

Tax Strategies and Consequences of Exits

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IIR VENTURE CAPITAL & PRIVATE EQUITY TAX PRACTICES

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TAX STRATEGIES AND CONSEQUENCES OF EXITS

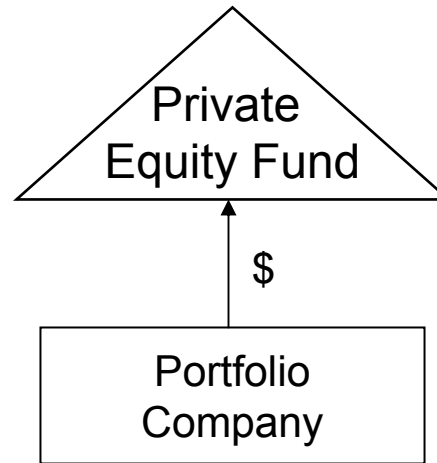
- Overview of Market Trends
- Tax Strategies Involving Portfolio Company Distributions
- Tax Strategies Involving Public Exits
- Alternative Exit Strategies
- Special Issues
- Where do we go from here?

Overview of Market Trends

- “Bubble” Collapse
- 2001 Recession
- Decimalization of Nasdaq
- Investment Banking Consent Decree
- Sarbanes-Oxley
- Institutional Investor/Investment Banking Consolidation
- Emergence of Hedge Fund/PE Driven Markets

Tax Strategies and Consequences

Tax Consequences of Portfolio Company Distributions



- Tax consequences depend on earnings and profits (E&P) of Portfolio Company
 - Dividend to extent of current or accumulated E&P
 - Then tax-free return of capital to extent of basis
 - Then capital gain from sale or exchange of shares

Tax Consequences of Portfolio Company Distributions, cont'd

- Taxation of dividend
 - For individual investors in Fund, through 2010, dividend taxed at same rate as long-term capital gain (15%), subject to limitations (holding period, diminished risk of loss)
 - For corporate investors, dividend will be eligible for 70% dividends received deduction, subject to limitations (holding period, debt-finance, diminished risk of loss)
 - For non-US investors, withholding may apply (30% or lower treaty rate)
- Special rules if dividend is an “extraordinary dividend” under § 1059:
 - For individuals, anti-stripping rule: loss on sale of shares treated as long-term capital loss to extent of dividends taxed at 15% rate
 - For corporate investors, basis in shares reduced by portion of dividend that is not taxed under dividends received deduction
 - In general, extraordinary dividend is any dividend that exceeds 10% (5% for certain preferred stock) of the shareholder’s basis in the stock (or, if the shareholder elects, the fair market value of the stock)

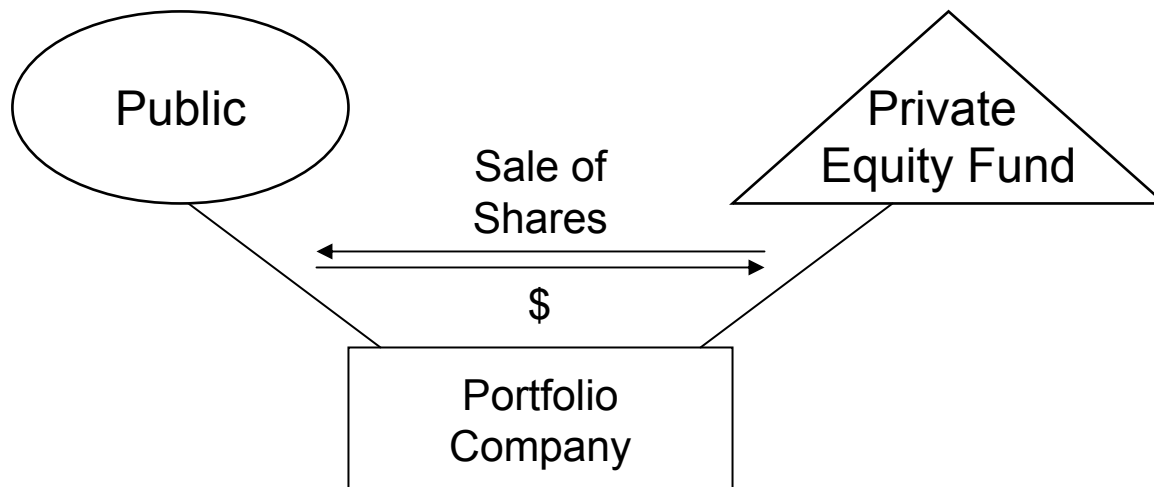
Tax Consequences of Portfolio Company Distributions, cont'd

- May be possible to structure acquisition of Portfolio Company to reduce E&P
 - So that all or part of later distribution by Portfolio Company to Fund will be treated as tax-free return of capital
- Purchase of Portfolio Company shares from existing investors will not reduce E&P
- Redemption of shares held by existing shareholders will reduce E&P
 - To be treated as redemption for this purpose, must completely terminate shareholder's direct or indirect ownership interest
- Nimble dividend rule

Tax Strategies Involving Public Exits

- IPO Exit in First Year of Portfolio Company Acquisition
- IPO of Foreign Portfolio Company
- IPO – Preserving “Tax Step-up” and “Recap” Accounting

