

THE NEWSLETTER OF THE BDO PRIVATE EQUITY PRACTICE

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KEY PROVISIONS IN THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010

By Randy Schwartzman, Tax Partner with BDO

On December 17, 2010 President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. As discussed below, the main provisions of the Tax Relief Act were to extend the Bush-era 2001 and 2003 tax cuts for all income levels for two years, extend unemployment insurance for another 13 months, and set the estate tax at 35 percent through 2012. Provided below are some key provisions affecting Private Equity and their investors.

► ORDINARY INCOME TAX RATES

Over the past several years, there has been a strong political debate about whether the favorable individual income tax rates, which were set to expire at the end of 2010, should be extended for everyone, or for everyone except those taxpayers who made more than \$250,000.

The new law settles the issue by extending the lower rates for all taxpayers. Under the new law, the rates that have been in effect in recent years will remain in place instead of reverting to higher rates. Instead of going up to 39.6 percent, the highest individual ordinary federal income tax rate will remain at 35 percent for two more years through 2012.

DID YOU KNOW...

U.S. companies have been targeted in 8,751 deals in this year alone — a 40% increase from the same time in 2009.

Source: Dealogic

According to **Thomas Reuters**, global mergers are expected to rise 36% in 2011. This increase is predicted to be a result of dealmaking in the healthcare, financial, and real estate sectors.

Private equity investment has been driven by the middle market (\$50 million-\$1 billion). To date in 2010, this accounts for 60% of the capital invested by PE firms. Deals between \$1 billion and \$2.5 billion saw a 33.6% increase this quarter from the second quarter of 2010, with 6 deals completed for a total of \$8.56 billion.

Source: Pitchbook's Private Equity Breakdown 4Q 2010

In Q3, the private equity industry continued its post-recession rebound, yet activity in the sector is still not at pre-recession levels. The total equity investment in PE transactions went from \$36.4 billion in Q2 to \$40.1 billion in Q3. First quarter investment was \$17.8 billion

Source: PE Index released by Private Equity Growth Capital Council

According to the most recent **ACG-Thomas Reuters DealMakers Survey**, nearly three-quarters of respondents (74%) anticipate a rise in M&A activity over the next six months. One in 10 predicts M&A activity will "increase significantly" from the previous six months, while 64% say it will "increase moderately."

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KEY PROVISIONS IN THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010

►CAPITAL GAINS TAX RATES

Capital gains and losses generally arise from sales of capital assets (i.e., generally non-inventory assets). Private Equity often realize capital gains from the sale of portfolio companies. For individuals, trusts and certain other members, capital gains flow through and are generally taxed at a preferential capital gains rate in comparison to ordinary income tax rates.

Since 2008, the highest rate of tax on long-term capital gains has been 15 percent. However, the 15 percent rate was scheduled to expire at the end of 2010 with the result that in 2011 the long-term capital gains tax rate would have risen to 20 percent if Congress had not acted. The new legislation forestalls the rate increase by extending the highest 15 percent long-term capital gains tax rates through 2012.

►QUALIFIED DIVIDENDS

Since 2003, "qualified dividends" have been taxed at the same low tax rates that apply to long-term capital gains, which is generally 15 percent.

To count as "qualified," dividend-paying common stocks must be held for at least 61 continuous days and preferred stock must be held for at least 91 days before the ex-dividend date—the last purchase day for collecting the dividend.

The low rates for qualified dividends, like the other Bush tax cuts, were scheduled to expire at the end of 2010. If Congress had not acted, beginning in 2011 taxes on dividends would have returned to the rates that were in effect before 2001, and all dividend income received in 2011 would have been taxed as ordinary income. Therefore, individual investors would have paid as much as a 39.6 percent tax on dividends (and even 3.8 percent more once the provision of the Health Care Reform Act becomes effective in 2013).

The new legislation prevents the rate increases from happening by continuing the tax regime in effect for qualified dividends whereby the



maximum tax rate on dividends will remain at 15 percent through 2012.

