THE M&A JOURNAL

THE INDEPENDENT REPORT ON DEALS AND DEALMAKERS

VOLUME 18 NUMBER 1

Michael Cannon
Gibson, Dunn &
Crutcher LLP

Let Me Roll It

What Every M&A Participant (and M&A Lawyer) Should Understand about Tax Free Rollovers[1]

By Michael Cannon[2]

Often, for strategic reasons, a buyer (particularly a private equity buyer) acquiring a target has a keen interest in ensuring that the founders or key personnel of the target stay fully engaged in the target's business following an acquisition. And the conventional wisdom is that one of the best ways to ensure an appropriate level of engagement is for the founders or key personnel to maintain a continuing ownership stake in the target following the acquisition. Invariably in discussions related to such continuing ownership, tax matters surface, with the management team members asking whether a tax free (*i.e.*, tax-deferred, in the jargon of tax practitioners) rollover will be feasible.[3]

To determine whether such tax treatment is available, at a minimum tax counsel will generally ask the following questions: (1) what does the management team currently own (and what is the tax classification of the entity in which the team owns whatever it owns); (2) what is the buyer's contemplated, post-closing structure (and where does the buyer want management to sit in that structure); and (3) what types of interests would the buyer like management to hold post-closing?

This article's primary purpose is to explain, in non-technical terms, *why* tax counsel asks these questions, thereby demystifying the tax-free rollover in order to provide helpful background for M&A participants and the M&A lawyers who advise them. While tax counsel should of course be consulted about every potential rollover transaction, having a basic grasp of the *why* behind tax counsel's inquiries adds value, both because it allows M&A participants and their lawyers to appropriately set expectations (*e.g.*, not promising tax-free rollover treatment where a tax-free rollover is not possible) and because it positions these participants and their lawyers to more effectively and efficiently communicate with tax counsel about the potential for a tax-free rollover.

Question #1: What does the Management Team Currently Own (And What is the Tax Classification of the Entity in Which the Team Owns Whatever it Owns)?

Tax counsel asks this question because certain types of interests (including interests in particular types of entities) are inherently more difficult to roll on a tax-free basis than others. The devil, of course, is in the details, but in very general terms, below is a chart that sets forth some of the most common types of interests (in various types of potential target entities) and summarizes whether these interests are likely to be able to be rolled over in a tax-free manner.

Question #2: What is the Buyer's Contemplated Post-Closing Structure (and Where Does the Buyer Want Management to Sit in that Structure)?

Just as the type of target entity has a bearing on whether a tax-free rollover is feasible, so too does the buyer's proposed structure for making the investment (including the tax classifications of the entity or entities the buyer proposes to use in its structure) and the location in the buy-side structure where the buyer would like management to hold its continuing ownership stake. While there are countless buy-side structural possibilities, and each one is unique, it is possible to make a few general observations.

- *C Corporations are Relatively Inflexible* – Many private equity sponsors use C corporations in their structure to "block" certain forms of income that certain classes of investors (predominantly non-U.S. investors

Rollovers →

Rollovers

continued

and tax-exempt investors) seek to avoid. However, in order for a contribution to a C corporation to be tax free, one of the requirements that must be satisfied is for the contributor to be part of a group that makes contributions to a corporation and that has, collectively, at least 80% control of such corporation immediately following such contributions.[11] While in some cases it may not be difficult to satisfy this 80% test if a new corporation is formed and capitalized by the private equity sponsor in connection with an acquisition (since, collectively, the management team and the private equity sponsor will generally hold at least 80% of that new corporation), if there is a proposal to use an existing C corporation to make an acquisition (*e.g.*, an add-on acquisition) and have the management holders roll their existing equity into that C corporation, given that the rollover percentage is generally quite small vis-à-vis the overall transaction size, this control test may not be able to be satisfied, absent further structuring (which the owners of the buyer may or may not be willing to undertake).[12]

- *Partnerships are Relatively Flexible* – Contributions of interests to entities taxed as partnerships are not subject to the 80% corporate control requirement described in the preceding bullet point, meaning that even a very small contributor can often make a tax-free contribution to a partnership.

- *Leaving Management Where it Is Minimizes Tax Complexity* – In some transactions, if management is retaining a stake in a business, the simplest course of action (from a pure tax perspective) may be to just cause the buyer to purchase less than all of the outstanding equity in the target for cash, and leave the rest outstanding. Tax counsel will ask questions to ascertain whether it is possible to structure the deal so no "roll" is needed to achieve continuing management ownership. Often, however, the buyer will prefer to move management ownership to a different entity, necessitating some sort of rollover.[13]

Question #3 What Types of Interests Would the Buyer like Management to Hold Post-Closing?