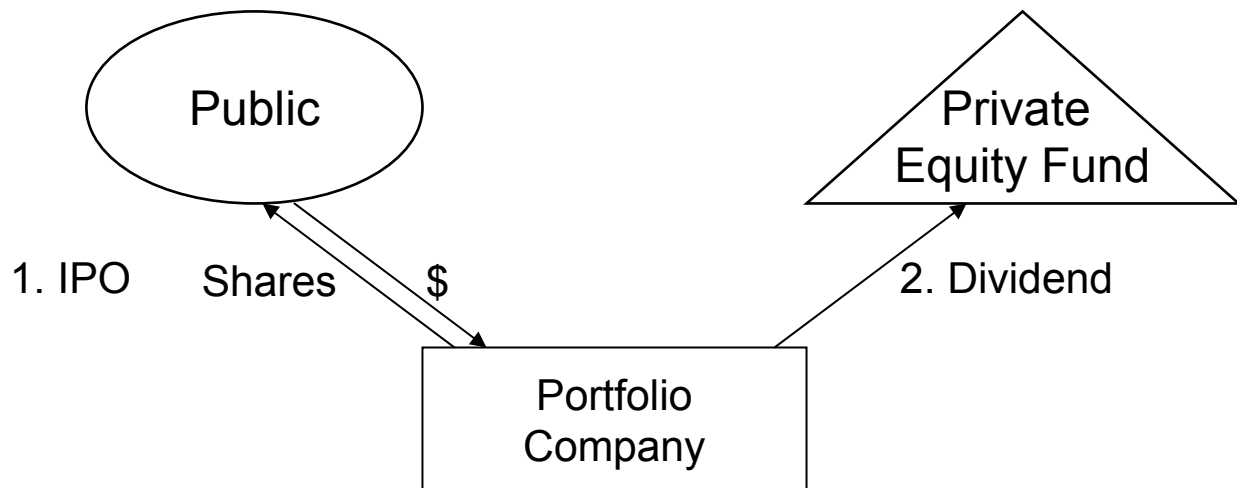
IPO in First Year of Acquisition: Secondary IPO



TAX CONSEQUENCES

- Secondary sale is capital transaction to Private Equity Fund seller
- If sale occurs within first year of holding period, then capital gain is short-term
- Taxed at ordinary income rates for individuals investors/GP

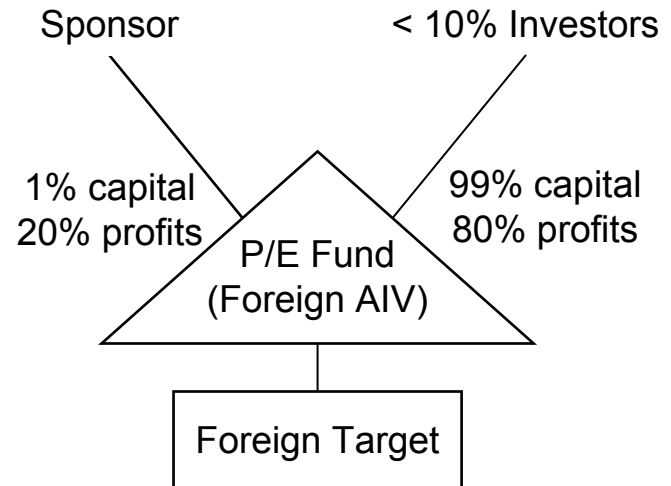
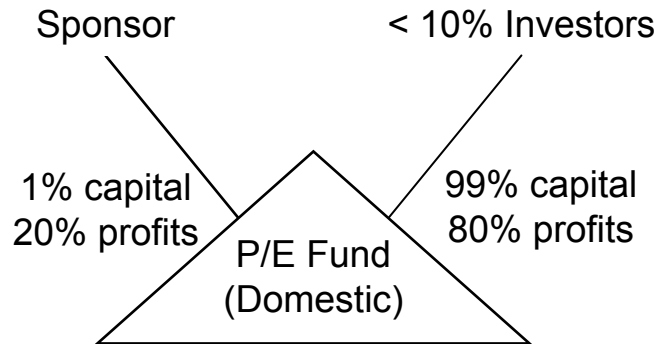
IPO in First Year of Acquisition: IPO Followed by Dividend



TAX CONSEQUENCES

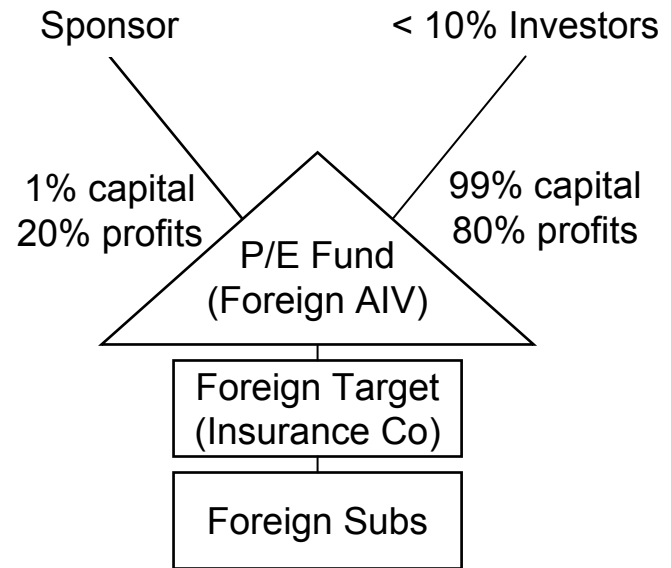
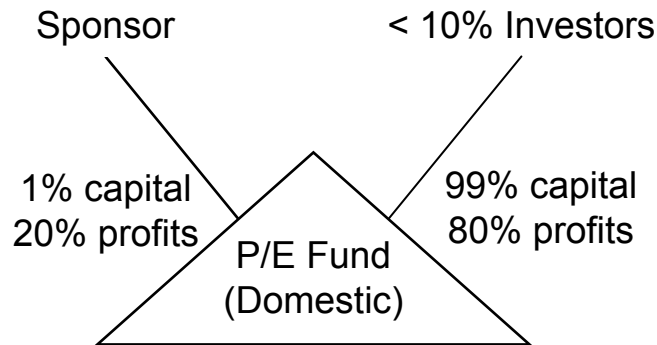
- Primary sale is capital transaction to portfolio company, so no gain or loss
- As noted above, Portfolio Company distribution will be treated as dividend to extent of current or accumulated E&P, then as tax-free return of capital to extent of basis, and then as capital gain from sale or exchange of shares

