify as a reorganization, Rev. Rul. 90-95 was applied to treat the first step as a qualified stock purchase followed by a tax-free liquidation
- Rev. Rul. 2008-25 clarifies (if clarification was needed) that a two-step failing as a reorganization will not result in corporate tax under Rev. Rul. 69-6, or other step transaction principles, thus the basis for the opinion to Applied re no corporate tax

SALE OF PRIVATE COMPANY EMPLOYMENT-BASED RESTRICTIONS – REV. RUL. 2007-49 AND THE CAP GEMINI CASES

- A significant majority of private company sales take the form of acquisitions of stock, either taxable or non-taxable
- It is not unusual for a portion of the consideration otherwise payable to common stockholders to be linked to continued employment whether or not the existing stock is already vested
- The characterization for tax purposes of these arrangements as compensatory or as capital can be uncertain

EMPLOYMENT-BASED RESTRICTIONS REV. RUL. 2007-49

- In 2007, the IRS published Rev. Rul. 2007-49, addressing the tax treatment of certain common scenarios
- The Ruling considers three distinct scenarios:
 - Situation 1 – Revesting of vested stock in single corporation
 - Situation 2 – The exchange of vested stock for unvested stock of an acquiror in an acquisitive “reorganization”
 - Situation 3 – The exchange of vested stock for unvested stock of an acquiror in a taxable acquisition
- In each of Situations 2 and 3, the value of the stock exchanged is presumed to be equal to the value of the stock received

EMPLOYMENT-BASED RESTRICTIONS

REV. RUL. 2007-49

- Situation 1 – No Section 83 “transfer” has occurred so the imposition of vesting has no tax effect under Section 83. A Section 83(b) election is not required to avoid future compensation income
- Situation 2 – A “transfer” has occurred under Section 83. Since the exchange was an otherwise tax-free exchange no gain is recognized on the relinquishment of the vested stock. A Section 83(b) election is required to avoid compensation income on any future appreciation
- Situation 3 – A “transfer” has occurred and capital gain is recognized on the receipt of the acquiror stock. A Section 83(b) election is required to avoid compensation income on any future appreciation
- In PLR 200828016, the IRS applied Rev. Rul. 2007-49 in the context of the revesting of vested stock in a corporation undergoing an “F” reorganization
 - The IRS ruled consistent with Situation 1 that no transfer had occurred; accordingly no Section 83(b) necessary to avoid compensation income on any future appreciation

EMPLOYMENT-BASED RESTRICTIONS

REV. RUL. 2007-49

- Rev. Rul 2007-49 provides relatively clear results where the shareholder receives stock and the value of the consideration paid, i.e., the target stock exchanged, is known. However, the facts are often not that clear
- Rev. Rul. 2007-49 also does not come into play where no “property” has been transferred other than rights under an arrangement to pay consideration in the future, i.e, an installment sale
- Stockholders, of course, seeking capital gain argue that a value for value exchange has occurred, in some variation of Situation 3 of Rev. Rul. 2007-49
- The purchasing corporation may prefer to assert that the restricted portion is deductible compensation
- Accepting stockholder’s position may expose employer to failure to withhold penalties
- The accounting treatment seems to be usually to require any amounts tied to future employment in any way to be treated as compensatory

EMPLOYMENT-BASED RESTRICTIONS – FACTUAL ANALYSIS

- The determination of whether the receipt of consideration should be taxed as compensatory or as capital gain is essentially a factual question, with the following factors often coming into play.
- The greater the percentage of equity holders not subject to employment-based restrictions, the stronger the argument for capital gain
- The nature of the restrictions is relevant. Under most agreements, the restrictions are lifted upon:
 - Death or disability
 - Termination without “cause”
 - Voluntary termination with “good reason”
- Query whether these types of restrictions really indicate a compensatory arrangement
- The presence or absence of other market level compensation is a significant factor
- The treatment of the forfeited consideration, i.e., is it returned to the buyer or recycled to the other sellers?

