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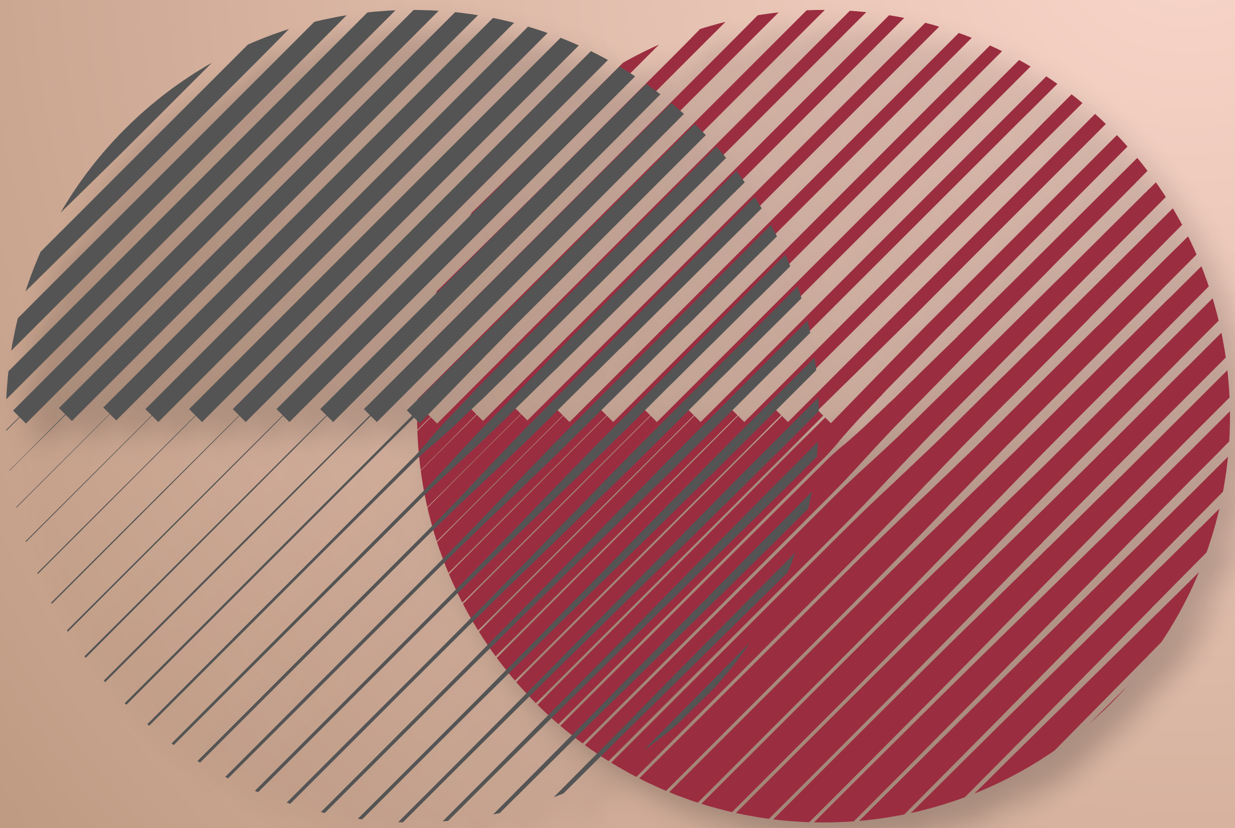

Helios Global Publications

Structured Success: Deal and Transaction Series

Leveraged Partnership

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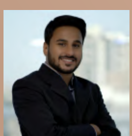

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Preface

Welcome to "Structured Success: Deal and Transaction Series." In the world of finance, the ability to understand and navigate complex deal and transaction structures is an invaluable skill. Whether you are an experienced financial professional seeking to sharpen your expertise or someone new to the intricate world of financial transactions, this publication series is designed to be your trusted companion on this journey. The aim of this independent publication series, produced by the Helios Global Publications, is to arm public and private sector leaders with fact-based insights to guide informed decision-making.