Tax Aspects of IPO of Foreign Portfolio Company



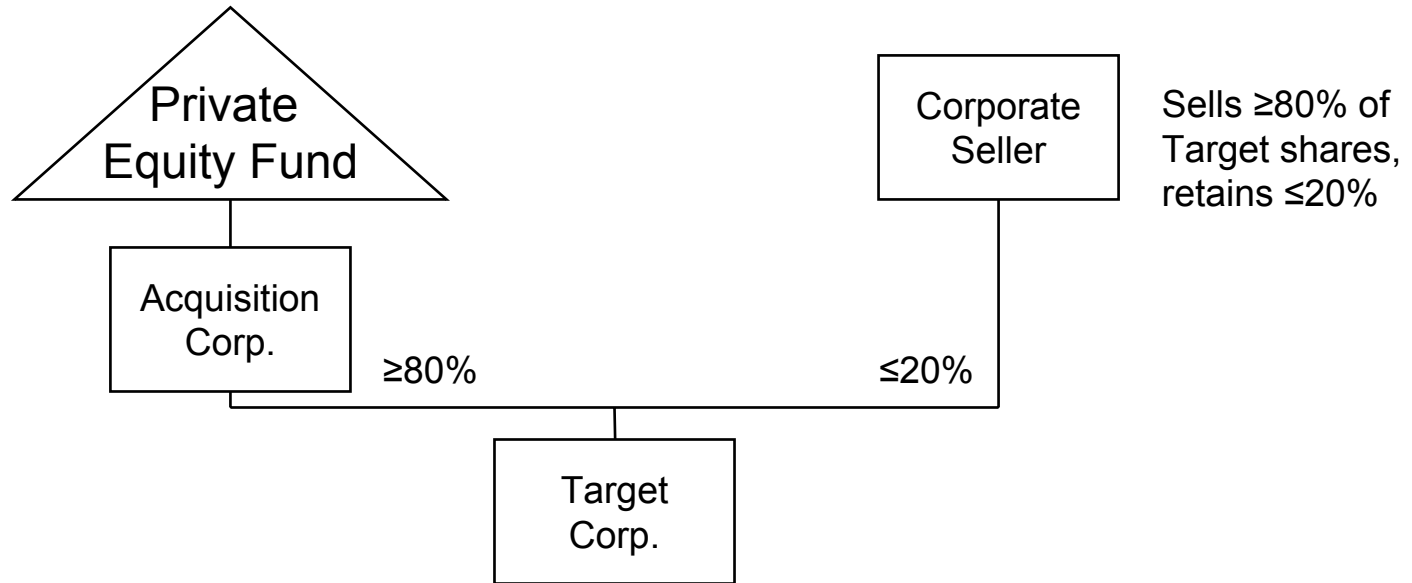
- If Foreign Target is a CFC, pass-through of Subpart F income to U.S. Shareholders
 - CFC if more than 50% of stock (by vote or value) is owned by “U.S. Shareholders”
 - U.S. Shareholder is a U.S. person that owns, directly, indirectly or by attribution, 10% or more of the total combined voting power of all classes of stock entitled to vote
- If CFC, portion of gain on sale will be ordinary income under § 1248
 - Section 1248 amount is eligible for 15% reduced rate for dividends; Notice 2004-70
- Check-the-Box Considerations

Tax Aspects of IPO of Foreign Portfolio Company, cont'd



- Special CFC rules apply to insurance companies – § 953, UBTI, RPII
- Voting Cutback
- Attribution from Subsidiaries – § 958(b)(3)
- Proxy/Bylaws – INI v. Comm'r, 1995-112 TC Memo

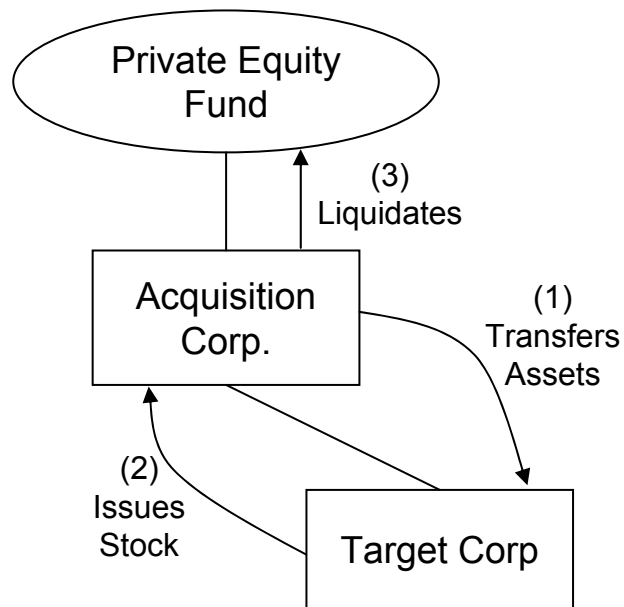
Tax Aspects of Combining (1) Tax Step-up Acquisition, (2) Recap Accounting and (3) IPO



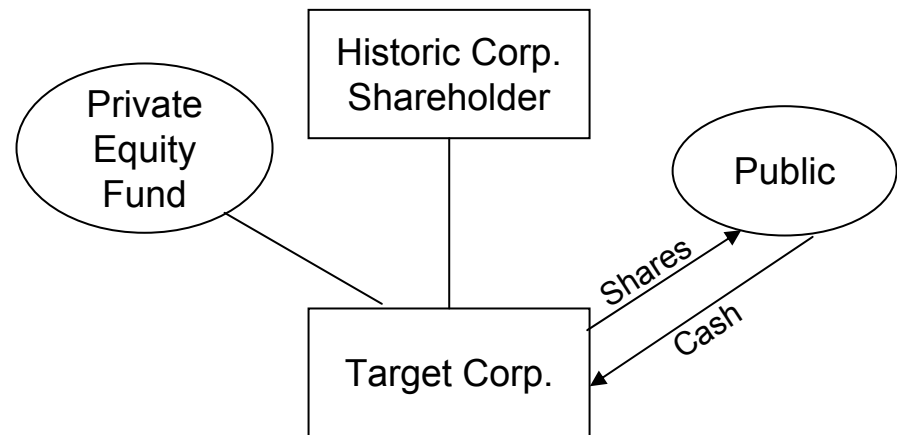
- Corporate Seller and Acquisition Corp. make Section 338(h)(10) election
 - Target's assets are stepped-up to fair market value
 - Asset gain paid by Corporate Seller
 - Purchaser must be a corporation for Section 338(h)(10) election to be available
- Recap Account applies because of Corporate Seller's continuing ownership
- Thus, step-up in basis for tax purposes, but no step-up for accounting purposes

Tax Aspects of Combining (1) Tax Step-up Acquisition, (2) Recap Accounting and (3) IPO, cont'd