EMPLOYMENT-BASED RESTRICTIONS – THE CAP GEMINI CASES

- A series of District Court cases have been decided in the last year or so involving certain tax aspects of the sale of the Ernst & Young consulting business to Cap Gemini in 2000.
- In the transaction, the E&Y consulting partners received shares of Cap Gemini in connection with a taxable sale of their interests in the consulting partnership:
 - 25% of the shares received were unrestricted and sold at closing to pay taxes
 - 75% of the shares received were “vested” immediately but were subject to a “liquidated damages” provision of the purchase agreement requiring the return of the shares upon the selling partner’s termination of employment for cause, voluntary termination without good reason or violation of their non-compete
- The record indicates that E&Y adopted the “liquidated damages” approach rather than more conventional “vesting” to avoid what was felt to be a greater risk that the restricted stock was a compensatory payment rather than payment for the partnership interests

EMPLOYMENT-BASED RESTRICTIONS – THE CAP GEMINI CASES - Continued

- All of the shares, then at the height of Cap Gemini's value were reported as currently taxable capital gain
- The facts are thus very similar to those of Situation 3 in Rev. Rul. 2007-49, although there is no mention in the cases of the potential application of Section 83 to the transaction and apparently no Section 83(b) elections were filed
 - Query whether the reporting of the transaction would be affected by the analysis of Rev. Rul. 2007-49?
- The value of the Cap Gemini stock declined precipitously, leaving the consulting partners with capital losses

EMPLOYMENT-BASED RESTRICTIONS – THE CAP GEMINI CASES - Continued

- In response to their predicament, some of the consulting partners sought to disavow their earlier treatment and report the transaction as a transfer of unvested property for services under Section 83
- According to one case, there were at one time over 200 matters in serious stages of audit or litigation involving former Ernst & Young consulting partners
- Beginning with U.S. v. Culp, 2007-1 USTC ¶50,399 (M.D. Tenn 2008), at least four District Court cases have held that the consulting partners were bound by (i) the characterization of the transaction, i.e., currently taxable capital gain, set forth in the transaction documents, and (ii) as the agreed-upon value, i.e., 95% of the Cap Gemini market price. See, e.g., U.S. v. Bergbauer, 2008-2 USTC ¶—(D. Md. 2008)

EMPLOYMENT-BASED RESTRICTIONS THE CAP GEMINI CASES – Continued

- The cases do not address the factual issues relevant to the capital gain analysis, but instead have been decided on the basis that the parties were bound by their own form. As the Court in U.S. v. Fletcher 2008-1 USTC ¶____ (N.D. Ill. 2008) stated:

“As discussed above, the undisputed facts show that the parties intended the stock to be treated as income to the ACPs in 2000 and reported the transaction to the IRS in that manner. Invalidating that provision would: amount to a unilateral reformation of the contract in defendant’s favor; deprive Cap Gemini of the tax consequences that it anticipated and for which it bargained; force the government to engage in litigation to collect the taxes due on the transaction; and expose the government to the risk of inconsistent adjudications and, thus, a loss of tax revenues. Given those undisputed facts and compelling policy considerations, the Restatement would also not permit Cynthia to go back on her agreement.”
- The issue is thus treated as an allocation of consideration, which is usually, respected by the courts, at least where the parties have adverse interests

REV. RUL. 2007-49 UNANSWERED COLLATERAL QUESTIONS

- Situation 2 – In a reorganization, how are the continuity of stockholder interest requirement (COSI) or the 368(a)(2)(E) control test applied?
- Situation 3 – In a taxable transaction, what is the timing and gain recognition?
 - If a Section 83(b) election is filed for the new stock?
 - If a Section 83(b) election is not filed for the new stock?

**CHANGE THE FACTS OF REV. RUL. 2007-49 – ASSUME
THE TARGET STOCK IS UNVESTED AT CLOSING AND THE
NEW STOCK HAS THE SAME VESTING CONDITIONS**

- Situation 2 – In a tax-free reorganization, what is the effect of Section 83(g)?
 - If a Section 83(b) election was not filed for the target stock, Section 83(g) clearly applies and no Section 83(b) election is permitted (i.e., Rev. Rul. 2007-49 does not apply)
 - If a Section 83(b) election was filed for the target stock, a new Section 83(b) should not be required; however, a cautious taxpayer will file a new Section 83(b) election (i.e., treat the transaction as if Rev. Rul. 2007-49 applied)

CHANGE THE FACTS OF REV. RUL. 2007-49 – ASSUME THE TARGET STOCK IS UNVESTED AT CLOSING AND THE NEW STOCK HAS THE SAME VESTING CONDITIONS

- Situation 3 – In a taxable transaction, what is the application of Rev. Rul. 2007-49?
 - If a Section 83(b) election was not filed for the target stock, the results are unclear:
 - ▶ Perhaps principles similar to Section 83(g) apply and no Section 83(b) election is permitted
 - ▶ Perhaps the exchange of unvested stock for different unvested stock is treated as a compensatory disposition of target stock and the acquisition of the new stock such that a Section 83(b) election is permitted for the new unvested stock
 - If a Section 83(b) election was filed for the target stock, a new Section 83(b) should be permitted—(i.e., treat the transaction as if Rev. Rul. 2007-49 applied)

