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# Equity Rollovers

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## I. A Tax Practice Problem

### A. The Reasons and the Culprits

The income tax system tries hard to accommodate taxpayers' desires to both dispose of and keep property. See, for example, sections 351, 368, and 721. They allow property in one form to be changed tax free into equity in an entity acquiring the property, subject to the receipt of boot. Indeed, "equity rollover" could describe the shareholder or partner posture in all three cases. Viewed that way, an all-stock merger may be called an equity rollover.[1]

But in tax practice today, equity rollover usually describes a different phenomenon, the subject of this report. In mostly taxable acquisitions of businesses (target), one or more owners, partners, or shareholders — usually either management or the principal owner — want some equity in the buyer, along with, or in lieu of, cash consideration for the target equity they own; assume the other owners sell for cash. Although equity rollover can occur with or without tax deferral, it usually entails tax deferral in these cases. One firm has estimated that the typical rollover when private equity buys portfolio companies is 20 percent.[2]

The rollover sellers can want buyer equity for many reasons. They may have more faith in the value of the target than the buyers have, and indirect equity retention allows them to share in growth. Or they may think tax rates will fall in the future. Or they may not want to pay tax on the gain ever (individuals hoping to die holding the rollover equity).

Alternately, the buyer of a target may want the equity rollover, particularly for management shareholders, in hopes of encouraging them to stay and work harder.[3] Or the buyer can't afford to pay cash for 100 percent of the equity. Or the rollover may be in lieu of an earnout. Sometimes the management rollover is combined with a "support agreement" in which management agrees to vote for the acquisition.[4] In those and other cases, a rollover by a minority of the shareholders can create conflicts of interest with the majority, particularly when the rollover persons are the founders or management.

In many — if not most — transactions involving rollovers, private-equity blockers or partnerships likely are the culprits. They may be the buyers who don't know how to run anything and so always need the target management to stick around; or private equity may be the sellers, who just can't let go of the last piece of the action.

Whatever the reason, a surprisingly large percentage of mostly taxable acquisitions of mostly closely held businesses involve equity rollovers. Equity rollovers can also occur in acquisitions of public companies, which presents additional issues of differential treatment, particularly of insiders. It is often the founder or manager that negotiates the takeover price with the private-equity acquirer, in which they will obtain a substantial rollover.[5] Rollovers can present different issues abroad, where public companies can be subject to unusual takeover rules.

Because the rollover deals addressed in this report are purchases mostly for cash, the buyers usually expect to obtain a cost basis in what they buy, and they want to buy business assets, if possible. The most straightforward path to that result is to buy the operating business property directly. But there are workarounds allowing asset basis step-up in other forms of acquisition, as discussed below.

And the buyer doesn't have to pay cash to get the desired basis result: If it's a corporation, it can pay its stock in a recognition exchange, which provides equity to the seller but without deferral. Such taxable stock deals rarely occur. However, the method can be attractive when the buyer corporation is not public and obtaining its stock has special value. Or the sellers are foreign and don't care about U.S. nonrecognition.

Another way for a buyer to not have to pay all cash but have the same basis result is the circular cash purchase of assets: It can produce a 100 percent asset basis step-up without actually spending all the cash. Or the seller can just keep part of the target equity as a sort of rollover.

### B. The Problems

Equity rollovers of the sort addressed here — mostly taxable deals with some equity rolled over — almost always present problems for the tax planners, even though the deal lawyers think rollovers are just great (they invented them). The major tax problems rollovers present are:

- How will the deal have to be structured to accommodate a rollover as a tax-deferred event for the rollover sellers (called here R, assumed to be an individual, although it could be a partnership or S corporation), while allowing the buyer to obtain most or all of the cost basis it wants?
- How might making R an owner of the buyer affect tax benefits R and other sellers want, such as recognizing a loss, or capital gains?
- How might the rollover jeopardize tax benefits the buyer wants?
- Will the buyer be responsible for ensuring R's tax deferral?

The benefits the buyer wants often can be jeopardized by the very equity rollover feature R wants. That cross-ownership, which usually arises "immediately after" the target acquisition, can jeopardize bonus depreciation, amortization of intangibles under section 197, the character of the sale gain under section 1239, and other benefits addressed in the final section of this report. But you can't know how to deal with those related-party issues until you have a tentative deal structure for the rollover.