Just as what management currently owns (in a target) is relevant to the question of whether the management holders will be able to roll tax free, so too is what the buyer would like management to own post-closing. Difficulties in this regard most frequently arise where a management owner currently holds something other than vested equity (*e.g.*, options), but the management holder and the buyer would like management to hold an actual equity stake following the acquisition.

As noted above, for several types of derivative interests (*e.g.*, options), generally the only type of tax-free transaction that is feasible is replacement of the existing derivative interests with an equivalent type of derivative interest in the buyer entity. Moreover, in many cases with respect to such derivative interests, even if a tax-free transaction is feasible, any income that is ultimately recognized in respect of the replacement derivative interests will be "ordinary" in character (and hence subject to relatively high tax rates) rather than being "capital gain" (and hence subject to relatively lower tax rates). It is important that M&A participants (and the lawyers that represent them) discuss these nuances with tax counsel so they can carefully manage expectations of management holders throughout the rollover negotiation process.

Conclusion

The desire to engage in a tax-free rollover transaction is very common in M&A transactions, particularly in the private equity space. Those M&A participants (and the M&A lawyers who advise them) that have a basic understanding of the types of issues that arise in a transaction with a potential rollover component have a meaningful advantage over those participants who do not, because this understanding will both allow them to (a) appropriately set expectations in negotiating with management sellers (by not over-promising the impossible, such as a tax-free rollover of target options into unrestricted acquirer equity) and (b) more efficiently and effectively communicate with tax counsel about the feasibility of a tax-free rollover.

MA

1 Paul McCartney & Wings, "Let Me Roll It" (1973) ("You gave me something I understand . . . . Let me roll it. Let me roll it to you. Let me roll it. Let me roll it to you."). Unless otherwise noted, references herein to Sections refer to Sections of the Internal Revenue Code of 1986, as amended (the "Code").

Type of Interest	Description	Tax-Free Rollover Feasible?
Fully-vested, Unrestricted[4] C Corporation[5] Stock	Fully-vested, unrestricted stock in an entity taxed as a C corporation for tax purposes	Often can be rolled over in a tax-free manner
Fully-vested, Unrestricted LLC or Partnership Interests	Fully-vested, unrestricted interests in a partnership[6] (or in an LLC classified as a partnership[7] for U.S. federal income tax purposes)	Often can be rolled over in a tax-free manner
S Corporation Stock	Fully-vested, unrestricted stock in an entity taxed as an S corporation for tax purposes.	Potentially can be rolled tax-free, but implementing the rollover is often significantly more complicated than implementing a rollover of equity in a C corporation or an entity taxed as a partnership[8]
Restricted Stock in a C or S Corporation	Unvested stock, held subject to conditions (e.g., continued service, attainment of performance goals)	Tax-free roll is generally feasible if the management holder made a special election (known as a "Section 83(b) election") to be treated as the owner for tax purposes.[9] If no Section 83(b) election was made, a tax-free substitution of unvested, restricted acquirer stock for unvested, restricted target stock may (subject to limitations) still be feasible.
Restricted Units in an LLC or Partnership	Unvested interests in a partnership or LLC, held subject to conditions (e.g., continued service, attainment of performance goals)	Tax-free roll is generally feasible if the management holder made a special election (known as a "Section 83(b) election") to be treated as the owner for tax purposes.[10] If no Section 83(b) election was made, a tax free substitution of unvested, restricted acquirer interests for unvested, restricted target interests may (subject to limitations) still be feasible.
Options Issued by any Type of Entity	Contractual right to acquire a number of shares/interests at a price fixed at grant for a defined number of years into the future	Cannot be rolled tax free, although it may be feasible to substitute existing options with buyer options in a tax free manner under some circumstances
Restricted Stock (Equity) Units ("RSUs) in any Type of Entity	Contractual right to receive a certain number of shares (or units) upon satisfaction of vesting conditions	Cannot be rolled tax free, although it may be possible to substitute existing RSUs with RSUs in the buyer in a tax-free manner under some circumstances
Stock (Equity) Appreciation Rights ("SARs) in any Type of Entity	Contractual right to receive a cash payment equal to the increase in the value of a designated number of shares (or interests)	Cannot be rolled tax free, although replacing target SARs with SARs of the buyer in a tax-free manner may be feasible under some circumstances
Phantom Stock/ Equity in any Type of Entity	Contractual right to receive a cash payment based on the value of a certain number of shares	Cannot be rolled tax free, although it may be feasible to replace target phantom stock with buyer phantom stock in a tax-free manner under some circumstances
Transaction Bonus or Change-of-Control Payment Rights Issued by any Type of Entity	Contractual right to receive compensatory cash payments triggered by the acquisition transaction	Cannot be rolled tax free

Rollovers ➔

Rollovers

continued

2 Michael Cannon is a tax associate in the Dallas office of Gibson, Dunn & Crutcher LLP. Advising clients on the tax aspects of M&A transactions comprises of substantial part of his tax practice. The author would like to acknowledge and thank Rob Little and David Sinak, partners in the Dallas office, for their helpful contributions to this article.

