

Financing Tax Aspects for Portfolio Companies & Funds

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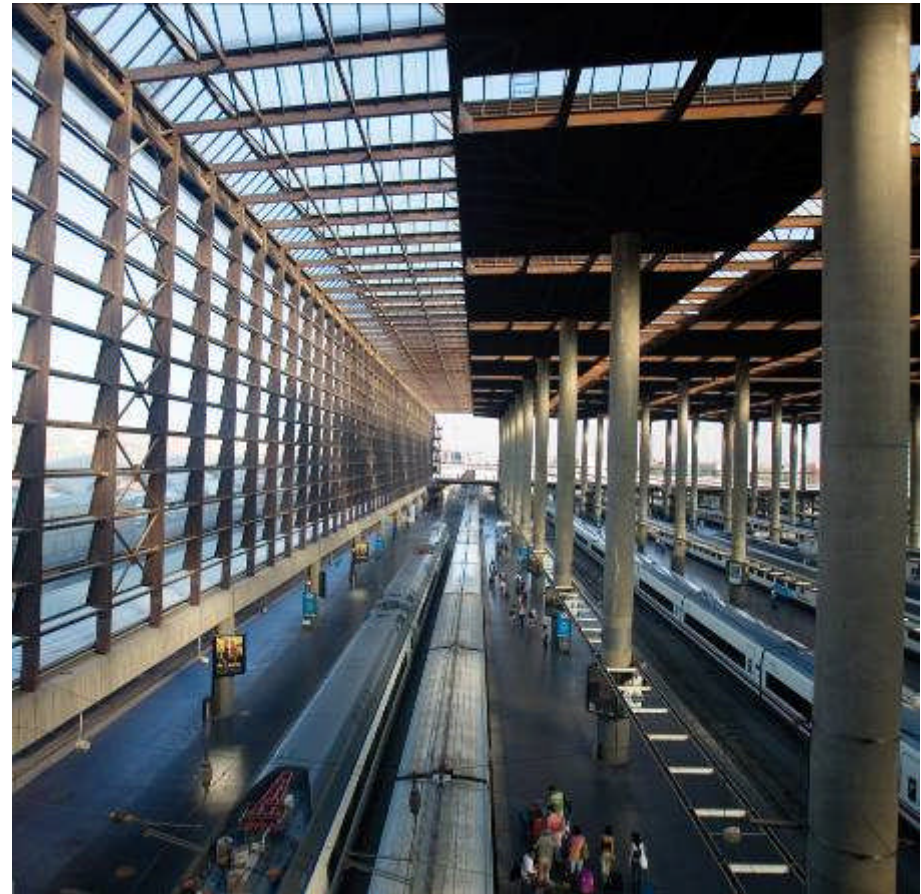
- The purpose of this document is to highlight certain U.S. Federal¹ tax issues and Israeli tax issues.
- The information contained in this presentation is for general guidance on matters of interest only. As such, it should not be used as a substitute for consultation with professional tax advisers.
- This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding any federal, state or local tax penalties.

¹ The scope of this document does not intended to cover any U.S. state or local tax aspects nor does it intend to cover any non-U.S. tax aspects.

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Part I: Financial Alternatives U.S. Tax Aspects



Cash Advances

Type of cash advance:

- Interest bearing / non-interest bearing.
- Convertible / non convertible.
- Loan / bridge loan / capital note.

Characterization of Cash Advances

- Cash (or cash equivalent) advances may be characterized, for U.S. Federal income tax purposes, as either debt or equity.
- The classification of specific advances depends on various facts that apply in the characterization of the instrument.
- The classification of specific advances may materially and adversely affect the taxpayers upon settlement, retirement or conversion of the cash advance.

Characterization of Cash Advances

Internal Revenue Code Section 385(c)

- Under IRC §385(c)(1), the characterization (as of the time of issuance) by the issuer, as to whether an interest in a corporation is stock or indebtedness, is binding on the issuer and on all holders of such interest but is not binding on the Secretary of the Treasury (“Secretary”).
- Consequently, IRC §385(c)(1) provides the Secretary with the authority to re-characterize such instrument, while it generally compels the issuer and the holders to be consistent with respect to such characterization in all tax years.

Characterization of Cash Advances – (cont.)

- Under IRC §385(c)(2), provided certain conditions are met, the consistency requirement of IRC §385(c)(1) shall not apply to any holder of an instrument if such holder discloses on his U.S. tax returns that he is treating such instrument in a manner inconsistent with the characterization referred to in IRC §385(c)(1).