DISTRESSED VENTURE BACKED COMPANY ASSET SALE

- Many sales by distressed technology companies are taking the form of taxable asset sales
- Working assumption is that existing net operating losses will far exceed the gain recognized on the sale
- These transactions present numerous potential pitfalls that must be addressed

DISTRESSED COMPANY ASSET SALE – FACTS

- TechCo is a private company
- Investors have invested \$50M in TechCo and own 75% of TechCo on an as converted basis; the common stockholders own the other 25%
- PublicCo is willing to purchase TechCo's assets for \$20M upfront and a contingent, deferred payment obligation ("DPO") with a maximum payment of \$40M
- TechCo has \$50M in NOL carryforwards and 0 basis in its assets

PRIVATE COMPANY ASSET SALE – CORPORATE IMPACT

- TechCo's tax cost must be assessed in light of potential limitations under IRC Section 382
- TechCo must determine useability of NOL's under Section 382, not an easy or definitive process in a private company with multiple financings involving different classes of stock
- If TechCo has had fluctuating valuations over multiple financings the impact of Section 382 may be especially difficult to gauge and the "built-in" gain rules may not come to the rescue
- Even if federal NOL is completely useable some AMT will be due

PRIVATE COMPANY ASSET SALE – CORPORATE IMPACT – Continued

SUSPENSION OF CALIFORNIA NOLs

- California approved the 2009 Budget Act on September 30, 2008, which included Section 17276.9 to the Calif. R&TC providing that:
 - “[No net operating loss deduction shall be allowed for any taxable year beginning on or after January 1, 2008, and before January 1, 2010.]”
- The pre-2008 California NOLs not useable by reason of the new law are given an extended life
- The Budget Act also limits the use of California tax credits generally to 50% of the tax due
- The impact of the California suspension may be dramatic, resulting in tax on the upfront payment and, depending on their timing, the receipt of payments under the DPO

PRIVATE COMPANY ASSET SALE – INSTALLMENT SALE COMPLEXITY

- The DPO is an installment obligation for Section 453 purposes
- Section 453A imposes an interest charge on the tax deferred with respect to installment obligations over \$5 million
 - measurement of the “excess” installment obligation and interest charge is difficult in the case of contingent obligations like the DPO
 - the IRS has yet to write regulations under Section 453A addressing contingent obligations
 - California has applied Section 453A using the so-called fair market value method
- If the DPO were distributed pursuant to a plan of liquidation then the \$5 million threshold would be applied at the shareholder (and with respect to VC Funds looking through to the partner level)
- Distributing the DPO, however, triggers gain for federal and California purposes, which may be unsheltered by net operating losses, as described above

PRIVATE COMPANY SALE – SHAREHOLDER IMPACT

- Provided distributions occur following the adoption of a plan of liquidation, they should result in recovery of basis and then gain, if any
- If the DPO is distributed, shareholders will be able to report any resulting gain under the installment method, subject to potential basis recovery anomalies
 - Shareholders may want to elect out to avoid front-loading of gain on initial payout
- The \$5 million Section 453A threshold will be applied at the shareholder level, with a lookthrough for partnerships
- However, early liquidation may favor the preferred investors with their significant preference “overhang.” Query are there mechanisms available to preserve the potential for value to the common stockholders in the event the DPO payments ultimately exceed the preferred stockholders liquidation preferences?
 - Liquidating Trust
 - LLC

LLC/Partnership Alternative

- Prior to selling its assets, private company target transfers its assets to a partnership in exchange for 2 interests. The first interest (the “retained interest”) tracks the economics of the earnout. The second interest has all of the residual economics (the “residual interest”).
- Private company target then sells the residual interest for \$20 million and keeps the retained interest. The retained interest is:
 - Either kept inside the company until the end of the earnout period; or
 - Distributed to the stockholders

LLC/Partnership Alternative

- Potential advantages
 - Avoid the application of Section 453A
 - The buyer avoids the recognition of income followed by the earnout payments being added to the basis of the assets acquired
- Potential problems:
 - The retained interest might not be treated as an equity interest for tax purposes
 - Will Section 382(c) limitations on the NOL in the event the continuity of business requirement is not satisfied come into play if the retained interest is not immediately distributed to the stockholders?