Many of the structuring alternatives described below can involve R recognizing some income, usually as a price of basis step-up for the buyer. The buyer (B) may agree to pay R or the selling entity some part of the value of the tax benefits B obtains from the cash portion of the purchase price. This report won't address those tax-sharing agreements.

The amount of responsibility B takes for R's tax treatment varies with their bargaining positions. The simplest approach is for the parties to just agree to treat the rollover as governed by section 721 or 351 — or whatever the key to deferral is.[6]

"Rollover stock" has a special meaning in some state corporation law statutes — for example, meaning stock that is required to roll over into stock of another party to a merger by contact other than the merger agreement.[7]

## II. Organizing the Issues

### A. Overview

The many fact patterns and possible structures make corralling rollovers hard. Answers to these four questions can provide the facts most likely to inform creation of the appropriate transaction structure to achieve the rollover and the parties' tax benefits:

- What kind of equity does R own: unincorporated business assets, limited liability company/disregarded entity (DRE), partnership interest, S corporation stock, or C corporation stock?
- What kind of equity does B issue: partnership interest, S corporation stock, or C corporation stock?
- Will B forgo asset basis step-up for the rollover part of the consideration? That assumes B prefers to buy 100 percent of the assets for cash.
- Which of the most common structuring alternatives might apply on these facts? The options are seller or asset bifurcation for part sale, part nonrecognition exchange; nonrecognition exchange with boot; circular flow of cash; or retaining target equity.

### B. The Not Super-Secret Rules

Rocket science isn't required to address the tax aspects of rollover deals. Aside from the circular cash flow cases, almost all the rest of the rollover structures depend on the two standby nonrecognition rules for obtaining equity in an entity: sections 351 and 721. Picture a partnership P, which owns a corporation C, which owns a partnership P1. R, the rollover seller, will have to engage in a section 721 exchange with P or P1 or a section 351 exchange with C.

Those are the principal options. When you realize that, the world of rollovers ceases to be mysterious. It's just a matter of structuring into the application of those sections. Obviously, section 351 is the more challenging alternative because of the control requirement. But the IRS has provided so many ways around it that it need not be an obstacle.

## III. R's Equity and the Deal Structures

Most of the structuring alternatives can be illustrated through examining the types of target equity Rs begin with. The following sections address each type of target, and the types of Bs, and how the rollover might be structured for that combination of B and R and target. Some structures repeat for various targets, so generally a basic structure is described only once.

### A. Sole Proprietorship Target

Rs large enough to require rollover planning rarely hold a business that is not within some sort of entity. Thus, this case can be moved to the next category because even if the target business starts without an entity, it will have to be packaged up into at least a disregarded LLC that can be conveyed to B.

### B. LLC/DRE Target

#### 1. Preliminaries.

Although anyone can own a DRE, we assume here that R is an individual. R should not incorporate the LLC in hopes of a tax-free reorganization with a large corporation B, thinking that will circumvent the inability to make a section 351 exchange with that corporation. Historically, the loss of control in the reorganization could cause such a preliminary incorporation to be a taxable exchange.[8] But recently the IRS has allowed ways to get around that problem.[9]

Nevertheless, R should not plan to convey the unincorporated business to B through a corporate merger because an asset reorganization will not allow for an asset basis step-up even for boot paid.[10] That is an important distinction between the application of section 362 to asset reorganizations as opposed to incorporating exchanges, which explains the prevalence of section 351 exchanges with boot in rollovers with buyer corporations.[11]

An LLC is a tailor-made target for any of the rollover structures. R can contribute the LLC interest to a buyer partnership for an interest under section 721; R can contribute it to a buyer corporation for stock plus boot if section 351 can apply (and it can, as discussed below); or the buyer corporation may be able to install a partnership on top of itself, and that TopCo partnership can acquire the LLC from R.

**2. For partnership interest.**

**a. Partnership buyer.**

Subchapter K originally treated boot received in partial exchange for a contribution as a distribution that reduces the partner's unified interest basis (generally the basis of the contributed property, disregarding liabilities) and then produced gain.[12] The partnership can elect to increase the carryover basis of the property received by the partner's recognized gain.[13] But since the advent of section 707(a)(2)(B), one partner's receipt of boot plus a partnership interest is likely to be bifurcated into a disguised sale of part of the property for the boot.[14] The result is similar to the taxation of boot in section 351 exchanges, discussed below. So a single seller that is R may have to suffer that result if she wants to receive a rollover partnership interest plus some cash. The partnership will have bought the deemed sold property for purposes of its basis.[15]

Use of a partnership buyer creates alternatives for the source of the boot to be paid to R. A new investor partner could supply it, or the existing partnership might borrow, which will have an effect on basis in the partnership under section 752.