Equity Characterization -Implications upon repayment

If a Convertible Loan were to be characterized as equity, any payments made by the Company to the Lenders would be classified as:

- (i) A dividend for U.S. tax purposes, to the extent of a Company's current or accumulated E&P.²
- (ii) Payments in excess of current and accumulated E&P would be treated as a return of capital and, therefore, not subject to U.S. Federal income tax.
- (iii) Any payments in excess of the capital investment would result in a capital gain.³

2 (a) Generally, in cases where a Lender is a tax resident of a country with which the U.S. has no tax treaty, or is not entitled to the benefits of such tax treaty, such dividends would be subject to U.S. WHT at a rate of 30%.

(b) When a Lender is a non-U.S. tax resident and his country of residency has a tax treaty with the U.S., provided certain conditions are met, such dividend payments may enjoy a reduced U.S. WHT rate.

(c) A U.S. tax resident partner would generally be subject to Federal income tax on dividends received.

3 A non-U.S. tax resident would not generally be subject to U.S. Federal income tax on such capital gains. However, a U.S. tax resident would, generally, be subject to U.S. Federal income tax on such capital gains.

Equity Characterization -Implications upon conversion

Provided certain conditions are met, the conversion of one equity instrument to another equity instrument may qualify as tax-free reorganization.⁴

4. IRC §386(1)(E) – a type E reorganization.

Equity Characterization - *Summary*

- As in most cases the portfolio companies have no current or accumulated E&P, the repayment of the cash advances should not result in a non-U.S. partner being subject to U.S. Federal income tax.
- A U.S. partner will be subject to U.S. tax only on the excess of the amount repaid over the basis and may be eligible for a tax-free treatment upon the conversion of the cash advance.

Debt Characterization - *Implications upon repayment*

- If a Convertible Loan were to be characterized as debt for U.S. tax purposes, any payments made to the Lenders, to the extent of the accrued and unpaid interest, would be classified as a payment of interest for U.S. tax purposes.
- In certain cases, interest paid by a U.S. company to a non-U.S. resident, may be exempt from withholding tax, e.g., if such interest qualifies as “portfolio interest”.
- If the Lender is a tax resident of a country with which the U.S. has no tax treaty, or is not entitled to the benefits of such tax treaty, provided the Interest would not qualify as “portfolio interest”, such interest payments would be subject to U.S. WHT at a rate of 30%.

Debt Characterization - *Implications upon repayment (Cont.)*

- If the Lender is a non-U.S. tax resident and his country of residency has a tax treaty with the U.S., provided certain conditions are met, and provided that the Interest would not qualify as “portfolio interest”, such interest payments may enjoy a reduced WHT rate.

Debt Characterization - *Implications upon conversion*

- In general, if convertible debt securities are not held until maturity but are instead converted into stock of the same corporation, the conversion may be a non-taxable event, even though the value of the stock received exceeds the basis of the debt.
- However, in the case of a contingent Original Issue Discount (“OID”) instrument, any gain recognized by the holder from the sale, exchange or retirement of the debt instrument described above, might be characterized as interest income.
- In general, OID is the excess of: (i) the stated redemption price at maturity over (ii) the issue price.

Debt Characterization - *Implications upon conversion* (*Cont.*)

- In order to determine whether a Convertible Loan is an OID instrument, and whether the Convertible Loan includes contingent payments, an in-depth analysis is required.

Example

Facts

- On 01/01/2005, a non-U.S. partnership invested an amount of \$1,000 in preferred A shares of a U.S. company. On 01/01/2006, the partnership invested an amount of \$1,500 in a convertible note.
- The convertible note provides for a conversion rate of two times the principal amount.
- On 01/01/2007, the convertible note was converted into shares at the value of \$3,000 which were immediately sold for \$3,000 and no consideration was received for the preferred A shares.

Example *Analysis*

	Debt characterization		Equity characterization
Interest income	\$1,500*	} No offset allowed	\$0
Net long term capital gain/loss	(\$1,000)		\$500

***Subject to WHT at the rate of up to 30%.**

Main Classification Criteria

- The factors indicated below are the main criteria which have been developed in U.S. case law, and which are customarily utilized in determining the classification of an instrument as either debt or equity for U.S. Federal income tax purposes.
- It should be noted that, in accordance with U.S. case law, the criteria below are examined in such case as a whole, and the classification is determined on the basis of the overall facts and circumstances of the case. Accordingly, the analysis of the criteria below further details relevant factors to be taken into account for purposes of the classification process.