FIRST STEP REORGANIZATION



SECOND STEP IPO – PRIMARY OR SECONDARY OFFERING

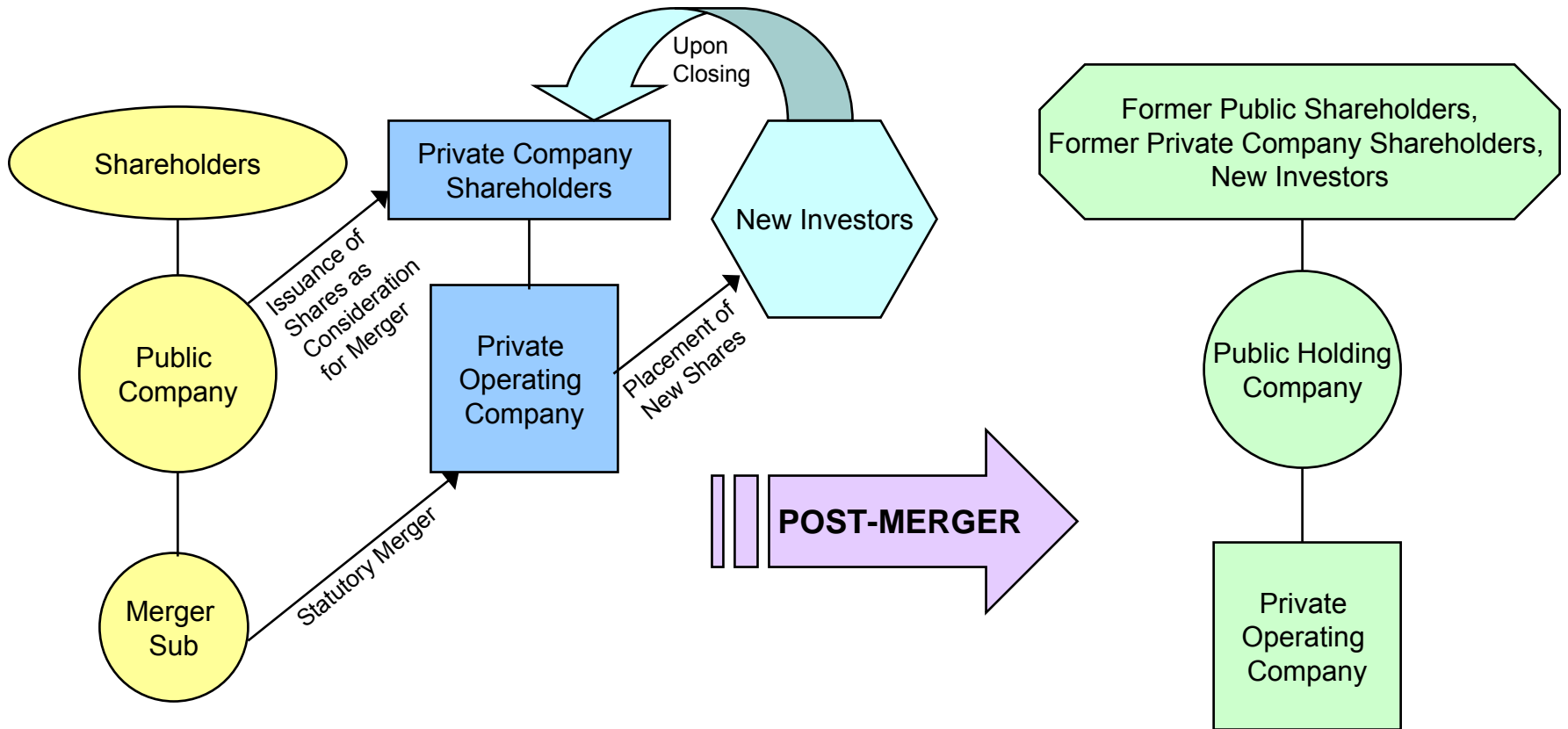


Alternative Exit Strategies

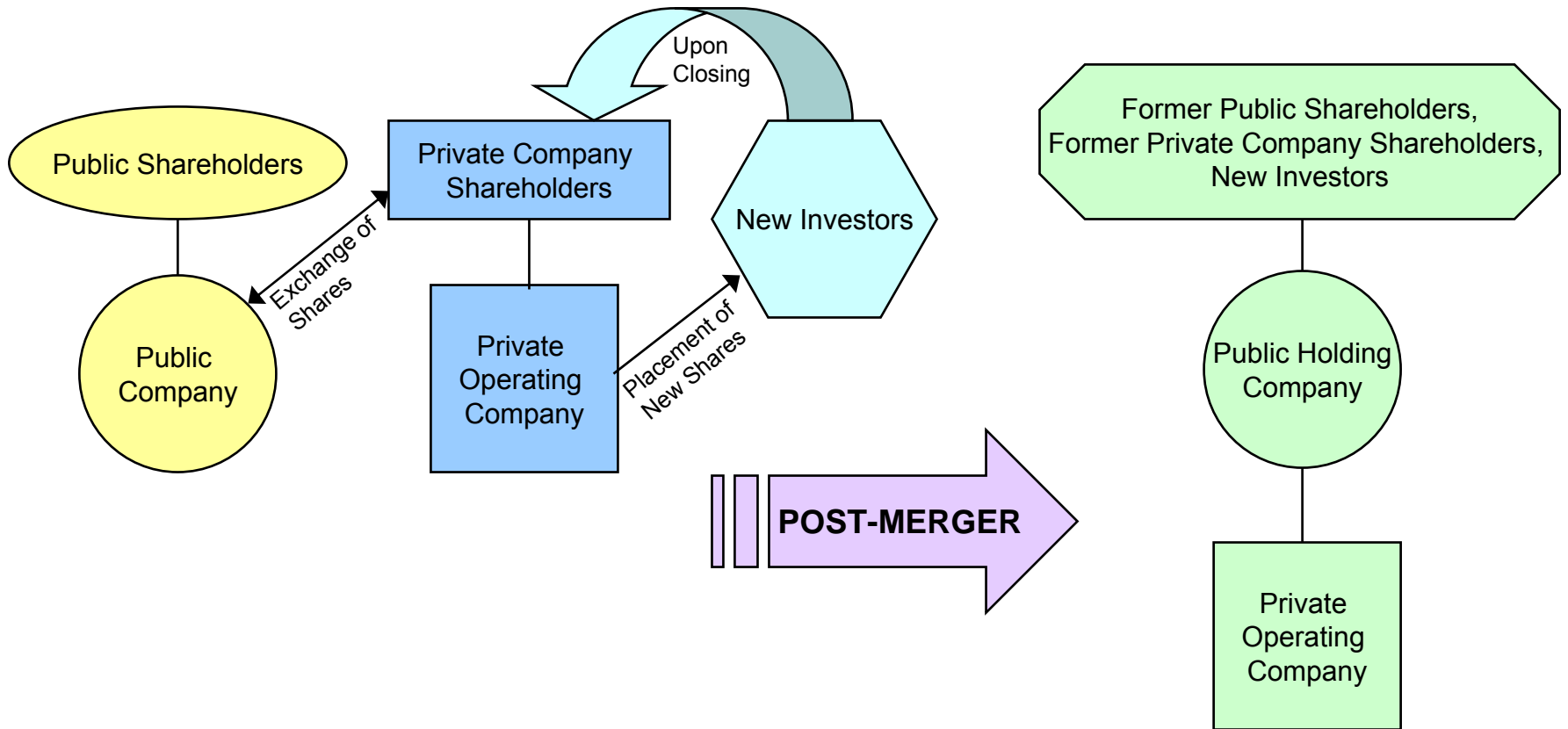
Reverse Mergers

- Well-established financing/exit strategy
 - Blockbuster Entertainment; Daimler-Chrysler, The New York Stock Exchange, Inc. etc.
- Emerging as clear alternative to traditional IPO
 - Private equity/VC portfolio companies
 - Small/micro-cap companies
- Process can take as little as 6 weeks, more commonly 2-3 months
- “Super” 8-K rules require Form S-1 comparable disclosure within four days of closing
- Prices for shell companies have increased significantly in past 12 months
- To increase liquidity in shares, most companies do an immediate PIPE in conjunction with the reverse merger
- Can be effected on AIM, AMEX, NASDAQ, OTC-BB or pink sheets

Structure of a Triangular Reverse Merger



Structure of a Share Exchange



Candidates for A Reverse Merger

Good candidates for reverse merger transactions are:

- Private operating companies with revenue-generating operations and/or substantial technology in growing industry
- Companies lacking immediate access to the initial public offering market, including access to appropriate underwriters
- Companies which require public status to facilitate rapid access to capital, including funding of PIPE (private investment in public equity) offerings
- Companies which desire to use stock as consideration in mergers and acquisitions
- Companies which require liquidity as an exit strategy for initial investors

Reverse Mergers Versus An Initial Public Offering (IPO)

- **Flexibility**
- **Reliability**
- **Access to Funding**
- **Liquidity**
- **Costs**
- **Timing**
- **After-Market Support**
- **Regulatory Issues**

What Is A Shell Company?

Definition

A public company that has:

- No or nominal operations; and
- Based on GAAP balance sheet at time of determination, either:
 - No or nominal assets; or
 - Assets consisting solely of cash and cash equivalents; or
 - Assets consisting of any amount of cash and cash equivalents and nominal other assets.¹

Common Characteristics

- Formerly operational or prior development stage company already subject to SEC reporting requirements with some public float, usually on pink sheets or OTCBB (“living dead company”)
- Usually has no or limited assets and liabilities, is in process of winding down its operations or no current operations
- Alternate forms: Form 10 bankrupt shell, Rule 419 “blank check company”, SPAC

¹Securities Act Rule 405 and Exchange Act Rule 12b-2

