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Venture Capital, Meet Capital Shift

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Some investors—particularly those in the venture capital arena—continue to swim against the current, or perhaps even against the rising tide. After all, just about everybody now overwhelmingly favors entities taxed as partnerships. LLCs are the prevalent vehicle these days.

Yet, some investors tend to be old school. These iconoclasts want an investment in a C corporation, and a return modeled on good old preferred stock. When they discover that partnerships can't issue preferred stock, they demand an equity interest that is the economic equivalent. And thus begins our story.

These investors are typically frustrated to learn that a preferred stock return won't always mesh neatly with a partnership interest. So we do the best we can, trying to put a round corporate preferred stock return into a square partnership hole. One especially troubling nuance of trying to model a partnership interest on preferred stock is a nebulous event that, in partnership tax parlance, is known as a "capital shift." A capital shift is a shift in capital interests among partners. No cash changes hands.

Instead, an entitlement to liquidation proceeds moves from one partner to another. Despite being a non–cash transaction, there is authority that capital shifts (or at least certain kinds of capital shifts) can be taxable. For that reason, capital shifts tend to be feared by partnership practitioners, even though they frequently are ignored by corporate attorneys.

Preferred Stock Masquerading As a Partnership Interest

Tinkering in the tax world often has consequence, and that's true here. A capital shift can arise when a partnership interest is modeled on preferred stock. Let's take an example.

Suppose a passive investor—call it "VC"—invests $1 million, and insists on a preferred interest of 10 percent on the investment

ALSO IN THIS ISSUE

Cleaning up Environmental (and Other) Cleanup Expenses *via* Claim of Right 4
When Is a Sale a Sale? 7

compounded annually, as well as a priority return of capital on liquidation. Clearly, this kind of fact pattern doesn't represent a difficult task for our old friend preferred stock.

But, in a partnership, this basic preference may cause sticky issues for the tax planner, including a potential capital shift. Here's how. Say a year goes by and the company's earnings are flat. There is no income available to allocate to the investor with respect to its preferred interest. There also is no cash to distribute to VC in respect of its preferred return.

The preferred return accrues unpaid. A careful attorney, mindful of VC's economic objectives, has drafted the liquidation provisions in the partnership agreement with a distribution "waterfall." That means the investor receives any accrued and unpaid preferred return first, its capital back second. Only then do the other partners receive any remaining distributions.

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Enter the Capital Shift

Lo and behold, a capital shift rears its head at the end of the very first year. Why? Because a partner's capital interest is typically determined by a deemed liquidation of a partnership. [*See* Rev. Proc. 93-27, 1993-2 CB 343.] In other words, we treat the partnership as liquidating and distributing cash equal to the fair market value of its assets in accordance with the distribution provisions in the partnership agreement, and we see which partner gets what. The amount each partner would receive is its capital interest.

When VC first acquired its interest, there was no shift in capital interest because no return had accrued. In other words, on a deemed liquidation, VC would receive its $1 million (under the second tier of the waterfall) and the other partners would receive their share of capital (under the third tier).

But the situation is markedly different at the end of the first year. At that point, VC's preferred return has accrued but there is no additional value in the company. Remember, we're assuming there is no income. On a deemed liquidation, the only way to distribute cash under the liquidation waterfall (so that VC receives its full $1 million plus an additional $100,000 of accrued preferred return) is to take, or "shift," some of the capital interests from the other partners, and give them to VC.

"What's the big deal?" you ask. Well, the concept of a capital shift conjures up all sorts of reactions among partnership practitioners. The reason for the various reactions is the almost laughable lack of guidance on noncompensatory capital shifts.

The (Lack of) Guidance

There is some limited guidance on the tax treatment of capital shifts, but none of it is on point with our example. On one hand, it is clear that a capital shift is taxable when it is received in exchange for services provided, or to be provided in the future, to the partnership. [Reg. §1.721-1(b)(1).] But outside the compensatory arena, the appropriate tax consequences arising from the receipt of a capital shift is, quite literally, anyone's guess.

For example, an older case treats a capital shift as taxable as ordinary income. [*H.W. Lehman*, 19 TC 659, Dec. 19,410 (1953).] However, this case has narrow facts, and may (or may not) involve a compensatory capital shift. Code Sec. 707(c) guaranteed payment rules may instead apply to VC in our example. [*See* Reg. §1.707-1(c), Example 2.] These rules suggest the capital shift should be treated as ordinary income that is includible to VC based on the accounting method of the partnership.

In other words, if the partnership is an accrual basis taxpayer, these rules suggest that VC should take the $100,000 into ordinary income at the end of the first year, even if unpaid. (VC is usually not pleased with this result!) But, if the partnership is a cash basis taxpayer, VC may be able to defer the inclusion of the income until the partnership actually makes the payment.

There are also recent proposed regulations on noncompensatory options that treat a capital shift as a nontaxable event. [*See* Proposed Reg. §1.704-1(b) (*see* especially the preamble).] However, these regulations require corrective allocations of gross income and deduction going forward to account for the shift, at least to the extent the partnership wants to maintain Code Sec. 704(b) compliant capital accounts.

But like a television infomercial, that's not all. For the more adventuresome planner, there are other theories floating around too. For example, maybe a noncompensatory capital shift is in the nature of a bargain purchase and not taxable at all. Alternatively, maybe a capital shift is an open transaction that shouldn't be characterized until it is closed on liquidation of the partnership. (Of course, the IRS has never been fond of the open transaction doctrine.) Finally, there is the (gulp) pragmatic approach of looking the other way.

The Plot Thickens

The dearth of guidance leads to even more discombobulated consequences when the investor's preference takes the form of a simple priority over the return of the other partners' capital, rather than a return that accrues ratably over time. Suppose in our previous example there is no 10percent return. Instead, on liquidation, VC receives its capital back first ($1M), then it receives an amount equal to its capital ($1M).

After that, suppose that each of the other partners receives an amount equal to 2x its invested capital, and any remainder is distributed *pro rata* among the partners based on percentage interests. Assuming the company is sufficiently profitable, everyone will share capital *pro rata* based on percentage interests. Is there a capital shift here?

Well, there appears to be a shift in capital interests on the day the interest is *issued* to the VC. On a deemed liquidation approach, VC's capital interest on day one is equal to two times its capital investment, or $2 million. But, the only source for additional capital is the capital interests of the other partners. Voila!—a capital shift. Depending on your view of noncompensatory capital shifts, this shift could be treated as a taxable event.

Nonpartnership Outrage

At this point, practitioners who are not routinely up to their ears in partnership minutia may be jumping up and down in outrage. After all, how can the purchase of the partnership interest be a taxable event to the investor? VC paid $1 million for the interest. It did so in an arm's length transaction. *A fortiori* (I've always wanted to say that), the interest has a fair market value of $1 million.

It seems unnatural, counterintuitive and, well, just plain *wrong*, to say that VC has somehow experienced an accession to wealth merely by purchasing an interest for $1 million that is worth exactly $1 million, regardless of how one analyzes the various capital interests.

But, there does seem to be a technical capital shift with unknown tax consequences. That leaves the unhappy tax planner in our story with a kind of Hobson's choice. Our tax planner can:

- draft to avoid the capital shift and alter the economic consequences sought by the investor;
- come up with some way to account for the capital shift; or
- look the other way.

As with so many other topics in our crazy tax world, practitioners can await future guidance on this point. Yet, given the dearth of guidance to date, it's inadvisable to hold your breath in the meantime.