**b. Corporate buyer: TopCo partnership.**

This structure can be surprising if you have not run into it. Rollover practitioners know that selling to a corporation does not preclude the use of a buyer partnership and the favorable section 721 nonrecognition rule for R (no control required). The buyer partnership needs to be a major shareholder of B; it may preexist or can be installed on top of the buyer corporation. But the partnership-shareholder works only if that partnership can contribute the property received from R down to the corporation in a section 351 exchange. So the TopCo partnership must own all or a controlling interest in the corporation or be able to make combined contributions to the corporation as part of a control group.

These TopCo partnerships mostly are private-equity partnerships that own closely held buyer corporations. A controlling group of private-equity partnerships and blockers could put their stock into such a partnership to facilitate rollovers. Of course, this entire approach assumes that R will be satisfied with owning that partnership interest and that the partners are willing for him to join. If the partnership owns all the stock, the answer to those questions is usually yes.

Also, B can be a public corporation, or what used to be a public corporation, as discussed below.

### 3. For stock and boot.

#### a. Getting into section 351.

Presumably, R won't obtain control of the buyer corporation and so will need help to obtain section 351 rollover treatment. There are several options. Existing shareholders can make "accommodation transfers."[16] A new investor can buy stock for cash, perhaps the cash the corporation will pay to R as boot. Or some version of the venerable double dummy structure can be used to facilitate a section 351 rollover, in which both target and B are incorporated into a new holding company.[17]

#### b. R side treatment.

If section 351 applies, R will recognize gain to the extent the cash R receives exceeds the basis of assets transferred (ignoring liabilities).[18] R will be deemed to sell each asset in the LLC for a proportionate share of the stock and cash.[19] Therefore, R can recognize gain on an asset up to the lesser of the appreciation in that asset and the boot allocated to it, but R cannot recognize loss. That result may differ from the section 707(b)(2) sale described above in which treating part of the property as sold outside the partnership relationship may not require bifurcation of each asset sold for part cash, part partnership interest.

Assuming R sells the trade or business assets for a net gain, section 1231 could produce mostly capital gains, with some ordinary income for excluded property and for recapture. R needs to carefully calculate the amount of ordinary income and how grumpy it will make her.

It might be possible for R to contribute part of the business to the corporation in a section 351 exchange and sell the rest, called the bifurcated method. For example, the LLC could sell some assets, and then R could contribute the LLC interests for stock. That might avoid the allocation of boot to each asset, as discussed next with partnership targets.

#### c. B side treatment; asset by asset.

Section 362(a) states that when a corporation receives "property" in a section 351 exchange with boot, "the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer." Although section 362(b) appears to state a similar rule for boot in reorganizations, in practice the buyer won't get the same result because the boot can increase the survivor's asset basis only if the target corporation retains the boot, which it usually will not. So if the desired basis results are to be had by a corporate B paying boot, it must be in a section 351 exchange (whether the target is a DRE, a partnership, or a corporation).

"Such transfer" is the new shareholder's transfer of property to the corporation. When the shareholder transferred multiple properties, it recognized gain or loss property by property, as described above.[20] Therefore, the gain the shareholder recognized for one "property" is the amount by which the corporation should increase the shareholder's basis for that one property.

Even though Rev. Rul. 68-55, 1968-1 C.B. 140, doesn't directly address section 362, some letter rulings strongly imply that the same method applies on both sides of the exchange.[21] The recent Tax Court opinion in *Complex Media*[22] applied Rev. Rul. 68-55 on the corporation side. It said: "The transferee corporation's basis in each asset equals the transferor's basis in the asset increased by the gain recognized by the transferor in the exchange of that asset for stock and boot. *Easson v. Commissioner*, 33 T.C. at 975."[23]

*Complex Media* applied that principle in that case but faced a factual problem: The parties had not applied Rev. Rul. 68-55 on the shareholder side, and by the time of audit or trial, the parties did not know the value of the various properties at the time of transfer. The court said a section 1060 allocation of the total purchase price might be made to determine the value of "each asset" transferred for purposes of the allocation described above. Of course, section 1060 is always applicable to assign part of the purchase price to multiple properties to determine their values.[24] *Complex Media* said the boot would be allocated pro rata to value determined under section 1060. The opinion stated, after using the residual method to value the intangibles: "Because the amortizable section 197 intangibles were worth 95.21 percent of the total asset value ($7,616,852 ÷ $8,000,000), we will assign to those assets the same percentage of the boot CMH received in the recharacterized section 351 exchange."