Transaction Agreements and Related Documentation

Agreement and Plan of Merger or Share Exchange Agreement:

- Includes deal structure, customary representations and warranties, covenants regarding SEC process and post-Transaction cooperation
- Outlines anticipated timing for key steps
- States any anticipated stock split, recapitalization, reincorporation, and/or name change

Share Cancellation Agreement
Escrow Agreement

} *If shares being cancelled or redeemed for cash*

Acquisition Company Organizational Documents

Board Consents – private company, shell company, acquisition company

Shareholder Consents — if proxy solicitation not required

Press Release, Form 8-K Reporting Definitive Agreement

Tax Consequences of Reverse Mergers: Inversions and Section 7874

- If U.S. target becomes subsidiary of foreign parent, need to consider whether Section 7874 applies
- If at least 80% of foreign parent stock (by vote or value) is held by U.S. target shareholders after merger, foreign parent will be treated as domestic corporation
- If between 60% and 80% of foreign parent stock (by vote or value) is held by U.S. target shareholders after merger, “inversion gain” must be recognized without offset for any deductions (such as NOLs) or credits
- In either case, these rules only apply if the foreign parent and its affiliates do not have substantial business activities in the parent’s country of incorporation

Reverse Mergers: Case Studies

SOLEXA INC. (NSDQ: SLXA)

- High-speed DNA sequencing
- VCs: Abingworth, Oxford, Amadeus, and Schroeder
- Reverse merger in March 2005 into Lynx Therapeutics (distressed public company but not a shell)
- Merger followed by \$65mm PIPE, led by ValueAct Capital of San Francisco
- Changed investor mix from exclusively VC to only about 1/3 VCs—remainder are hedge funds and other more classic public company investors

Reverse Mergers: Case Studies, cont'd

CYBERKINETICS NEUROTECHNOLOGY SYSTEMS INC. (OTC BB: CYKN)

- Medical devices creating interfaces between computers and the human brain for use by paraplegics
- VCs: Oxford, Global Life Science Ventures
- Reverse merger in October 2004 into Trafalgar Ventures Inc. (Canadian public company incorporated for purposes of mining copper, nickel, and platinum—a true public shell)
- \$8 million PIPE in November 2004, one month after reverse merger
- Additional PIPEs in 2005 and 2006

Concurrent Financing

Financing the Shell

- Company pays – either from cash on hand, bridge financing, or proceeds of concurrent private offering
- Outside third party “provides” the shell for equity