►QUALIFIED SMALL BUSINESS STOCK

Subject to limitations, certain non-corporate taxpayers including investors of Private Equity firms, may exclude 100 percent of the gain realized on the sale of "qualified small business stock" ("QSBS") held for more than five years and acquired in a temporary period (see detailed discussion in article entitled Significant Tax Provisions in the 2010 Small Business Jobs Act). Additionally, the excluded portion of the gain from eligible QSBS is excluded from treatment as an alternative minimum tax (AMT) preference item.

For certain periods before and for all periods after the temporary period, the exclusion is only partial – generally 50 percent. For regular income tax purposes, the portion of the gain that *can be* included as taxable income is taxed at a maximum rate of 28 percent. Thus, for regular tax purposes, the gain from QSBS that is subject to the 50 percent exclusion is taxed at a maximum effective rate of 14 percent – which is only 1 percent less than the 15 percent maximum capital gains rate in effect in previous years (not much of an incentive).

The 2010 Tax Relief Act extends the 100 percent exclusion and exception from

minimum tax treatment for QSBS for one year by changing the date before which eligible QBS must be acquired from before January 1, 2011 to before January 1, 2012. Thus, subject to meeting all of the QSBS limitations and the more-than-five-year holding requirement, no regular tax or AMT is imposed on the sale or exchange of QSBS acquired after September 27, 2010 and before January 1, 2012. QSBS gains are available as a flow through to investors of Private Equity.

►SOCIAL SECURITY PAYROLL TAX

The Jobs Creation Act reduces individual, but not employer, Social Security payroll tax by two percent during 2011, from 6.2 to 4.2 percent. This should provide immediate cash to individuals subject to social security with the hope that they will use the excess cash flow to purchase goods and services – including those provided by portfolio companies owned by Private Equity.

►BONUS DEPRECIATION

Under the Tax Relief Act, companies will be allowed to expense the full cost of any capital investments made during 2011. Two of the most significant changes provide incentives for businesses to invest in machinery and equipment by allowing for faster cost recovery of business property.

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KEY PROVISIONS IN THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010

Businesses are allowed to deduct the cost of capital expenditures over time according to depreciation schedules. In previous legislation, Congress allowed businesses to more rapidly deduct capital expenditures of most new tangible personal property, and certain other new property, placed in service in 2008 – 2010 (or 2011 for certain property), by permitting the first-year write-off of 50 percent of the cost (see Extension of Bonus Depreciation in article entitled Significant Tax Provisions in the 2010 Small Business Jobs Act).

The new law extends and temporarily increases this additional first-year depreciation provision for investment in new business equipment. For investments placed in service after September 8, 2010 and through December 31, 2011 (through December 31, 2012 for certain longer-lived and transportation property), the new law provides for 100 percent additional first-year depreciation. In other words, the entire cost of qualifying property placed in service during that time frame can be written off, without limit. Fifty percent additional first-year depreciation will apply again in 2012.

The new law leaves in place the existing rules as to what kinds of property qualify for additional first-year depreciation. Generally, the property must be (1) depreciable property with a recovery period of 20 years or less; (2) water utility property; (3) computer software; or (4) qualified leasehold improvements. Also the original use of the property must commence with the taxpayer – used machinery doesn't qualify.

For those taxpayers who do not otherwise benefit from bonus depreciation because they have net operating losses, the Act extends through 2012 the election to accelerate the AMT credit instead of claiming additional first-year depreciation. Now even those portfolio companies with net operating losses will have a cash incentive in the form of a potential refund from the government to purchase qualified property through December 31, 2011.

►SECTION 179 EXPENSING

The election to expense fixed asset additions is made available, on a tax year by tax year basis, under Section 179 of the Internal Revenue Code, and is often referred to as the "Section 179 election." As discussed in the article on Small Business Jobs Act, the expensing limit of Section 179 was increased to \$500,000 and the start of the investment ceiling phase-out was raised from \$800,000 to \$2,000,000 for tax years beginning in 2010 or 2011.

The new law makes three important changes to the Code Section 179 expense election. First, the new law provides that for tax years beginning in 2012, a small business taxpayer will be allowed to write off up to \$125,000 (indexed for inflation) of capital expenditures subject to a phase-out once capital expenditures exceed \$500,000 (indexed for inflation). For tax years beginning after 2012, the maximum expensing amount will drop to historical levels of \$25,000 and the phase-out level will drop to \$200,000.