The Rev. Rul. 68-55 approach can be helpful to a transferor wanting to reduce gain recognition. For example, if part of the assets of the DRE/LLC sold are cash or high-basis receivables, boot should be allocated to those assets too, thus diverting it from assets with gain.

**d. For stock; retransfer alternative.**

R can exchange the LLC solely for B stock in conjunction with contributions by other members of the control group, and then R can sell part of the stock received to one of the other contributors. The stock retained is the rollover, and the stock sold produces the cash R wants. Of course, B won't obtain any asset basis increase.

Rev. Rul. 79-194, 1979-1 C.B. 145, describes these facts. A and B contributed their LLC to a corporation along with C, who contributed a not insubstantial amount of cash. Then A sold part of the stock she received to C for cash. The sale doesn't cause a loss of control for section 351 purposes because of the magical principle created by this ruling that retransfer of stock among the control group does not bust control.

The ruling was based on the theory that stock can be issued in a section 351 exchange in disproportion to the relative values of properties contributed by the shareholders.[25] It traced that idea to legislative history, which informed the regulation saying so. Whatever Congress had in mind concerning disproportionate stock issuances (and it probably wasn't this), it likely didn't justify the ruling. Therefore, the ruling is somewhat counterintuitive, so you just have to know about it, as rollover practitioners do.

**4. UP-C.**

The umbrella partnership corporation (UP-C) structure could be used for a target DRE or partnership, so it will be addressed here. The UPC technology was designed as one solution to the problem that a small contributor of property to a larger corporation could not be covered by the nonrecognition rule of section 351 in most cases. Also, the UP-C usually involves an R that wants to maintain a direct interest in the target business but have the option to cash out later, usually by converting the partnership interest into stock of the other partner. So the buyer corporation forms a partnership and allows the tax-shy investor to transfer his business to that partnership with the corporation as the other partner, in exchange for an interest in the partnership, tax free under section 721.

But because the target owner wanted the option to cash out at some point, maybe even to get the corporation's stock, he also receives an option to sell his partnership interest for stock in a recognition exchange, which allows the corporation to step up basis through a 743 election (the partnership will remain a partnership with one other small partner). Obviously, this is a different sort of rollover in which the rollover is initially complete and the cash-out comes later and will also be complete.

#### 5. Equity investment.

The buyer corporation could just invest cash into the target LLC for the majority of its equity as a partnership, leaving the original owners as rolled over by doing nothing. B will have bought part of the assets of the LLC.[26]

### C. Partnership Target

#### 1. Preliminaries.

If it becomes advantageous to the rollover structuring for the target to be a partnership, it is easy enough to turn an LLC/DRE into a partnership by the addition of one very small partner, perhaps a person related to R. If the rollover is to be a management rollover, almost surely the target will be at least a partnership, if not a corporation. The sellers of a partnership interest can recognize capital gain under section 741, subject to section 751.

#### 2. Partnership buyer.

##### a. For partnership interest plus boot.

The partnership could contribute its assets for buyer equity and boot, as discussed above, and liquidate its assets up to R. Or the partners could contribute their interests to the buyer for its interests and cash, and the partnership would terminate. Or the partnerships could merge. The results above apply: largely capital gain for R and basis step-up for the partnership.

Treasury issued and withdrew prop. reg. section 1.707-7.[27] It would have applied the disguised sale rule to the contribution of a partnership interest to a partnership in part exchange for a cash distribution. However, it would not have treated the transaction as a deemed sale of partnership assets.

An advantage of a partnership as B is that it can issue profits interests to management, which may also be receiving a management rollover of their target partnership interests.[28] The managers usually can receive those interests, deemed to have no current value, tax free, and later sell them for a capital gain. That is a better result than stock options.

##### b. Bifurcated.

Of course, the transaction can be easily bifurcated when most partners want cash and R wants a B partnership interest. B could acquire the rest of the partnership interests for cash, and R could keep her target interests, constituting a rollover. Or R can receive interests in the buyer partnership in a section 721 exchange. If R also wants some cash, she can sell part and keep part of her interest and be in a partnership with the buying partnership as the other partner or acquire a partnership interest in B.