Each article in this series is carefully curated to unpack the complexities of deal structures, presenting concepts in a clear and actionable manner. From the basics to advanced techniques, we will explore various aspects of deal structures, delving into real-world case studies, tax issues, contract issues, regulatory issues, and practical applications. Our goal is to equip you with the tools and knowledge necessary to make informed financial decisions, whether you are involved in mergers and acquisitions, real estate transactions, or any other financial deal.

The research underlying this series was run by the dedicated team of Helios Financial Group M&A practice team, led by Asad Khan, a partner. Valuable perspectives and advice were offered by a distinguished panel of academic and industry experts. Including, various articles, publications, books and research materials.

The report also benefited enormously from the contributions of HFG's global network of industry experts. It drew on HFG's indepth analytical expertise, our work with leading preferred acquirer organizations, distinguished lawyers, esteemed tax advisors and our understanding of deals space around the world.

The authors would like to thank the external and internal advisers for their contributions. In addition, the authors would like to thank Ammad Ahmed and Waqas Ahmed for their help in art directing, producing, and disseminating this report.

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1. This report was not commissioned or sponsored in anyway by a business, government or other institution.
2. Farah N. Homsi, (Winter 2010), *The Leveraged Partnership—Have Your Cake And Eat It Too*
3. ALICE A. UPSHAW, (December 2010), *Leveraged Partnership a Disguised Sale*
4. By reviewing this paper, no individual is endorsing its conclusions. All errors remain our own.

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INTRODUCTION

A leveraged partnership transaction involves the owner contributing the asset to a newly formed partnership, which then leverages the asset to generate capital. The owner guarantees the partnership debt, allowing for a tax-free distribution of funds from the partnership. However, it is essential to acknowledge that while a leveraged partnership transaction presents an opportunity for tax efficiency, it is not without risks and potential scrutiny from the Internal Revenue Service (IRS). Therefore, prudent guidance and a clear understanding of the associated risks are imperative for taxpayers contemplating this strategy. This paper aims to provide comprehensive insights and guidance for informed decision-making in leveraged partnership deal structures.

WHAT IS LEVERAGED PARTNERSHIP STRUCTURE

BUILDING THE STRUCTURE

Outlined below is a concise, guideline on the general steps of the partnership dynamics between an buyer and seller in a leveraged partnership deal structure :

1 Asset and Capital Contributions

The Owner (Seller) injects appreciated assets into the partnership, and the Investor (Buyer) injects working capital or assets.

The Investor typically desires to either acquire these appreciated assets or integrate them into the partnership's operational framework.

2 Debt Financing

The partnership secures funding by borrowing from a bank or any financial institution, enhancing its capital base. Ideally, the loan should be structured as interest-only loan with ballon payment which provides for the maximum tax deferral.

3 Recourse Debt with Owner's Guarantee

The Owner personally guarantees the partnership's debt, designating it as recourse debt. Consequently, the Owner's basis in her partnership interest increases by the debt amount.

4 Loan Proceeds Distribution

The partnership allocates a portion or the entirety of the loan proceeds to the Owner. Consequently, the Owner's equity interest in the partnership diminishes, establishing her as a minority partner.

The partnership agreement should encompass provisions for adjusting percentage interests to account for distributions and potential supplementary contributions.

5 Tax Implications

Assuming proper adherence to structuring guidelines to bypass disguised sale rules, the distribution of loan proceeds to the Owner remains tax-free. This depends on the debt-induced increase in the Owner's basis.

If the debt fails to increase the Owner's basis, the distribution is likely to trigger taxable gain.

6 Long-Term Strategy and Asset Allocation

Post approximately seven years, the partnership gains the flexibility to distribute the Owner's original assets to the Investor or allocate other partnership assets to the Owner as per the agreed-upon transaction.

BUILDING THE PARTNERSHIP:

When individuals come together to establish a partnership, it is imperative that they contribute assets aligning with the partnership's defined "business purpose" and supporting the intended objectives of the involved parties. The determination of whether a partnership has indeed been formed heavily rests on the genuine intent of the parties. If the partnership formation appears superficial, the tax authorities retains the right to disregard the partnership and treat it as a fraudulent entity.