►EXTENDERS

A number of popular business tax breaks that expired at the end of 2009 have been retroactively reinstated and extended through 2011 by the Tax Relief Act. These extenders could favorably affect the tax liabilities of portfolio companies and some of the more popular ones are summarized below:

- The research and development credit.
- 15-year write-offs for qualified leasehold improvements, and restaurant buildings (and certain improvements to such restaurant buildings).
- The active financing exception from the Code's Subpart F rules for a controlled foreign corporation predominantly engaged in the conduct of a banking, financing, or similar business.
- The new markets tax credit.
- Expensing of environmental remediation costs.
- The enhanced education for contributions of food and book inventories, and computer equipment for educational purposes.
- The work opportunity credit (extended for four months (through the end of 2011)).

The Tax Relief Act appears to contain substantial tax benefits to all taxpayers. If so, the increased cash flow available to individual and businesses alike will lead to additional spending thereby averting a further recession.

For more information on the above provisions or any other provisions of the new tax legislation, please feel free to contact Randy A. Schwartzman at rschwartzman@bdo.com.

EXAMINING THE TAX TREATMENT OF TRANSACTION COSTS IN MERGERS & ACQUISITIONS



By **Randy A. Schwartzman, Tax Partner, and Patricia Brandstetter, Tax Associate with BDO**

Transaction costs, which are the fees paid to outside vendors (investment bankers, lawyers, accountants and other consultants) for services made available in connection with a corporate acquisition, merger, or other business activity, have long been the cause of much tax uncertainty during the course of a merger or acquisition. The issue that consistently arises is whether a transaction cost incurred must be capitalized as costs related to the acquisition, amortized as start up costs, or whether an immediate deduction as ordinary and necessary business expenses is allowed. In general, costs considered "facilitative" to a transaction for example the taxable acquisition of a trade or business or the restructuring or reorganization of a business entity (so-called "covered transactions") must be capitalized, unless these costs are incurred before the "bright-line date," usually the date on which the Board of Directors authorizes the main terms of the transaction or the parties execute a written letter of intent or unless those costs are considered "inherently facilitative" irrespective of the bright-line date.

Determining the tax treatment of transaction costs is highly fact-intensive and the investigation leading to such a determination

can be extremely time-consuming. Recently, however, the IRS and the Tax Court have issued taxpayer-favorable guidance on the tax treatment of transaction costs. The three rulings outlined below illustrate that both the IRS and the Tax Court take a wide array of supporting records into account when determining the deductibility of transaction costs. Because the applicable tax laws and regulations tie in with the facts and circumstances of the transaction, the taxpayer's thoroughness in providing supporting records may ultimately determine the tax treatment of transaction costs.

ALLOCATION SPREADSHEETS IN SUPPORT OF DEDUCTION: Technical Advice Memorandum (TAM) 201002036

Issue: The use of allocation spreadsheets developed by an accounting firm as "supporting records" in determining the portion of contingent fees paid to professional advisors that may be deducted in connection with an acquisition.

Background: The taxpayer, which was the target in a corporate acquisition in which it became a wholly owned subsidiary, hired an accounting firm to conduct a study of transaction costs incurred in the form of investment banking services. The accounting firm developed cost allocation spreadsheets in

conjunction with the service providers through interviews with employees on activities performed and estimates of time spent on those activities.

Conclusion: The spreadsheets do satisfy the contemporaneous documentation required and could be used in determining what part of the fees may be deducted in connection with the acquisition. However, the IRS' Large & Mid-Sized Business Division must evaluate whether the taxpayer has maintained sufficient documentation to establish what portion of the contingent fees are allocable between facilitative and non-facilitative costs.

DEDUCTIBILITY OF MERGER TRANSACTION COSTS: IRS Letter Ruling 200953014

Issue: The tax treatment of various costs associated with a merger transaction, including fees for financial advice, legal services, due diligence services, and expenses to arrange debt financing for the transaction.

