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An Introduction to the Use of Blocker Corporations in M&A Transactions

In an earlier article titled "Rollover Equity Transactions 2019," we discussed the various business and tax issues associated with transactions involving private equity (PE) buyers who include rollovers of target owner equity in their leveraged buyout (LBO) transactions. Here, we take a deeper dive into the ramifications of having some PE investors invest in target companies through blocker corporations.

What are "blocker corporations?"

Blocker corporations are corporations that effectively "block" taxable income at the corporate level for U.S. federal, state and local income tax purposes. When a PE firm structures an LBO transaction, some PE investors, generally tax-exempt and foreign investors, will invest directly or indirectly in portfolio company equity through one or more newly-formed Delaware C corporations (the blocker corporation). The right of tax-exempt and foreign investors to use blocker corporations and provisions protecting the economic rights of tax-exempt and foreign investors are often spelled out in PE firm's fund documents and limited partnership agreement.

Why are "blocker corporations" used when a PE fund invests in a U.S. based business taxed as a partnership for federal income tax purposes?

Taxable income passed through on a Schedule K-1 by a portfolio company generally falls into the category of income "effectively connected with a U.S. trade or business" for foreign investors and unrelated business taxable income (UBTI) for U.S. tax-exempt investors. Foreign investors want to avoid being allocated effectively connected income because exposure to an allocation of that income subjects them to a U.S. income tax filing requirement and potentially to U.S. federal income and withholding taxes. Tax-exempt investors want to avoid being allocated income that is UBTI because that income will subject the otherwise tax-exempt investor to U.S. excise taxes. So, neither foreign or tax-exempt

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investors want to hold directly an equity interest in a U.S. business taxed as a partnership. Hence, the use of a U.S C corporation as a "blocker corporation" to block the flow-through of income on a Schedule K-1 at the corporate level.

PE investors also favor the use of blocker corporations because when the portfolio company investments held by the blocker corporations are eventually sold, the stockholders will sell their blocker corporation stock instead of having their blocker corporations directly sell the portfolio company investments. In a sale of blocker corporation stock, tax-exempt and foreign investors will generally avoid U.S. income taxes because neither foreign nor tax-exempt investors are subject to U.S. federal income tax on capital gains.[1] In contrast, if a blocker corporation sold its portfolio company investment and then liquidated, the blocker corporation would be subject to federal, state and local income taxes. Blocker corporation investors generally negotiate for the right to sell blocker corporation stock when they invest with the PE firm.

So, when a sale process in undertaken with respect to a portfolio company, the PE firm will conduct a sale process that includes the sale of blocker corporation stock by its stockholders and the sale of portfolio company equity by the remaining PE investors and rollover participants. After closing, a buyer presumably has the choice of either liquidating the blocker corporation and take the tax hit associated with a deemed sale of the blocker corporation's assets or holding the blocker corporation stock (and indirectly that portion of the portfolio company's equity). Either way, the buyer won't benefit from the full tax basis step-up otherwise associated with the purchase of a portfolio company's equity (i.e., the typical 15-year amortization of goodwill under Section 179). The portion of the purchase consideration paid for the blocker corporation stock cannot be amortized. For example, if the equity of a portfolio company taxed as a partnership is purchased for $100, and its assets consist solely of goodwill, the buyer will be able to amortize this $100 investment over 15 years. In contrast, if the buyer purchases 80% of the portfolio company's equity directly and 20% indirectly through the purchase of blocker corporation stock, the buyer will be able to amortize only the $80 investment in portfolio company equity. The buyer won't be able to amortize its $20

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investment in the blocker corporation's stock. The buyer is worse off in terms of future tax benefits. So, unless a buyer is entirely tax insensitive (e.g., perhaps a public company that strictly views the purchase in terms of whether it is accretive to earnings?), the buyer will make some adjustment to the purchase price to reflect the loss of future tax benefits.

Most blocker corporations are C corporations domiciled in the United States, so taxable income from an equity investment in an LLC taxed as a partnership passes through on a Schedule K-1 to the blocker corporation, taxes are paid at the corporate level at the current 21% federal income tax rate, and stockholders do not report income and are not taxed unless a taxable distribution is made by the blocker corporation to its stockholders. There is the potential for double taxation with blocker corporations if after-tax profits are distributed to stockholders. Non-liquidating distributions made by blocker corporations to foreign investors are generally subject to a 30% U.S. withholding tax, but there are exceptions to double taxation where distributions are made to U.S. tax-exempt investors, non-U.S. governmental entity investors, or non-U.S. investors qualifying for tax-treaty withholding exemptions or reductions. However, the threat of double taxation is generally an empty one because prior to the sale of a portfolio company investment, most distributions from portfolio companies acquired through an LBO will be limited to tax distributions. There generally won't be any excess distributable cash that could potentially be subject to double taxation prior to the sale of the portfolio company.

