

M&A Tax Talk

PIPEs – Potential tax opportunities and considerations



Introduction

When evaluating and executing private investment in public equity (PIPE) transactions, appropriate consideration should be given to the tax implications by properly evaluating the terms of the proposed investment. Early tax planning will inform and may serve to mitigate potential (i) income accruals to US taxable investors without corresponding cash, (ii) withholding taxes, and (iii) adverse consequences to existing tax attributes of the public company (Pubco).

What is a PIPE?

PIPE transactions involve the private placement of a Pubco's equity or convertible debt to select accredited investors, such as private equity (PE) funds. Whereas PE funds have traditionally used the leveraged buyout (LBO) as their principal investment strategy, during times of volatility in public equity markets, PIPE transactions have become an attractive investment opportunity that can provide much-needed liquidity and other financial benefits to Pubco while offering significant return on investment to PE funds. In addition to analyzing the financial benefits of PIPE investments, a careful evaluation of the anticipated tax consequences to a PE fund (including its limited partners (LPs) and coinvestors) during the holding period and potential exit, as well as to the Pubco itself, is critical.

Commercial Advantages of PIPEs

A PIPE generally provides Pubco a source of capital on an expedited basis relative to public or alternative market sources. Thus, streamlined execution timelines may result in lower overall transaction costs, as there is often minimal need (or time) to conduct lengthy regulatory reviews or more fulsome "take-private" due diligence processes. PE funds may also benefit from structural flexibility in the form of the PIPE instrument, overall purchase price discounts, or other financial incentives embedded in, or issued in connection with, the PIPE instruments.

Although PIPEs typically do not provide a PE fund with the ability to control Pubco, PIPEs are often used by PE fund managers as an attractive entry point to facilitate broader investment goals. For example, a PIPE instrument could be structured by a PE fund to achieve the following objectives:

- Obtain board seats or board influence
- Preliminary investment as a precursor to a full take-private transaction
- An investment to participate, or track, a specific high-growth segment
- An investment that is convertible or exchangeable into a portion of the equity of Pubco, or a subsidiary of Pubco, in a separation transaction such as a spin-off

Common types of PIPEs

The desired structure of the PIPE instruments and governing agreements can take various forms, including, but not limited to:

- i. The issuance of **common stock** at either a fixed or variable price
- ii. The issuance of **preferred** or **convertible preferred** stock
- iii. The issuance of **convertible debt**

PIPE instruments may also include certain embedded incentives like redemption

rights, warrants to purchase Pubco common shares, or coupons that may be payable in kind (PIK) at the option of Pubco, among others.

PE fund-level tax considerations

As PIPE transactions vary by investment structure and investment agreement, so do the fund-level tax implications. Common tax considerations include the following:

Phantom income

It is very common for PIPE investments to be structured in the form of preferred equity. One of the primary tax concerns with such an instrument is whether it will generate taxable income without a corresponding receipt of cash (phantom or dry income) for US taxable investors in the PE fund.

To the extent Pubco has current or accumulated "earnings and profits" (E&P), certain PIPE features and economic entitlements may result in a deemed dividend from the Pubco to the PE fund for US federal income tax purposes.

This deemed dividend crystalizes a current income inclusion to US taxable PE fund investors, as well as a possible withholding obligation on behalf of certain foreign taxable PE fund investors, which can often be phantom in nature if not otherwise associated with a distribution of cash.

Example 1:
Issuance of convertible preferred stock, treated as preferred stock

On January 1, 20XX, Corporation M issued \$250M of Series A cumulative convertible preferred stock (Series A) with an 8 percent coupon per annum to Investor R. The investment included 10M warrants to acquire M's common stock exercisable for five years at \$0.01 per share. At closing, it is determined the warrants have a fair value of \$10M.

M can elect to pay the Series A coupon "in kind" by issuing new preferred shares (commonly referred to as PIK), and as such, the Series A coupon is payable in cash only when declared by the board of directors.

The Series A does not participate on an "as-converted" basis with common stock upon liquidation events. Also, the investor agreement is silent on the intended US federal income tax treatment of the instrument.