Background: The transaction at issue was a taxable stock purchase where a merger subsidiary (an indirect wholly owned subsidiary of the parent or acquirer) merged with and into a target, whose shareholders exchanged their target stock for cash furnished by the parent to the merger subsidiary. According to the target:

- The transaction was a "covered transaction" under Treasury Regulations and all transaction costs were paid or reimbursed by the target at or before closing.
- Its method of accounting for the debt issuance costs was in compliance with relevant regulations.
- The costs at issue were not "inherently facilitative" because they were incurred in the process of investigating or otherwise pursuing a covered transaction before the bright-line date.
- The transaction enhanced the growth of its business, which is important to sustain the "business expansion principle," which allows for deduction for allocable pre-bright-line date costs.

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TAX TREATMENT OF TRANSACTION COSTS

Conclusion: The target should determine the allocation of costs based on all available evidence, including documents generated in connection with the transaction (i.e., engagement letters, minutes, calendar entries, general ledger entries, and financial statements). Moreover, investigatory due diligence costs that were incurred before the bright-line date and were not inherently facilitative or allocable to the financing could be immediately deducted. The IRS ruled that a portion of the fees paid to the financier, financial advisers, legal counsel, accounting professionals, and general service providers could be allocated to the underlying debt instrument and would be allocable under Treasury Regulations.

LEGAL FEES IN AN ASSET ACQUISITION:

Tax Court Memo. 2009-291

Issue: The allocation of transaction costs to a buyer in a taxable asset acquisition. More specifically, whether legal fees incurred in the acquisition of a car dealership were solely related to inventory and deductible as soon as the inventory was sold.

Background: West Covina Motors, Inc. purchased a car dealership and paid acquisition-related legal fees to the dealership's counsel. In a previous decision, the Tax Court stated that West Covina had not provided sufficient substantiation that any fees were allocable entirely to inventory. Revisiting its previous decision in this case, the court concluded that the excess legal fees were capital expenditures because they were incurred in connection with the purchase of the business's capital assets.

Conclusion: The Tax Court concluded that the legal fees could be allocated proportionately to the assets with which they were associated if both parties agreed on the allocation of the purchase price. Therefore it held that some of the legal fees that were paid could be allocated to the physical inventory and thus would become deductible business expenses in the year the inventory turned over.

For more information about transaction costs in mergers & acquisitions, contact Randy A. Schwartzman at RSchwartzman@bdo.com and/or Patricia Brandstetter at Pbrandstetter@bdo.com.

PROPOSED LEASE ACCOUNTING RULES WILL HAVE PROFOUND IMPLICATIONS TO COMPANIES

By Lee Duran, Assurance Partner and Private Equity Practice Leader with BDO

IN AUGUST 2010, THE FASB ISSUED AN EXPOSURE DRAFT WHICH COMPLETELY OVERHAULS U.S. GAAP ACCOUNTING FOR LEASES. ALTHOUGH THE PROVISIONS OF THE EXPOSURE DRAFT ARE SUBJECT TO CHANGE, THEY PRESENTLY INCLUDE THE FOLLOWING SIGNIFICANT CHANGES TO CURRENT ACCOUNTING:

Bring on Balance Sheet all leases: All leases would be reported on the balance sheet. The distinction between operating and capital leases would cease to exist.

Consideration of lease renewals: The capitalized asset and liability would be based on "the most likely lease term," which may include lease renewals.

Contingent rents: The capitalized asset and liability would be based on "the most likely rental payments," including contingent rentals. The likely amount of contingent rentals would be reevaluated periodically with changes being recorded in profit and loss.

►BALLOONING BALANCE SHEETS

The capitalization of all leases will increase both assets and liabilities. Entities with significant operating leases will be heavily impacted. For many of those companies, interest bearing debt (including lease obligations) will increase by 100% or more, with total assets reflecting smaller percentage increases. For entities with significant lease activity, this will have a major impact on key ratios such as Debt to EBITDA and Debt to Equity.

►SIGNIFICANT CHANGES TO EBITDA

Under the proposed rules, total expenses hitting the statement of operations will not change. However, the geography of the changes will change with consequential and significant impact to both EBITDA and operating income. With the capitalization of leases, rent expense will be replaced by depreciation and amortization, which is

normally added back in deriving EBITDA. BDO Retail Industry specialist, Doug Hart, believes this change will increase EBITDA for many consumer companies by over 20%.

