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KIRKLANDPEN
Private Equity Newsletter

July 27, 2017

New Court Decision May Affect PE Fund Blocker Corporation Structures

PENpoints

As a result of a recent U.S. Tax Court decision, a private equity fund may consider using a non-U.S. (rather than a U.S.) blocker corporation to protect tax-sensitive investors from potential adverse tax effects of investing in a flow-through portfolio company.

Where a private equity fund invests in a flow-through (e.g., partnership or LLC) portfolio company engaged in a U.S. business, fund LPs which are non-U.S. persons/entities or are tax-exempt entities often hold their share of such fund investment through a "blocker corporation." This structure blocks:

- flow-through to a non-U.S. LP of income "effectively connected with a U.S. business" ("ECI"), and
- flow-through to a U.S. tax-exempt LP of "unrelated business taxable income" ("UBTI"),

either of which would otherwise be subject to U.S. tax if received directly by the LP.

General industry practice has long been to (i) organize a blocker corporation as a U.S. entity (either as a U.S. corporation or U.S. partnership/LLC electing to be taxed as a corporation) and (ii) endeavor to structure a fund's ultimate exit transaction as a sale of blocker corporation stock (rather than a sale of the blocker's ownership interest in the flow-through portfolio company) in order to avoid triggering blocker-corporation-level tax.

A non-U.S. blocker corporation has not generally been used in these circumstances for two reasons:

- a private equity fund's exit of its investment in a portfolio company through the sale of non-U.S. blocker corporation stock would be tax inefficient for most buyers (as compared to private equity fund's sale of U.S. blocker corporation stock), e.g., because of branch profits taxes on future operating income, and
- tax advisers have long been concerned (because of a 1991 IRS published position) that structuring the ultimate sale of a non-U.S. blocker corporation's ownership interest in the flow-through entity would be tax inefficient by subjecting to U.S. tax substantially all of the non-U.S. blocker corporation's gain from sale of its ownership in the U.S. flow-through portfolio company.

Recently, the U.S. Tax Court (in the *Grecian* case) disagreed with the 1991 IRS published position and concluded that a non-U.S. corporation was not liable for U.S. tax on capital gain derived from the sale of its equity interest in an LLC engaged in a U.S. business (except to the extent such gain was attributable to U.S. real property). As a result of this case, it may be advisable for a private equity fund to consider using a non-U.S. (rather than a U.S.) blocker corporation to protect tax-sensitive investors from the flow-through entity's ECI and UBTI, particularly where the fund anticipates that it will not be able to exit the investment via a sale of blocker corporation stock.

However, the decision whether to use a U.S. or a non-U.S. blocker corporation requires careful consideration of a number of other factors, including:

- possible incremental tax leakage as a result of non-U.S. blocker corporation being subject to U.S. "branch profits" tax,
- possible partial U.S. tax imposed on non-U.S. blocker corporation's sale of its flow-through portfolio company ownership interest on account of portfolio company's ownership of U.S. real estate assets and/or assets subject to depreciation recapture,
- risk that the private equity sponsor's U.S. presence and activities could be attributed to the blocker, producing a different tax result than was reached in the *Grecian* case, and
- risk that the *Grecian* decision could be reversed on appeal or by Congress.

INSIDE KIRKLANDPEN

Readers seeking a more detailed discussion of the *Grecian* decision and the related tax issues can access a longer version of this article by clicking here.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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PENbriefs

Google Hit With Record European Commission Fine

Last month, the European Commission (EC) fined Google €2.4 billion for abusing its dominance in the search engine market by favoring its own price comparison service in searches. Google, which has already noted its disagreement with the EC's analysis, has the right to appeal what is the largest-ever penalty against a single company by the EC. To learn more, see our recent *Alert*.

Increasing U.S., Global Scrutiny of Foreign Investment: Things to Watch

Recently, stakeholders on both sides of the Atlantic have voiced increasing skepticism and concern regarding the potential impact of foreign investment on national security. This global debate over balancing foreign investment and national security continues to affect the environment for cross-border transactions. To learn more, see our recent *Alert*.

EU Renews Sanctions and Restrictive Measures Targeting Russia

Recently, the European Union renewed territorial sanctions and restrictive measures in respect of Russia, Crimea and Sevastopol. These measures were originally introduced in 2014 following the annexation of Crimea and Sevastopol by Russia and the shooting down of a civilian airliner in eastern Ukraine. To learn more, see our recent *Alert*.