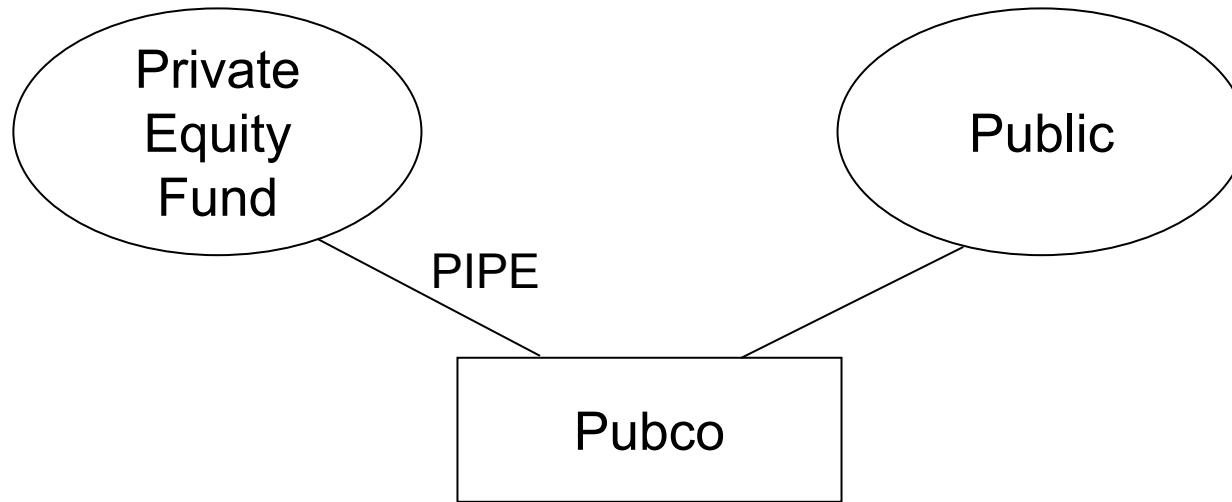
PIPE

- *Non-traditional:* raise by private company completed prior to the closing or concurrent with the closing, shares exchanged into public company as part of reverse merger
- *Traditional:* raise conducted immediately post-closing

PIPEs

- Private Investment in Public Equity
- Over \$25 billion raised through 1,657 PIPEs in 2005
 - Top industry sectors: energy (\$3.96 billion; 201 deals; average \$19.7 million) and life sciences (\$1.29 billion; 105 deals; average \$12.3 million)
- Thru 9/30/06, 1,354 PIPEs completed, raising over \$25.45 billion
- Two steps
 - Private Placement with Registration Rights
 - Register Securities for Resale with SEC
- Initial abuses have been stemmed, but SEC continues to monitor activity closely
- Issues to watch
 - Blue sky
 - Hedge fund/mutual fund activity
 - Shareholder approval
 - Ongoing listing requirements
 - Accounting issues, e.g. EITF 00-19

Tax Consequences Relating to PIPEs

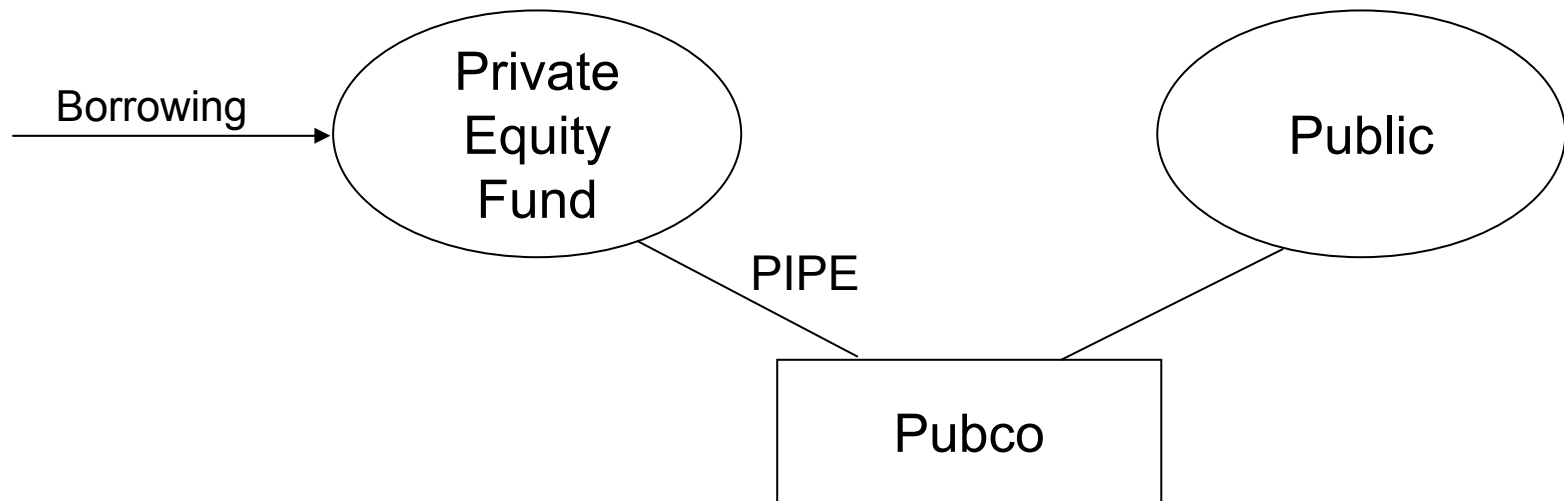


PIPE

- Convertible Debt
 - Phantom Income
 - Character of Income (higher ordinary income tax rates)
- Convertible Preferred Stock
 - Avoiding Phantom Income
 - Character of Income

Tax Consequences Relating to PIPEs, cont'd

ADDING LEVERAGE TO THE STRUCTURE



- LEVERAGE IMPACT
 - UBTI
 - Use of “Blocker”
 - Impact on Exit

SPACs

- Popular financing strategy in mid-'90s; succumbed to dot.com boom
- Regained popularity as private equity and hedge fund money sought better returns in volatile markets
- Market statistics:
 - 50 registered with SEC in 2005 alone
 - More than 25 have gone effective, raising \$1.2 billion in 2005
 - 11 deals in 2004 raising less than \$500 million
 - Aggregate \$2.8 billion raised since 2003
 - Average aftermarket performance once deal announced -- +86%
 - In 8/06 alone, 10 mergers announced
- Examples of Recent SPACS

