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Passthrough Entities

John LeClaire and Jamie Hutchinson of Goodwin Procter write that facility and experience with passthrough entities are crucial qualifications for anyone who wants to succeed as an investor in growth companies. Unique issues and opportunities accompany investments in passthrough entities, the authors write, and a lack of familiarity with passthroughs can result in lost opportunities and even return-crushing structural botches.

Tackling Blockers: Using Passthroughs to Power Your Investment

BY JOHN LECLAIRE AND JAMIE HUTCHINSON

Many growth companies are organized as passthrough entities for tax purposes, most commonly as limited liability companies. Thus, facility and experience with LLCs and other tax-passthrough entities are crucial qualifications for anyone focused on growth companies.

Yet many investors, particularly those new to the growth sector and even experienced ones, lack knowledge of the unique issues and opportunities that accompany investments in passthrough entities. This lack of familiarity can result in lost opportunities and even return-crushing structural botches. This article aims to provide guidance through the relevant pitfalls and opportunities.

Passthroughs and C Corporations

The rise of LLCs and other passthroughs as a preferred form of organization for growth companies has been dramatic.[1] Circa 1980, the numbers of C corporation tax returns and tax returns of passthrough entities filed with the Internal Revenue Service annually were approximately equal, each averaging around two million. By 2009, the number of C corporation returns filed annually was still approximately two million, but returns filed by passthrough entities exceeded seven million.

The relative advantages and disadvantages of the passthrough form of organization is a topic beyond the scope of this article, but the increased use indicates that many entrepreneurs have concluded that the advantages of a passthrough outweigh the disadvantages.[2]

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[1] A passthrough is an entity that doesn't pay federal income taxes but rather allocates taxable income to its investors, who pay taxes directly on their allocated portion of income.

[2] Advantages of a passthrough structure include a single level of taxes on earnings, tax basis build-up from retained earnings, creation of tax benefits in connection with liquidity events, a more favorable format for tax-advantaged employee equity grants and greater overall flexibility, including with respect to governance, among others. Principal detriments include incremental complexity, potentially higher taxes on company earnings year to year, potential self-employment taxes on employee owners, complexities for some investors as described below and limits on exiting in a tax-free stock deal, among others.

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The preference of many entrepreneurs for the passthrough form of organization collides, however, with the tax requirements and preferences of many institutional investors. Under applicable tax rules, U.S. tax-exempt investors (mainly pension funds other than state plans, educational endowments and private foundations) recognize ''unrelated business taxable income'' (UBTI) if they invest directly in a passthrough.

Similarly, many non-U.S. investors realize income that is ''effectively connected with a U.S. trade or business'' (ECI) if they invest directly in a passthrough and thereby become subject to U.S. taxation. Accordingly, most tax-exempt and non-U.S. investors require fund sponsors to avoid recognizing UBTI or ECI.

Adaptations

Over time, investors and entrepreneurs have devised various ways of addressing UBTI and ECI concerns in investments in operating companies organized as passthroughs.

Historically, the ''fix'' was a blunt instrument. Passthroughs taking on institutional investors or going public simply converted to C corporation at that time, eliminating UBTI and ECI concerns but also snuffing out many of the potential advantages and benefits that the passthrough form of organization can provide in the process.

More recently, entrepreneurs and private equity (PE) investors have developed more creative ways to address UBTI and ECI concerns, mainly in response to the desire of increasingly sophisticated entrepreneurs to utilize and retain a passthrough form of organization and greater appreciation by PE sponsors of the potential benefits associated with passthroughs.

Fund-Level Solutions

At the fund level, PE sponsors have sought greater flexibility from their limited partner clients to invest a portion of fund assets directly in passthroughs, or in some cases to invest in passthroughs without limitation. This is of course the simplest way to address UBTI and ECI issues. But if a general partner's clients won't allow it, an alternative approach is required. Investors who don't have PE investors with UBTI/ECI limitations (including many family offices) emphasize this flexibility in negotiations with entrepreneurs to win deals.

Holding a passthrough investment through an intermediate blocker corporation prevents UBTI and ECI from flowing from the passthrough business to the tax-exempt and non-U.S. investors who don't want to receive it.

PE investors with UBTI-sensitive or non-U.S. investors who lack the ability to do direct investments in passthroughs typically use a ''parallel fund'' or ''alternative investment vehicle'' approach to solving the UBTI/ECI challenge, or simply invest all capital through a ''blocker'' corporation.

The alternative investment vehicle (AIV) approach allows for a deal-by-deal division of limited partners in a PE fund who are UBTI/ECI sensitive from those who aren't. A parallel fund approach utilizes the same division, but with separate funds for UBTI/ECI-sensitive investors and non-sensitive investors established on a permanent basis. A single blocker approach groups UBTI/ECI-sensitive investors with those who are not in a single corporate entity.

In either case, holding a passthrough investment through an intermediate blocker corporation prevents UBTI and ECI from flowing up from the passthrough business to the tax-exempt and non-U.S. investors who don't want to receive it.

Blocker Structures

Employing a blocker structure in a buyout or other investment transaction is relatively simple in concept but potentially complex in implementation.

To implement a blocker structure, the PE fund forms a C corporation to acquire and hold an equity interest in a portfolio company organized in passthrough form, either for all investors or for UBTI/ECI-sensitive investors exclusively. The C corporation typically has all of the rights and obligations of the other investors under the issuer's governing documents. At the operational and day-to-day levels, the arrangement ''feels'' relatively transparent, at least until exit. But complexities exist throughout.