With the capitalization of all leases, some of the former rent expense would be replaced by interest expense, which is excluded from the calculation of operating income (included as a nonoperating expense). Accordingly, this may increase operating income.

The new lease accounting will result in both increases in EBITDA and debt. However, debt will generally increase at a higher rate than EBITDA, resulting in large increases in companies Debt to EBITDA ratios. This will infer that some companies have proportionally less cash flow to cover their debt obligations.

►SO WHAT IS A COMPANY TO DO?

We would recommend reviewing debt covenants to determine how terms such as Debt, EBITDA and Cash Flow are defined. Based on those definitions, it is advisable to then consider the impact of the new lease accounting on the debt covenants. Pro forma calculations of the effect of capitalization of your leases on Assets, Debt and EBITDA may be useful in this process. Finally, to the extent debt terms are negotiated in the future, companies should be proactive to carve out the effect of capitalized leases or new accounting pronouncements from the definition of debt in such debt agreements.

For more information about the implications of proposed lease accounting rules, contact Lee Duran at LDuran@bdo.com.

SIGNIFICANT TAX PROVISIONS IN THE 2010 SMALL BUSINESS JOBS ACT

By **Randy Schwartzman, Tax Partner with BDO**

On September 27, 2010, President Obama signed the 2010 Small Business Jobs Act into law. The new law contains significant tax provisions, and provisions intended to stimulate investment in small businesses and facilitate small business owners' access to capital.

The following is an overview of some of the tax provisions of the 2010 Act that are of most interest to private equity portfolio companies.

►SECTION 179 EXPENSING

Many portfolio companies may be seeking additional capital infusions to fund investments in eligible property before the end of the year. Section 179 of the Internal Revenue Code (IRC) provides that certain small businesses may immediately deduct costs of certain qualified property in the year of acquisition rather than depreciating it over several years. The 2010 Act increases Section 179 limitations on expensing of depreciable business assets and expands the definition of qualified property for tax years beginning in 2010 or 2011.

Under the previous law, the maximum annual expensing limit was \$250,000, reduced (but not to below zero) by the amount by which the total cost of qualifying property exceeded \$800,000. The 2010 Act increases the expensing limit to \$500,000 and raises the investment ceiling from \$800,000 to \$2,000,000 for tax years beginning in 2010 or 2011.

Moreover, the definition of property qualifying for expensing under Section 179 is expanded to include qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

It should be noted that the Jobs Creation Act provides that for tax years beginning in 2012, a small business taxpayer will be allowed to write off up to \$125,000 (indexed for inflation) of capital expenditures subject to a phase-out once capital expenditures exceed

\$500,000 (indexed for inflation). Also, absent further Congressional action, for tax years beginning after 2012, the maximum expensing amount will once again drop to \$25,000 and the phase-out level will drop to \$200,000.

►EXTENSION OF BONUS DEPRECIATION

The 2010 Act extends the bonus depreciation provisions for one additional year through December 31, 2010. Eligible property placed in service before January 1, 2011 will thus qualify for the first-year deduction of 50% of the cost.

Eligible property qualifying for bonus depreciation include: (a) property with a depreciation life of not more than 20 years to which the "Modified Accelerated Cost Recovery System" (MACRS) applies, (b) computer software other than software covered by IRC Section 197, (c) water utility property, and (d) qualified leasehold improvement property as defined in IRC Section 168(k)(3). The remaining 50% of the property's cost is depreciated over the normal depreciation life. Bonus depreciation is allowed as a deduction for both regular and alternative minimum tax purposes.

For investments placed in service after September 8, 2010 and through December 31, 2011 (through December 31, 2012 for certain longer-lived and transportation property), the Jobs Creation Act provides for 100 percent additional first-year depreciation. In other words, the entire cost of qualifying property placed in service during that time frame can be written off, without limit. Fifty percent additional first-year depreciation will apply again in 2012.

►BIG TAX PERIOD FOR S CORPORATIONS REDUCED TO 5 YEARS FOR 2011

Generally, a C corporation that converts to an S corporation must pay a "built-in gains" (BIG) tax of 35 percent on built-in gains that existed as of the date of the S corporation election, if those gains are recognized during the ten year period immediately following the date of the S corporation election. This rule also applies when an S corporation acquired a

C corporation in a tax-free transaction during the previous ten year recognition period. This ten year recognition period was reduced to seven years for taxable years beginning in 2009 or 2010.