Debt vs. Equity - Main Classification Criteria

Classification Criteria

- The presence or absence of a fixed maturity date.
- The intent of the parties, as indicated by the terms and the form of the agreement, and the way the parties classified the instrument in their financial statements and tax returns.
- The provision of a fixed rate of interest.
- Right to enforce the payment of principal and interest.
- The relative position of the obliges as to other creditors regarding the payment of interest and principal.
- The voting power of the holder of the instrument.
- The “thinness” of the capital structure in relation to debt.
- The risk involved.

Debt vs. Equity - Main Classification Criteria

Classification Criteria (Cont.)

- Certificate evidencing indebtedness.
- The source of payment, and the ability of the debtor to make repayments based on expected cash-flow on the date of issuance of the instrument.
- The ability of the corporation to obtain funds from outside sources.
- Presence of conversion rights.
- A provision for pre-payment by the borrower.
- A provision for pre-payment by the holder (creditor).
- The identity between creditors and security holders.
- The extent of participation in management by the holder of the instrument.

Points for consideration

- Grant of options for no consideration.
- Increased conversion rates (e.g., 2 or 3 times the principal amount).
- Discount given on share price upon conversion.
- Consider to add language as to the loan classification intent of the parties

Part II: Unrelated Business Taxable Income ("UBTI")



Overview

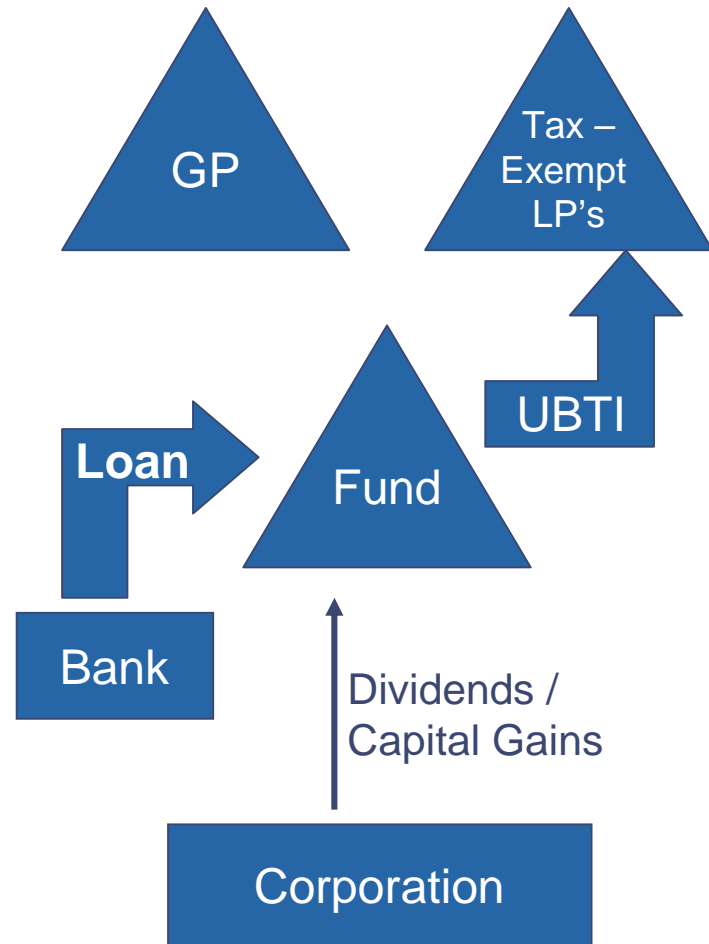
- Although generally exempt from tax, the Code imposes tax on a tax-exempt partner on its "unrelated business taxable income ("UBTI").
- The partnership agreement usually provide that the fund will avoid or will do its best effort to avoid UBTI.
- UBTI is defined as "*gross income derived by any organization from any unrelated trade or business.... regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business*
- Generally it would appear that an investment partnership will not subject a tax-exempt partner to UBTI unless the partnership has invested in:
 - Another partnership which generates UBTI, or
 - Debt-financed property (see discussion below)

Partnership which generates UBTI

- As a practical matter, most VC Funds do not invest in operating partnerships. As such, in most cases, a VC Fund's tax exempt partners will not be subject to UBTI.
- As a general rule dividends, interest, payment with respect to loans, gain or losses from the sale, exchange, or other disposition of noninventory property are exempt from the definition of UBTI unless the fund invested in debt-financed property.