Typically, partners undergo no gain or loss recognition upon their asset contributions to the partnership. Similarly, the partnership itself does not recognize any gain or loss resulting from the property contributions made by the partners. Each partner holds a basis in their partnership interest equivalent to the adjusted basis of the assets they individually contributed. The partnership, in turn, assumes a transferred basis concerning the contributed assets. Additionally, a partner is granted basis credit for his proportionate allocation of the partnership's liabilities. An increase in his share of liabilities is viewed as a monetary contribution to the partnership, leading to a subsequent elevation of his basis in the partnership interest. Conversely, a decrease in his share of liabilities is treated as a cash distribution from the partnership, causing a reduction in his basis by the equivalent of the deemed distribution.

Special provisions come into play when a partner contributes property with a fair market value differing from its existing basis. This scenario involves a discrepancy between the property's "book" value or fair market value at the time of contribution to the partnership and its tax basis. This property is known as "built-in" gain property, emphasizing the discussion on "built-in gain" property in this context.

The partnership regulations stipulate that income, gain, loss, and deductions pertaining to property contributed by a partner must be apportioned among the partners to account for the variation between the property's basis to the partnership and its fair market value at the time of contribution. The primary objective of this allocation is to assign any built-in gain to the partner who contributed the appreciated property, preventing any strategic gain shifting to a partner in a lower tax bracket or one who could potentially benefit from the gain, such as offsetting a loss.

Several methods are employed to effectuate this allocation, including the traditional method, the traditional method with curative allocations, and the remedial allocation method. In general, for non-depreciable property contributions, the contributing partner is allocated the tax gain upon the partnership's eventual disposal of the property. Conversely, in the case of depreciable property, depreciation deductions may be more heavily allocated to the non-contributing partner, thereby addressing additional income and the corresponding built-in gain for the contributing partner, considering the disparity between tax and book accounts.

If the contributed property is distributed to a partner other than the contributing partner within a span of seven years from the contribution, the built-in gain is allocated to the contributing partner. During such instances, gain or loss recognition occurs, accompanied by a corresponding basis adjustment in the contributing partner's interest in the partnership and the property distributed to the non-contributing partner. Additionally, if other property is distributed to the contributing partner within seven years of the original contribution, apart from the contributed property, the contributing partner must also recognize the gain, with a corresponding basis adjustment in both the partner's interest and the partnership's interest in the contributed property.

In a non-liquidating distribution of property, the partner acquires a transferred basis in the property either from the partnership or the partner's basis in the partnership (reduced by cash distributed), selecting the lesser of the two. Conversely, in a liquidating distribution, the partner assumes a basis in the property equal to her adjusted basis in the partnership interest (reduced by cash distributed). Subsequently, when the property is later sold, gain or loss recognition ensues. If the partnership has an effective election in place, the partnership will adjust the basis of its remaining assets by the gain or loss amount recognized by the distributee partner.

MODEL DEAL STRUCTURE

BUILDING THE STRUCTURE

Outlined below is a concise, guideline on the general steps of the partnership dynamics between an buyer and seller in a leveraged partnership deal structure :

1 Formation of Partnership / LLC

Subsidiary (owned by the seller) and Investor (eventual buyer) form a partnership. In the form of an LLC.

2 Asset and Capital Contributions

Subsidiary contributes Business assets to the Partnership in exchange for:

a. cash payment equal to, for example, 90% of the value of the contributed Business assets (corresponding to their appreciated value), and

b. 10% equity stake in the LLC

3 Asset and Capital Contributions

The Investor contributes assets (working capital and/or comparable assets) in exchange for a 90% equity stake in the Partnership.

4 Debt Financing

The LLC incurs debt (secured by the Partnership's assets) in an amount equal to 90% of the contributed Business assets and distributes the cash to Subsidiary tax-free (see step 2(b) above).