SPACs, cont'd

- SPACs have no operations
 - Go public with intent of acquiring an operating company with proceeds
 - Typical investors – large institutions, hedge funds
- At least 80% of funds go into an escrow account until target is found
 - Current trend up to 96%+ with significant management investment
 - Must acquire company with FMV of at least 80% of SPAC's net assets
- Must effect acquisition within 18 months of IPO to comply with “blank check” rules
- Depending upon amount raised, SPACs can list on AMEX, OTC-BB or AIM
 - AMEX requires \$60 million minimum
 - NASDAQ policy prevents listing of SPACs even if qualitative requirements are met
- SPAC acquires target which then becomes listed company

SPAC vs. Reverse Mergers

- Valuation is higher for the Reverse Transaction
- Liquidity favors the SPAC
- Timing and process favors the Reverse Transaction
- Less Risk in the SPAC
- Market support favors SPAC initially
- Control favors the Reverse Transaction

SPACs: Case Study

NationsHealth (NSDQ: NHRX)

- Medical products and prescription services company
- Began trading on National Market January 2006; previously on Small Cap
- Gained access to public markets in September 2004 through merger with Millstream Acquisition Corp, a SPAC
- \$15 million PIPE in February 2005
 - Investment units comprised of 7-³/₄% 7-year Secured Convertible Notes plus 1,785,714 shares of common

Facts About AIM

- \$139.3 billion total market capitalization
- 2,200 IPOs since 1995
- All industry sectors
- 274 non-UK company IPOs
- 519 IPOs in 2005
- \$16 billion raised in 2005
- \$11.4 billion total IPO funds in 2005
- \$4.4 billion further fundraisings in 2005

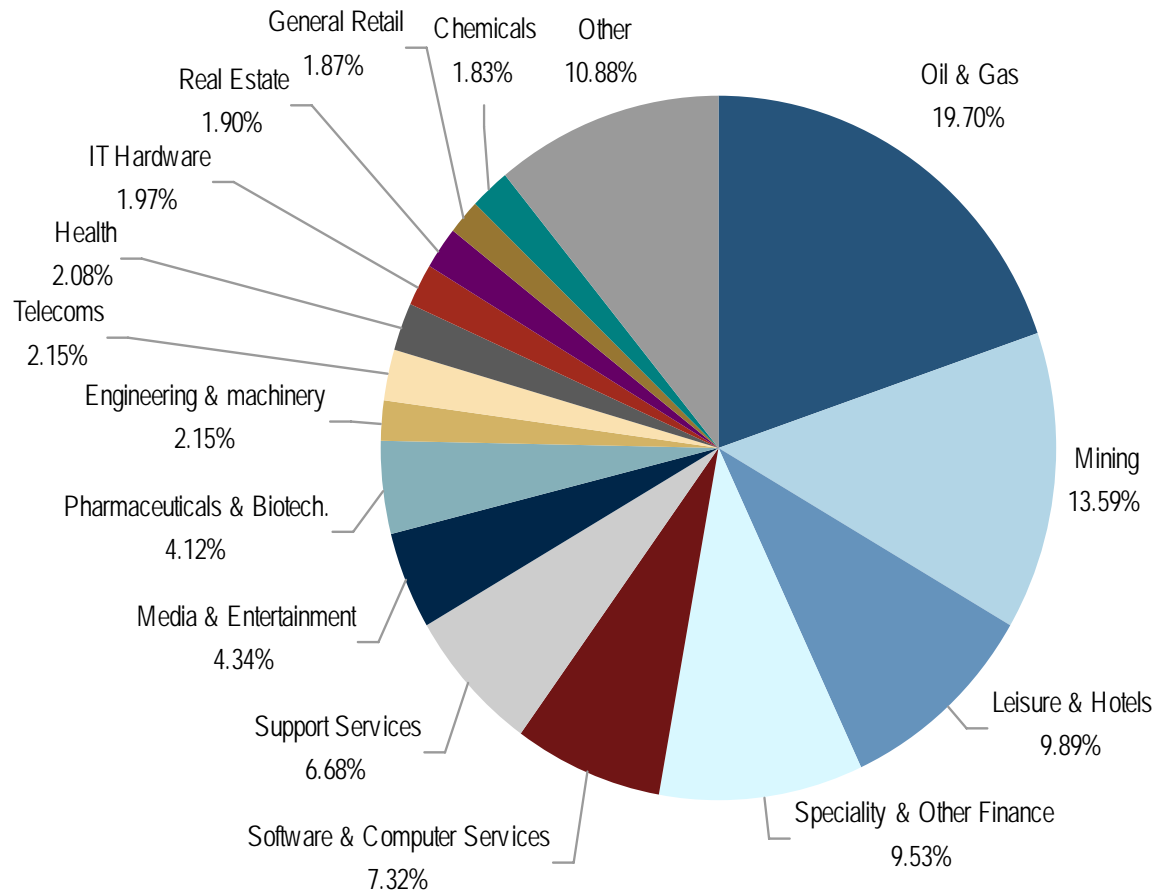
AIM Admissions

- Emerging as the listing option of choice for small/micro-cap companies
- Over 1,400 companies listed with more than 20% from outside the UK
- Target market cap = \$500 million
- Regulation “Light”
 - No compliance with Sarbanes-Oxley or equivalent stringent standards
- Can trade in US dollars
- Stepping-stone to NASDAQ or AMEX