The 2010 Act temporarily shortens the holding period of assets subject to the built-in gains tax to five years if the fifth tax year in the holding period precedes the tax year beginning in 2011.

The new law presents a window of opportunity for Private Equity investors to acquire an S corporation with a stepped-up tax basis in the acquired assets without the need to make the sellers whole for the marginal BIG tax. After 2011, the recognition period for built-in gains will go back up to 10 years unless additional legislation is enacted.

►GAINS ON CERTAIN QUALIFIED SMALL BUSINESS STOCK TEMPORARILY EXCLUDED

Prior to the 2010 Act, individuals could under IRC Section 1202 generally exclude from their taxable income 50 percent of the gain on the sale or exchange of "Qualified Small Business Stock" ("QSBS") held for at least five years. For alternative minimum tax (AMT) purposes, a percentage of the excluded gain was treated as a preference item and the portion of the gain included in alternative minimum taxable income was taxed at the AMT rate of 28 percent. Under the American Recovery and Reinvestment Act of 2009, the percentage exclusion for gain on QSBS sold by an individual was increased to 75 percent for stock acquired after February 17, 2009 and before January 1, 2011.

PRIVATE EQUITY EVENT SCHEDULE

(January 2011 – March 2011)

The following is a list of upcoming conferences and seminars from the leading private equity associations and business bureaus:

JANUARY 2011

- January 25-26** **Investment and M&A Opportunities in Healthcare**
Nashville Convention Center, Nashville, TN
- January 26-27** **The Emerging Markets Summit**
TBA, New York, NY
- January 27** **Impact Investing & Responsible Investment Strategies**
The Princeton Club, New York, NY
- January 27** **BDO PERSpective Webinar Series "Recent Accounting & Tax Developments with Direct Affect on PE/VC Firms"**
1 p.m. EST
Please contact Todd Kinney for details at tkinney@bdo.com

FEBRUARY 2011

- February 17-18** **Global Private Equity Summit**
TBA, New York, NY
- February 28-March 3** **Super Return International 2011**
Intercontinental Hotel, Berlin

MARCH 2011

- March 3-4** **4th Annual Women's Private Equity Summit**
The Ritz Carlton, Half Moon Bay, CA
- March 7-8** **The Cleantech Investor Forum 2011**
The Four Seasons, Palo Alto, CA
- March 21-23** **ACG InterGrowth 2011**
Manchester Grand Hyatt, San Diego, CA
- March 28-30** **Super Return China 2011**
The Ritz Carlton, Beijing

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2010 SMALL BUSINESS JOBS ACT

The 2010 Act increases the exclusion to 100 percent for both regular and alternative minimum tax purposes for QSBS acquired after the enactment date of the 2010 Act and before January 1, 2011 and held for at least five years. In addition, the new law eliminates the AMT preference item attributable to the excluded gain. As a result, neither the regular tax nor the AMT will apply to such gains and this provision will allow taxpayers to avoid federal income tax on up to \$10 million in gain from the sale of certain QSBS. Since this provision applies to non-corporate taxpayers, Private Equity Funds may be able to pass this benefit through to their investors.

The 2010 Tax Relief Act extends the 100 percent exclusion and exception from minimum tax treatment for QSBS for one year by changing the date before which eligible QSBS must be acquired from January 1, 2011 to January 1, 2012.

Care needs to be taken when structuring investments intended to qualify under IRC Section 1202. To meet the definition of QSBS, the stock must be acquired by the taxpayer at its original issue in exchange for money or other property (not including stock) or as compensation for services provided to the small business corporation. To be a qualified small business, the entity must be a domestic C corporation with gross assets that do not exceed \$50 million, and at least 80 percent in value of the corporation's assets must be used in the "active conduct of a qualified trade or business" throughout the period during which the taxpayer owned the stock. The term "qualified trade or business" does not include professional services like banking, insurance, or investment businesses.

For more information on the above provisions or any other provisions of the 2010 Act, please feel free to contact Randy A. Schwartzman at rschwartzman@bdo.com.

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