On September 30, 20XX, M elects to PIK the \$20M coupon due January 1, 20XY, and for the foreseeable future.

Under these facts, it is likely the Series A would be treated as preferred stock for purposes of IRC section 305 and, therefore, the PIK coupon of \$20M may result in phantom income to Investor R for their 20XY tax year to the extent of Corporation M's current and accumulated E&P.

In addition, because of the \$10M of value ascribed to the warrants, the fair valuation of the Series A is only \$240M. This could require the \$10M discount (\$250M redemption price less \$240M value) to be amortized into taxable income over five years as original issue discount (OID), potentially creating additional phantom income of \$2M per year to Investor R.

In addition, phantom income can also change the holding period for US income tax purposes with respect to a portion of a PE fund's PIPE. Under IRC section 305, common characteristics or entitlements that can generate phantom income include:

- i. Redemptions and recapitalizations that alter proportionate shareholder interests and discharge dividend arrearages.
- ii. Distributions that are not payable in cash or that are payable in shares at the option of the issuer
- iii. Changes in the buying power of convertible stock or securities or rights to acquire stock, through antidilution adjustments
- iv. Accrued redemption premiums, including as a result of the issuance of warrants, and phantom income accrual on any discount amortization (commonly referred to as preferred OID)

Identifying phantom income risks early is critical so a PE fund can assess potential impacts of such income inclusions or, alternatively, allow it to negotiate for provisions in the instrument that may

Example 2:
Issuance of convertible preferred stock, treated as common stock

Same facts as Example 1, except Investor R participates on an "asconverted" basis with common stock on voting matters and dividends and upon certain liquidation or similar events. M and Investor R have also expressly agreed to treat the Series A as common stock for US federal income tax purposes in the investor agreement.

On September 30, 20XX, M elects to PIK the \$20M coupon due January 1, 20XY (same as Example 1).

The Series A now appears to have several features of common stock and is treated as common stock per the investor agreement.

Under these facts, neither the PIK coupon nor the fair value ascribed to the warrants is likely to result in phantom income to Investor R.

mitigate this risk. These provisions may include features that allow the PE fund to treat the preferred stock instrument as common stock for tax purposes and thus allow it to potentially avoid at least some of these phantom income inclusions (for example, allowing the preferred stock to participate with common stock on voting matters or entitlements to dividends and liquidation proceeds on an "asconverted" basis with common stock).

Character of income from redemptions

Cash distributions out of current or accumulated E&P on a PIPE can generally result in taxable dividend treatment (and possible withholding taxes). However, PE funds and their LPs may be surprised to find that certain redemptions can also be characterized under US tax rules as a dividend rather than a sale or exchange. Sale or exchange treatment may allow a PE fund to access their tax cost basis in the investment and thus pay tax only on the incremental capital gain. However, to the extent a redemption is treated as a dividend for US federal income tax purposes, the corresponding taxable income could not be offset by the tax cost basis in the investment, and a PE fund or Pubco may be required to withhold US



income tax on the gross distribution. This can occur where Pubco's distribution in partial redemption of a PE fund's PIPE interest does not satisfy any of the tests of IRC section 302(b). For this very reason, many instruments prohibit the Pubco from redeeming a portion of the PE fund's PIPE equity investment (terms may require an "all or nothing" approach to redemptions).

Withholding tax considerations

As mentioned above, PE funds must also consider the tax profile of their LPs to model impacts of potential withholding taxes on overall investment returns.

Depending on the tax character of a distribution, the Pubco or the PE fund itself may need to withhold US federal income tax on behalf of certain non-US or tax-exempt LPs. Where Pubco makes a distribution that is treated as a dividend for US federal income tax purposes, the dividend income allocable to non-US LPs may be subject to US withholding tax

of 30 percent before consideration of applicable income tax treaty benefits.