3 Tax-free rollovers can also serve other useful purposes, including reducing the required cash outlay for a buyer.

4 The description of an interest as "fully-vested" and "unrestricted" means that the interest is not subject to conditions such as continued service or the attainment of performance goals.

5 There are two, basic types of corporations for U.S. federal income tax purposes – C corporations and S corporations. C corporations are subject to tax on their income (and any distributions are also generally taxed at the shareholder level). *See* Code §§ 11, 301. S corporations are generally not subject to tax (*i.e.*, income generally flows through to the owners of the S corporation, who pay tax on that income). *See generally* Code §§ 1361-1379.

6 These interests would also include any vested "profits interests."

7 LLCs are chameleons for tax purposes, in that they can have several different possible tax classifications. Very generally, a multi-member LLC can be taxed either as a partnership (*i.e.*, a flow-through that generally does not pay U.S. federal income taxes) or as a corporation (generally a taxpaying entity, unless it is an S corporation). *See generally* Treas. Reg. § 301.7701-2. More often than not, multi-member LLCs are classified as partnerships for tax purposes. Thus, for purposes of simplification, when this article refers to an LLC, it means an LLC classified as a partnership (rather than an entity that has elected to be classified as a corporation for tax purposes). However, any time an LLC is encountered in a transaction involving a potential rollover component, an M&A participant (or its lawyer) should *always* inquire as to the U.S. federal income tax classification of that entity.

8 In most cases, a direct rollover of S corporation stock is not desirable from the perspective of a buyer because such a rollover will often make it impossible for the buyer to obtain a basis step-up (and a basis step-up is desirable because it reduces taxes payable post-acquisition). Sometimes, it is possible to complete a pre-closing reorganization that will permit a rollover (by allowing the historic S corporation to continue as an equityholder following an acquisition), but this type of reorganization (which is beyond the scope of this article) can be difficult to implement and may not be fully effective if not all of the shareholders of the S corporation are maintaining the same, post-acquisition stake (as a percentage matter) in the enterprise.

9 Section 83(b) elections are not frequently made with respect to restricted C or S corporation stock because such elections immediately trigger tax to the management holder when made (which usually makes such elections prohibitively expensive for the management holder).

10 Section 83(b) elections are more frequently made with respect to restricted units in an LLC or partnership than they are with respect to restricted stock in C or S corporations because incentive units in LLCs or partnerships are often "profits interests," for which a Section 83(b) election can generally be made without incurring an immediate tax.

11 *See generally* Code § 351(a).

12 This further structuring could potentially include, for example, creating a new holding company above the buyer entity and having the rollover holders contribute their interests in the target to the holding company in exchange for interests in that company at the same time that the existing holders of the buyer entity contribute their interests in the buyer entity to the new holding company.

13 For example, in the event an acquisition is being partially financed with debt incurred at the buyer level, the lender may be unwilling to permit the management holders to maintain a direct, continuing stake in the target entity, since permitting this continuing ownership would result in the lender's debt being structurally subordinated to the management holders' continuing equity. Similarly, a private equity sponsor may want the management team at a holding company level to consolidate control over the entity where the operating assets are located and to simplify future exit transactions.

WEBSITE: www.themandajournal.com

E-MAIL: info@themandajournal.com

EDITORIAL OFFICE: 215-309-5724

ORDERS & SUBSCRIPTIONS: For individual subscriptions, discounted multi-copy institutional subscription rates, or additional copies, please call 215-309-5724 or FAX 215-309-5724.

THE M&A JOURNAL
the independent report on deals and dealmakers

Editor/Publisher **John Close**
Design and Production **John Boudreau**
Senior Writers **Gay Jervey, R. L. Weiner**
Writing/Research **Frank Coffee, Jeff Gurner, Terry Lefton**
Circulation **Dan Matisa**
Web Production **John Boudreau**

The M&A Journal, 614 South 4th Street, Suite 319 , Philadelphia, PA 19147