Foreign corporations are generally not used as blocker corporations to invest in U.S. target companies because foreign owners don't want to expose the foreign corporation to a U.S. tax return filing requirement, along with a potential exposure to U.S. income tax and withholding requirements.[2] Instead, foreign corporations will also make their U.S. equity investments through U.S. based blocker corporations.

Does the use of blocker corporations result in a misalignment between the economic interests of blocker corporation stockholders, on the one hand, and other PE investors and rollover participants, on the other hand?

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Generally, the interests of blocker corporation stockholders, on the one hand, and PE investors and rollover participants, on the other hand, are not aligned because in spite of the fact that a buyer might reduce the overall purchase price solely due to the presence of a blocker corporation, blocker corporation stockholders typically share equally in the sale proceeds. Further, it can be argued that the inclusion of the requirement that a buyer purchase blocker corporation stock, places foreign and tax-exempt investors in a better tax position that other holders of portfolio company equity. Finally, although it is difficult to quantify, it is possible that the pool of interested buyers is reduced if buyers must purchase blocker corporation stock.

To summarize, rollover participants (and other PE investors) generally are told that there are the following requirements with respect to blocker corporations: (i) some investors (foreign and tax-exempt investors) will invest through blocker corporations, (ii) when the target company's equity is eventually sold in a sale process three to seven years down the road, the sale process will include the sale of blocker corporation stock, and (iii) blocker corporation investors will share equally (pro rata with the indirect interest in the portfolio company equity) in the sales proceeds, disregarding any differentiation in purchase price paid for the blocker corporation stock. A reasonable question to ask is why PE firms cooperate with the demands of foreign and tax-exempt investors if structuring an LBO with blocker corporations puts other PE investors and rollover participants in a worse position?

A big part of the work of PE firms is attracting investors and competition for those investors' dollars is intense. A healthy slice of many PE firm's investor pool consists of tax-exempt and foreign investors. For those reasons, PE firms are highly motivated to make investing in their funds attractive to foreign and tax-exempt investors. As a result, PE firms routinely include in their fund documents the blocker corporation provisions discussed above. In some cases, particularly where a minority interest in a business is acquired in a partial recapitalization, the sale of blocker corporation stock is not required but is expected to be pursued on a commercially reasonable best efforts basis. Few if any PE

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agreements require blocker corporation stockholders to shoulder the purchase price haircut imposed by a tax sensitive buyer (e.g., even where the buyer expressly reduces the price paid for the blocker corporation stock because of the loss of future tax benefits [3]). Our experience has been that most PE firms treat these provisions as a non-negotiable aspect of a purchase transaction. Of course, everyone hopes that the future buyer of the portfolio company won't be particularly sensitive and reduce the purchase consideration. But at the end of the day, rollover participants and other PE investors should recognize that their interests are not aligned on these issues with those of the blocker corporation shareholders and this misalignment generally translates into some economic cost borne by the rollover participants and some PE investors.

Is it really necessary for blocker corporation stockholders to sell stock rather than have the blocker corporation sell its equity interest in a portfolio company?

If a PE firm is asked why it is necessary for some PE investors to invest through a blocker corporation, a likely response is a discussion of the problems associated with "effectively connected income," "UBTI" and double taxation. While we agree that blocking "effectively connected income" and "UBTI" is necessary, we question whether most blocker corporation stockholders would be subject to double taxation if the blocker corporation sold its equity interest in the portfolio company and then liquidated. If a blocker corporation sells its portfolio company investment, it will be taxed at the 21% federal corporate tax rate on taxable gain on the sale. A subsequent liquidation of the blocker corporation would be treated as a stock sale for federal income tax purposes. Tax-exempt and foreign investors are not generally subject to U.S. federal income tax on the capital gains triggered by a corporate liquidation. So, the net result of a blocker corporation's sale of its portfolio company investment would be to place its stockholders (the tax-exempt and foreign investors) on par with other PE investors and rollover participants in terms of the overall tax burden generated by the sale (e.g., a 21% federal corporate income rate for the blocker corporation and a 20% or 23.8% federal income tax rate for other

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investors).[4] What PE firms really should be saying to PE investors and rollover participants is that tax-exempt and foreign investors are accustomed to an overall 0% tax rate for U.S. income tax purposes and the blocker corporation structure allows these investors to avoid U.S. income taxes. Again, what the PE firms could be saying is that in reality, the demands of tax-exempt and foreign investors must be met and blocker corporations help those investors maintain their accustomed favorable tax treatment.

How should PE investors and rollover participants view the issue of blocker corporations?