5 Recourse Debt with Owner's Guarantee

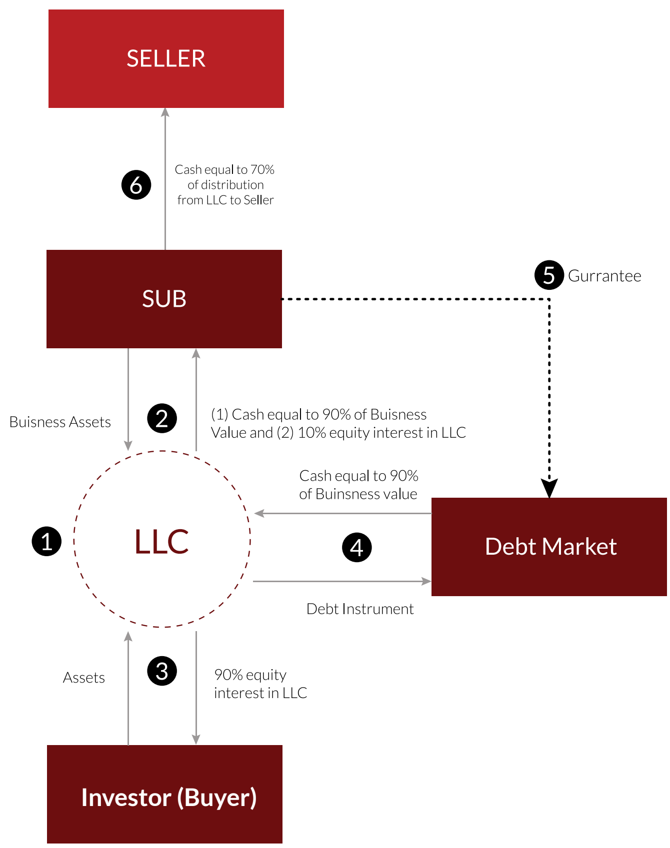
Subsidiary guarantees the debt of the Partnership equal to the amount of cash received

6 Long-Term Strategy and Asset Allocation

Subsidiary distributes 70-75% of cash to the seller.

a. Subsidiary should be respected, for tax purposes, as guarantor of the debt with assets equal to only 20-25% of the value of the guarantee.

b. The remaining 25-30% cash may be loaned to Seller in exchange for a Seller note.



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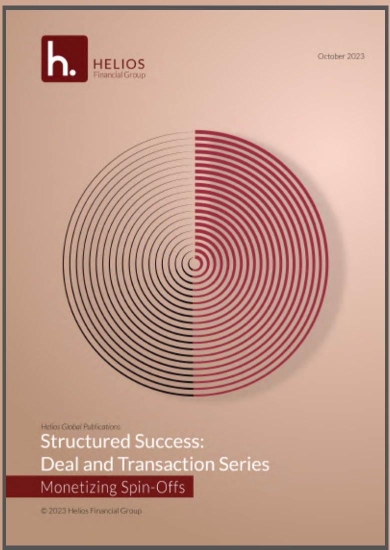

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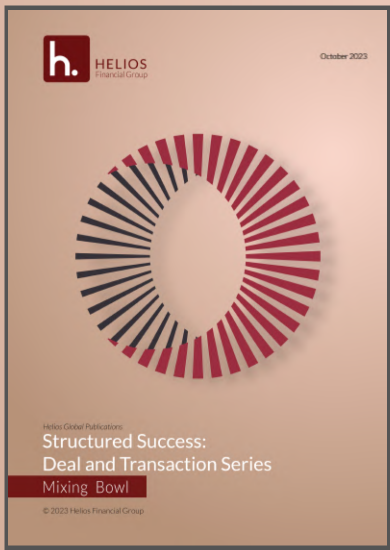

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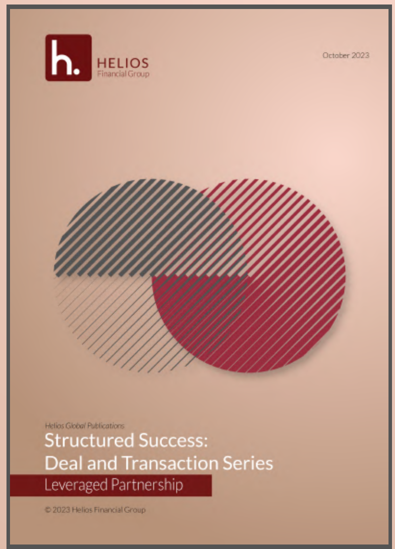

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Endnotes

1. Farah N. Homsi, (Winter 2010), *The Leveraged Partnership—Have Your Cake And Eat It Too*
2. ALICE A. UPSHAW, (December 2010), *Leveraged Partnership a Disguised Sale*
3. Based on HFG's own consultative experience of working with clients on Mergers & Acquisitions.
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