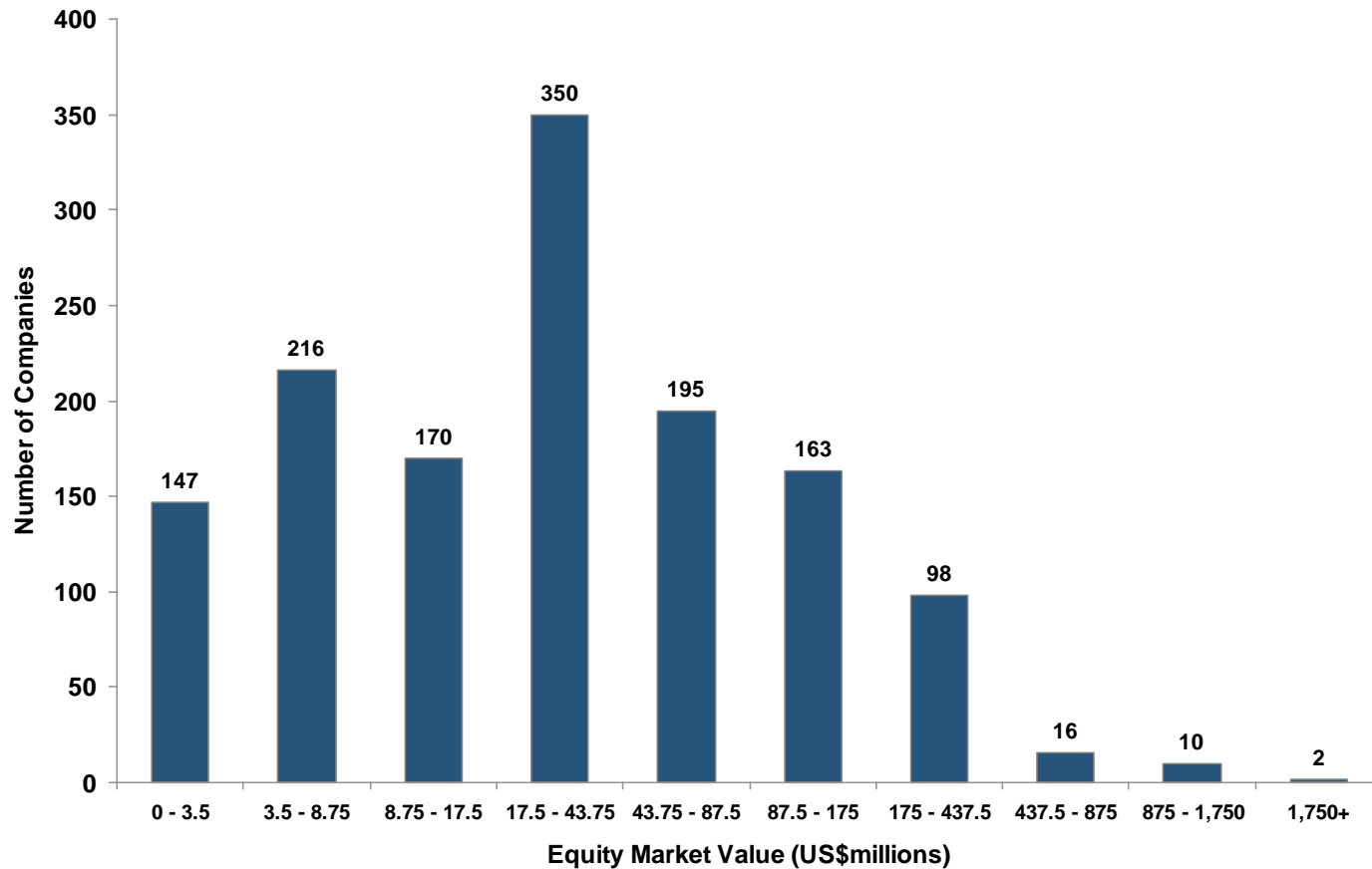
U.S. Companies on AIM

- 46 U.S. companies on AIM
 - 43 have a primary listing in London
 - 33 have joined since January 2005
 - 10 joined via non-U.S. holding company
- Average Market Capitalization: £47.6m (\$88.5m)
- Average Market Capitalization of companies listed since January' 06: £75.8m (\$141.0m)
- Average number of Market Makers: 3 per company
- Average number of capital raisings: 3

Industry Sector



Market Cap Distribution



AIM Admissions: The Process

- Pre-IPO reorganization (if needed)
 - Tax issues
 - Imposition of UK “Topco”
- Legal Issues
 - Compliance with US federal securities laws
 - CREST trading issues
 - Restricted shares
 - Depositary interests
- Due diligence
- Documentation
- Marketing
- Admission
- Continuing obligations

AIM Admissions: Case Studies

Spacelabs Healthcare, Inc. (AIM: SLAB)

- Market cap \$150 million
- \$26.9 placing and admission to AIM in October 2005
 - Global healthcare equipment services and supply company
 - The first-ever spin-out from a NASDAQ-listed company (OSI Systems) onto the AIM market

Current Issues to Keep Your Eye On...

The Return of Tender Offers

- Tender offers have been shunned in recent years because of fear of litigation
- Uncertainty about how executive comp arrangements, particularly golden parachutes, affect price per share deemed to have been received by executives, compared to other shareholders
- SEC proposed new amendments to Sec. 14d-10 on December 15 that would provide a safe harbor for executive comp in tender offer situations
- If this issue is resolved, tender offers may have advantages over mergers
- Merger may take months; tender offer can be completed in 20 business days

Current Issues, cont'd

EITF 00-19 (2000)

- “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”
- Contains explicit guidance on classification and measurement of warrants and instruments with embedded conversion features
- Involves accounting analysis of instruments under SFAS 150 and SFAS 133 to determine if liability or equity
- Recent attention by SEC in connection with PIPEs, but may affect other transactions as well
 - Warrants
 - If settled in cash or required to be settled in registered shares
 - Variable convertible securities
 - If conversion feature based upon variable mechanism (e.g. trading price) and no cap
 - Liquidated damages clauses
 - May impose significant penalty with or w/o cap
 - Measure difference in value between registered and unregistered shares

Current Issues, cont'd

Advisory Committee on Smaller Public Companies

- Final recommendations issued in April 2006
- Tiers of issuers based upon revenues/market cap
- Controversy over application of SarBox Section 404 on Internal Controls

Conclusion

- **Traditional exit strategies and capital markets have proven volatile and uncertain post-bubble and post-Sarbanes-Oxley**
- **Alternative financing techniques and exit strategies have filled the liquidity gap and gained wide-spread market acceptance**
- **Private equity and venture groups are utilizing these techniques to realize returns on their portfolio companies**
- **There is no “one size fits all” – each company needs to be evaluated separately on its own merits**

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