SEC Allows All Companies to File Confidential Draft IPO Registration Statements

The U.S. Securities and Exchange Commission (SEC) recently announced that all companies will be permitted to file a confidential draft registration statement for (1) IPOs, or (2) any other offering during the first 12 months after an IPO. Previously, only emerging growth companies (those with annual gross revenues of less than $1 billion during the most recent fiscal year) and certain foreign private issuers were allowed to submit confidential draft registration statements with the SEC. To learn more, see our recent *Alert.*

KirklandAIM Update

Recently in our *KirklandAIM* newsletter, which is directed toward Chief Compliance Officers and other compliance professionals, we discussed: the passage by the U.S. House of Representatives of the Financial CHOICE Act, which, if it became law, would replace much of the Dodd-Frank Act, including a repeal of the Volcker Rule and an exemption for private equity fund managers from registration and many reporting requirements of the Advisers Act (click here to access this edition of *KirklandAIM*); a U.S. Supreme Court decision limiting the SEC's disgorgement remedy to five years (click here to access this edition of *KirklandAIM*); and a recent cybersecurity alert issued by the SEC's Office of Compliance Inspections and Examinations (click here to access this edition of *KirklandAIM*).

PENnotes

PENews Conference Call Series

Kirkland regularly hosts short PENews conference calls covering topics most critical to private equity business professionals. Recent topics include "Selling a Minority Stake in a PE Sponsor — Trends and Opportunities" and "Block Trades and Bought Deals: Increasingly Common Path to Liquidity for PE Sponsors."

Kirkland Registered Adviser Seminar and CCO Summit
New York, NY, September 12, 2017
San Francisco, CA, October 11, 2017
Los Angeles, CA, October 17, 2017
Houston, TX, October 24, 2017

As the SEC continues its focus on private fund managers registered as investment advisers, firms must be familiar with the evolving regulatory environment. This seminar is designed specifically for private fund manager CCOs, general counsel and other senior executives. Seminar topics will include: market and fundraising developments; practical tips for private fund managers operating in today's regulated environment; SEC enforcement developments for private fund managers; and legislative and regulatory developments, among other topics. More information to follow.

PLI Hot Topics in Mergers & Acquisitions 2017
New York, NY, September 26, 2017
Chicago, IL, October 20, 2017

An expert faculty of lawyers, general counsel, regulators and investment bankers will explore the state of M&A and trends for the year ahead. Kirkland partners Scott Falk and Sarkis Jebejian are co-chairs of the event and will serve as panelists on the "Current Landscape of the M&A Market." Partner Sara Zablotney will be a panelist on "Important Tax Issues in M&A." Click here for more information.

PLI Understanding the Securities Laws 2017
Chicago, IL, September 27-28, 2017

This program will provide an overview and discussion of the basic aspects of the U.S. federal securities laws by in-house and law firm practitioners as well as SEC staff. Emphasis will be placed on the interplay among various regulations, as well as legislative and regulatory changes in the wake of the election. Kirkland partner Bradley Reed will be a panelist on "Regulation of Proxy Solicitations" at the Chicago event. Click here for more information.

Kirkland Structuring and Negotiating LBOs Seminar
San Francisco, CA, October 12, 2017
Chicago, IL, October 17, 2017
New York, NY, October 24, 2017

This biennial seminar will review the legal, tax, structuring and practical negotiating aspects of buyouts and other complex private equity deals. More information to follow.

9th Annual Womens' Alternative Investment Summit
New York, NY, November 2-3, 2017

The Women's Alternative Investment Summit will bring together more than 400 senior-level women across the broad spectrum of alternatives. Multisession tracks address the many asset classes, including private equity, venture capital, hedge funds, real estate, infrastructure and real assets investing. Kirkland partners Sarah Kirson and Erica Williams will be panelists, and the Firm is a sponsor of the event. Click here for more information.

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Kirkland & Ellis' nearly 500 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and fund formations on behalf of more than 400 private equity firms and hedge funds around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in each of the last six years by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. U.S. News Media Group and Best Lawyers have ranked Kirkland as a Tier 1 law firm for Leveraged Buyouts and Private Equity Law for seven consecutive years and as a top-tier firm for Private Funds/Hedge Funds Law since 2012. The Firm was recognized as the #1 law firm for private equity in the 2017 Vault 100 rankings, and, in 2016, Private Equity International named the Firm "Law Firm of the Year in North America: Fund Formation" for the third year in a row.

In 2012-2016, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011-2016*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite," having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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