If Pubco is deemed to be a US real property holding company (USRPHC) because it holds significant US real property interests, the Foreign Investment in Real Property Tax Act (FIRPTA) could raise further withholding tax considerations for certain non-US LPs. To the extent the FIRPTA rules apply, a PE fund may be required to withhold taxes at a rate of 15 percent of the gross proceeds realized on certain capital gain distributions (generally, distributions in excess of (i) current and accumulated E&P, and (ii) tax cost basis) or on the sale of Pubco shares by a PE fund. If the PIPE investment is small enough, the PE fund may be able to utilize the publicly traded exception to FIRPTA withholding contained in Treas. Reg. § 1.897-9T (for example, where PE fund holds, or forms multiple investment vehicles to hold, <5 percent Pubco interest(s) that are regularly traded).

UBTI

US tax-exempt LPs may create further PE fund-level tax considerations when structuring a PIPE. For example, if a PE fund uses leverage to finance a portion of the PIPE investment into Pubco, the debt-financed portion of income from the investment (both current income and gain on the disposition) could be treated as unrelated business taxable income (UBTI) for certain US tax-exempt LPs and potentially subject to US withholding tax. A non-US corporate "blocker" entity may be used to potentially mitigate UBTI, but any applicable withholding tax consequences on distributions should also be considered.

Pubco-level tax considerations

The size of the investment and potential application of change of control (CoC) rules will generate varying degrees of tax implications for Pubco.

Tax attributes and TRAs

A typical PIPE transaction is not structured to acquire a majority interest in Pubco. However, if large enough on its own, or if combined with other historical transactions, the PIPE could trigger a CoC for tax purposes. IRC sections 382 and 383 impose an annual limitation on Pubco's tax attributes (such as net operating losses or tax credits) resulting from a greater than 50 percent cumulative increase in ownership over a rolling three-year period. This limitation could have significant cash tax consequences and, therefore, both the PE fund and Pubco should be aware of such consequences when structuring the PIPE.

In addition to preserving tax attributes, tax receivable agreements (TRAs), which seek to provide pre-IPO owners with the actual tax savings resulting from Pubco's use of specified tax attributes, are generally not accelerated in the absence of a CoC. An increasingly common term of a TRA is a prepayment provision, whereby following a CoC transaction, Pubco is required to make a termination payment based on the present value of the tax attributes subject to the TRA. These payments can be significant and often act as a poison pill for a control transaction. Thus, it would be critical to determine whether a PIPE causes a CoC.

Interest deductibility

For a Pubco issuing convertible debt with an interest component, tax deductibility of the interest expense by Pubco is subject to several highly technical sets of tax rules. (Note that the coupon on preferred equity, whether paid in cash or PIK, is not deductible for US federal income tax purposes.)

Under IRC section 163(l), if the PIPE investment is treated as a “disqualified debt instrument” (if, at the option of the issuer, interest payments are required to be paid in or converted into equity of Pubco), the interest paid or accrued is not deductible by Pubco.

In addition, for PIPE debt investments, the applicable high yield discount obligation (AHYDO) rules of IRC section 163(e) (5) and the general interest expense limitation rules of IRC section 163(j) should be considered as well.

Much like PE fund-level considerations related to phantom income, Pubco will need to analyze these rules for its own cash tax planning purposes.

Example 3: IRC section 382 limit from PIPE transaction

As of December 31, 20XX, Corporation T has significant cumulative net operating losses (NOLs) of \$200M.

On April 1, 20XX, Investor A acquired 37 percent of T’s common stock. There were no other significant equity transactions of greater than 5 percent in the three prior years.

On July 1, 20XY, T issued Investor J convertible preferred stock, giving Investor J a 15 percent ownership stake in T. Investor A is unrelated to Investor J.

The acquisition by Investor A on April 1, 20XX did not constitute an ownership change for IRC section 382 purposes. However, the subsequent issuance of convertible preferred stock to Investor J on July 1, 20XY, triggered a change of ownership for IRC section 382 purposes because an ownership change of more than 50 percent occurred within a three-year rolling period.

As a result of Investor J’s transaction, T calculated its IRC section 382 limit for the NOLs generated prior to July 1, 20XY to be \$10M per year. If T had \$75M of taxable income in 20XY, it can use just \$5M of NOL carryforward to offset that amount (prorated for six months). The remaining \$195M of NOLs can be used to reduce taxable income in future years, subject to the IRC section 382 limitation of \$10M per year.

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