Investors and entrepreneurs who are experienced with blocker corporations are well aware of the potential inefficiencies the structure brings with it. For example, earnings distributed to an investor in a blocker corporation will be taxed inside the blocker and then again on distribution from the blocker to certain types of investors.

In addition, if an investor were to liquidate its investment by having the blocker sell the passthrough equity interests it holds, a corporate level tax would be in-

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Blocker Best Practices

Holding a passthrough investment through an intermediate blocker corporation raises unique considerations. Some best practices to consider:

- From an investors' perspective, it is critical that the investment documents in a deal involving a blocker give the investor the right to exit in a trade sale or redemption by selling the blocker stock rather than the passthrough units owned by the blocker.
- When a private equity investor buys or invests in a passthrough, the tax basis of the investor's portion of the target assets sometimes can be written up to the value implied by the transaction, resulting in amortization deductions going forward that shelter income from tax.
- Sponsors that must use blockers may wish to divest separate parts of an acquired company in different transactions, and typically use ownership of separate investments in free-standing structures or a series limited liability company structure to address this concern.

curred. As a result, a PE fund that holds its interest in a portfolio company through a blocker must exit by selling the blocker's stock, which doesn't provide the buyer with a write-up in the way that direct sales of units in the passthrough will achieve. Also, a buyer that is itself in passthrough form will inherit the going-forward inefficiencies of a blocker structure established by a seller.

Given the challenges, investors and entrepreneurs who deal regularly with blocker structures have evolved a set of practices to address potential inefficiencies. These are tailored to the contours of the particular deal and typically reflecting the relative leverage and knowledge of the parties.

Parallel Exit. From an investors' perspective, it is critical that the investment documents in a deal involving a blocker give the investor the right to exit in a trade sale (or redemption) by selling the blocker stock rather than the units in a passthrough owned by the blocker. A minority investor who doesn't include such a position can find itself dragged into a liquidity transaction that is highly tax inefficient.

The right to exit via a blocker stock sale also typically includes an agreement that the owners of the blocker will receive the same price for their shares that the direct owners of passthrough units of the same class receive, without a haircut, despite the fact that the blocker shares are theoretically less valuable to the buyer because their purchase doesn't generate any tax benefits for the buyer.

Advanced blocker provisions apply a similar concept for an initial public offering (IPO) exit in which pre-IPO owners will be paid for tax benefits they confer on the public company (a so-called ''Up C'' IPO), with provisions for such an offering anticipated and baked into the governing documents.

Amortization Benefits. When a private equity investor buys or invests in a passthrough, the tax basis of the private equity investor's portion of the target assets sometimes can be written up to the value implied by the transaction, resulting in amortization deductions going forward that shelter income from tax. These step-ups can benefit either the target company or the sponsors, depending upon structure.

Separate Exits. Sponsors that must use blockers face special challenges when they wish to divest separate parts of an acquired company in different transactions, and thereby maximize aggregate returns. Sponsors typically address these concerns by owning the separate investments in separate, free-standing structures while operating them more or less in tandem or using a series LLC structure, with each series representing interests in a different business and a separate partnership for tax purposes.

Preferred Returns. In some cases, investors in a blocker structure enhance their returns and obtain downside protection by providing for an accumulating preferred return on their equity coupled with tax distributions at the statutory rate.

The economic effect of such an arrangement is somewhat similar to that of a participating preferred stock structure, with the right to receive the favorable tax distributions or the preferred return sometimes declining and disappearing at a specified level or levels of cash-on-cash return for the investor.

Treatment of Distributions. Investors who use blockers need to be familiar with the various tax and economic issues related to distributions, such as the rate of assumed taxation for tax distributions, the extent to which tax distributions are to be treated as advances, whether deductions uniquely attributable to an investor should be reflected in calculating the distributions, frequency of tax distributions and the effect of tax distributions in calculating satisfaction of applicable investor preferences and/or return hurdles.

Blocker Capitalization. To reduce the impact of taxable income inside a blocker corporation resulting from income allocations and distributions, investors often capitalize blockers partially with debt to the extent feasible under the tax rules.

Killing the Blocker. In relatively rare cases, the buyers of a company with blocker owners are individuals rather than institutions. When this happens, the owners can eliminate many (but not all) blocker inefficiencies after the closing by electing to treat the blocker as an S corporation for tax purposes going forward.

Liability, Working Capital and Tax Refunds. It is usual for blocker owners to retain full and complete responsibility for taxes and other liabilities inside their blocker vis-a-vis acquirers, including in transactions involving representation and warranty insurance.

Presentation. From an entrepreneur's perspective, getting clarity about an investor's limits and requirements with respect to a blocker structure is an important diligence item to know at the front end of an investment process, and knowledge of the various techniques used to address blocker issues is essential.

Conclusion

Expertise with passthroughs, blockers, AIVs and the like is an essential requirement for successful private equity investing. Tax passthroughs abound; many successful entrepreneurs utilize them and often insist on being able to retain a passthrough structure after an investment transaction.

Just as you can't score a touchdown without good blockers, operating in the middle market without a deep knowledge of the potential pitfalls and opportunities associated with passthroughs and blockers can result in leaving money on the table, or worse, in fumbles and losses.

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