It is a fact that PE investors investing in portfolio companies through blocker corporations are afforded special treatment at the expense of other investors in portfolio companies. This fact might appear unfair to non-blocker corporation investors and rollover participants, but the difference in tax treatment among the investors is more a result of the way tax-exempt and foreign investors are accorded special favorable treatment under U.S. income tax laws than a result specially engineered through blocker corporations. Blocker corporations preserve the disparity in treatment created by Congress through the Internal Revenue Code – the fact that while most investors will be taxed on their capital gains, foreign investors and tax-exempt investors avoid taxation. For rollover participants, the participation of blocker corporations on the PE firm side of the equation is certainly worth taking note of, but the potential incremental haircut on the sales proceeds received in connection with a future sale of a portfolio company represents just one of numerous economic and business factors that merit close attention when selecting target company's buyer. Our experience has generally been that the consequences of blocker corporations aren't well understood by sellers, and when the ramifications of blocker corporations are fully explained and considered, the issue seldom rises to the level of a deal-breaker for the target company's owners. Rollover participants are usually more focused on the amount of up-front cash, and gauging whether the PE firm will contribute towards a successful future sale of the portfolio company.

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Finally, a factor to keep in mind with respect to foreign investors who invest through blocker corporations is that they may be subject to tax in their home jurisdiction on gains from the sale of their blocker corporation stock. For example, when blocker corporation stock held by a Canadian resident is sold, the Canadian investor may escape U.S. federal withholding or income tax liability but will be subject to tax on the gain in Canada. On the other hand, this might not be true for foreign investors residing in tax havens who may not be subject to U.S. federal withholding or income tax or foreign taxation on the sale of the blocker corporation's stock.

Should rollover participants and other non-tax-exempt or foreign investors invest through blocker corporations or should a pass-through portfolio company be converted into a C corporation?

This question sometimes comes up when rollover participants look at the benefits of blocker corporations for tax-exempt and foreign investors. While the basic choice of entity analysis is beyond the scope of this article, there are a few general thoughts that should be kept in mind. First, if a U.S. taxpayer isn't a tax-exempt investor, there won't be a problem with UBTI and the investor is already filing a U.S. federal income tax return. When the portfolio company is sold, owning the pass-through LLC interest through a blocker corporation won't significantly decrease an owner's tax liability because the portion of the gain taxed at ordinary income rates under Section 751 (e.g., accounts receivable, appreciated inventory and depreciation recapture) doesn't typically represent a significant percentage of the sale consideration. So, for the U.S. taxpayer, the blocker corporation doesn't generally improve the tax result. Investors and rollover participants should keep in mind that if the portfolio company is a C corporation or a significant percentage of its owners hold their interests through a blocker corporation, a buyer might calculate a significant reduction into the purchase price if it is tax sensitive (i.e., the buyer strongly objects to the loss of future goodwill amortization and prices the deal accordingly). Perhaps one situation where the use of a blocker corporation would be worth pursuing is if there is a reasonable possibility that the blocker corporation's stock could be treated as qualified small business stock (QSBS) for purposes of Section 1202's generous gain

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exclusion.[5]

For more information, contact Scott Dolson or any attorney on Frost Brown Todd's **QSBS & Tax Planning Services** team.

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[1] Gain on the sale of blocker corporation by a foreign investor could be subject to U.S. federal income tax under the FIRPTA rules if the blocker corporation's assets are primarily composed of U.S. real estate at any time during the five-year period preceding the sale.

[2] Foreign corporations are taxed on income allocated to them on a Schedule K-1 as effectively connected income subject to U.S. corporate income tax, along with a 30% "branch profits" tax on the after-tax effectively connected income withdrawn from the U.S. flow-through portfolio company's U.S. business (unless otherwise reinvested in a U.S. business). Also, a sale by a foreign corporation of a U.S. based pass-through entity interest will be subject to unfavorable tax treatment under Section 864(c)(8) of the Internal Revenue Code when contrasted with the tax treatment afforded foreign investors who sell U.S. blocker corporation stock.

[3] Most letters of intent and purchase agreements are silent about price reductions associated with buyer's loss of tax benefits. Generally, buyers will take this reduction in tax benefits into account when setting the purchase price rather than expressly addressing the reduction through a formula or otherwise. But, of course, silence doesn't mean that the buyer isn't taking the loss of those benefits into consideration.

[4] For the non-corporate taxpayers' portion of the gain may be subject to taxation at ordinary income rates under Section 751. This differential in tax rates doesn't apply when blocker corporation stock is sold or the blocker corporation sells its portfolio company equity.

[5] If all of the requirements of Section 1202 are met, each individual taxpayer might qualify for at least a $10 million gain exclusion with respect to the sale of an issuing corporation's stock. The application of Section 1202 to portfolio company investments and equity rollover arrangements has not been fully explored and certainly

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represents an interesting opportunity for tax savvy PE firms and venture capitalists.

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