Debt-financed Property

- Debt-financed property is any property held to **produce income** and with respect to which there is "acquisition indebtedness" at any time during the tax year (or during the preceding 12 months if the property is disposed of during the tax year). Acquisition indebtedness is defined as indebtedness incurred:
 - To acquire or improve the property
 - Before acquisition, if such indebtedness would not have been incurred but / for the acquisition; and
 - After acquisition, if indebtedness would not have been incurred but / for the acquisition and the indebtedness was foreseeable at the time of the acquisition



Debt-financed Property- Additional considerations

- Possible alternatives to avoid UBTI as a result of investment in debt-financed property.
 - Short-term borrowing
 - Deferral of management fees (Is it a liability?)
 - GP provides the financing and “parks” the investment until the capital call
 - Tax exempt partners actually contributed cash while the other partners borrowed the cash
 - Waiver / Preferred Return

Part III: Other Tax Issues



Distressed Debt

- Current market conditions provide an environment conducive for debtor default on convertible loans.
- As a general rule, an accrual basis taxpayer would recognize interest income as earned on convertible loans treated as debt under IRC §385.
- If never received, then bad debt deduction or worthless security loss might be available
- Doctrine of doubtful collectability allows income not to be accrued if no “reasonable expectation” of receipt

Distressed Debt

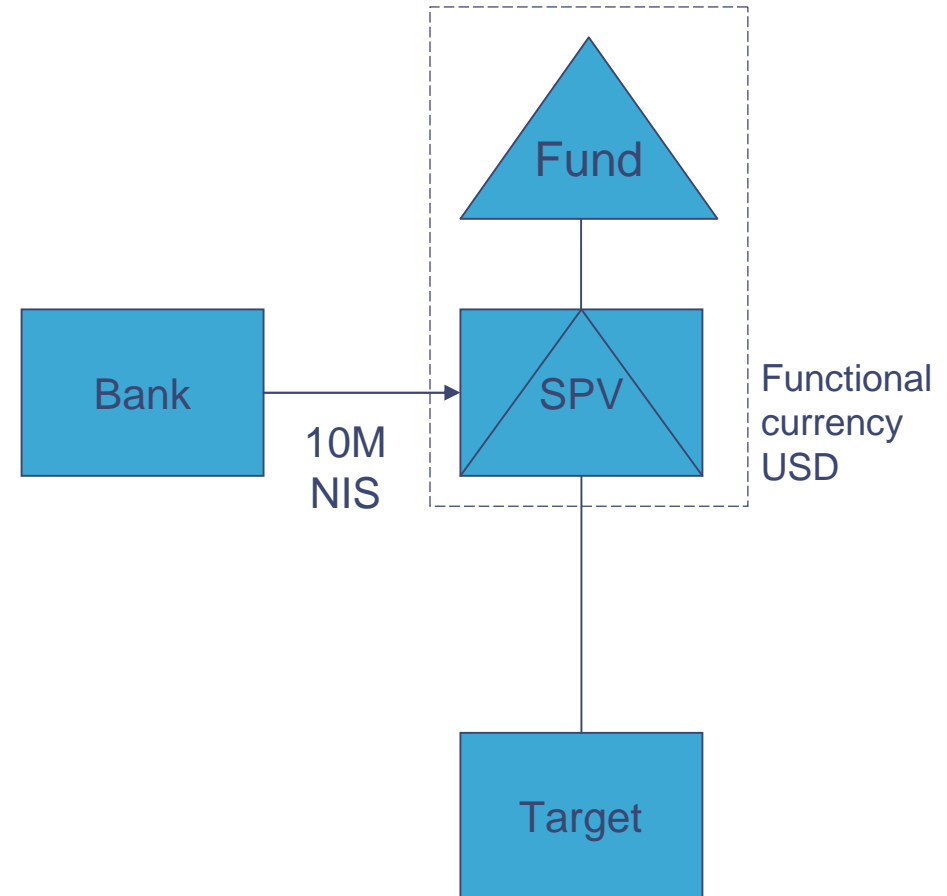
- Example:

Calendar year Taxpayer X lends Company Y \$100,000 bearing 8% interest on Jan, 1. At the end of each year, Taxpayer X must recognize \$8,000 of interest income (accrued, not yet paid). In Year 3, Company Y becomes worthless: Taxpayer X will recognize \$116,000 of capital loss (\$116,000 = \$100,000 basis + \$16,000 increase to basis from interest payments). The \$100,000 loss will be capital in nature whether we accrued interest or not. Thus, the “real” discrepancy is between the tax paid on the \$16,000 of interest income (i.e., at ordinary rate of 35%) and the tax benefit received from the capital loss on the \$16,000 (i.e., 15% for individuals). Note that a corporate partner will not have the above issue.

- When is there no reasonable expectation of receipt?

Section 988

- IRC §988 deals with foreign currency transactions and provides that certain foreign exchange gains or losses are treated as ordinary income or loss
- Application to Private Equity Fund - gains/losses as a result of exchange rate differences on non functional currency loans may be taxed as ordinary income/loss.



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