In fact, the whole arrangement is so convenient that B can be willing to accommodate the rollover desire of management for as little as half a million dollars of equity. This example comes from another model for this approach, in which the TopCo partnership is a publicly traded partnership that qualifies as a partnership.[29] PTPs can avoid corporate classification if most of their income is from dividends, which should be true of a PTP that owns a corporation and nothing else.[30]

One LLC target (a partnership) recapitalized the units of management into "rollover units" that management then contributed to the LLC parent of the merger subsidiary that would merge into the target for cash. The new units approximated the cash-out value.[31]

**c. Become a partner.**

B can buy a majority interest in the partnership from the partnership for cash, and the partnership can liquidate the majority of the target's partners that want cash.

**3. Corporation buyer.**

The corporation B with a TopCo partnership owning it was discussed above. When B corporation itself buys a partnership target with a rollover, section 351 must be navigated in the ways discussed above: accommodation transferors, double dummy, and other variations discussed below.

**a. For stock plus boot.**

The target partnership could transfer its business and liquidate, or the partners could transfer their interests and the partnership would be deemed to liquidate into the partners and they transfer the assets to buyer.[32] The seller and buyer consequences of an asset exchange for stock and boot are discussed above.

**b. Bifurcated.**

There may or may not be a tax difference between a section 351 exchange with boot and a section 351 exchange of part of the target for stock and a sale for cash of another part of the target. The IRS has long opposed some shareholder efforts to bifurcate the incorporation of business assets into an all-stock exchange and a sale. However, there is no generally applicable controlling authority that bifurcation cannot be done if correctly papered and the particulars observed. Taxpayers have won these cases, even when the sale and the incorporation occurred on the same day by the same person.[33]

In these cases, R usually will not be the controlling, much less the sole, shareholder of B, which will distinguish the facts from most of the cases lost by taxpayers who tried for a part sale, part incorporation. In any event, the taxpayers will be obliged to report the two transactions as they were papered; and only a public-reporting B that is audited by one of the extraordinarily finicky Big Four accounting firms will have any reason for concern, absent an unlikely equally finicky IRS audit.

The result would be the same if R sold some of the property, here a partnership interest, to a co-investor who exchanged it with the corporation for stock. If, for example, R sold high-basis property to the corporation and incorporated the lower-basis property, R would have accomplished the identification of boot to particular properties that Rev. Rul. 68-55 does not allow.[34]

#### c. Circular cash.

The buyer could buy 100 percent of the target's assets from the target partnership, the partnership would liquidate, and R would invest her part of the cash in the equity of the buyer, with no concern about section 351 control because none of the gain or loss will be deferred. The circular cash reduces the amount of cash the buyer actually spends and can be used when the buyer cannot afford the full cash price.[35] Note this is the reverse of old cases in which the shareholder contributed the cash to the corporation, the corporation paid the cash back to buy loss property, and the IRS disregarded the circular flow.[36]

The concern would be that the IRS would recharacterize the transaction as a sale of 70 percent of the assets and a contribution of 30 percent of the assets to the corporation, by ignoring 30 percent of the cash. If 30 percent of the cash is ignored, it would never go into the buyer corporation, meaning that the buyer somehow got an extra 30 percent of the assets it did not pay for. The only explanation for that is that the seller would be deemed to contribute 30 percent of the assets to the buyer corporation, and section 351 likely would not apply.

But that proves why the IRS should respect the circular cash flow. R and the other partners will include all the gain recognized by the partnership in all its assets in either case. What is the difference if the partnership distributed part of its assets to R and R sold that part in an equally taxable sale for buyer stock? The Supreme Court effectively respected a circular cash flow in *Cottage Savings*.[37] The two thrifts paid each other cash for their respective mortgage pools, which amounted to a circular flow of cash. The IRS did not contest the circular flow in objecting to the loss recognition, which the Court allowed because there was no applicable nonrecognition rule.

The IRS has a track record of seeking recasts in circular cash cases, but most of them involve reorganizations in which a more robust step transaction theory can embrace multiple steps in the plan of reorganization.[38] *Tracinda*[39] has some similarities to the proposal, but the IRS has characterized it this way: "While the step transaction doctrine may be used to collapse steps actually taken that do not have independent significance, the Tax Court opined that it cannot be employed by the government to recharacterize transactions by creating new steps that the parties in fact failed to take."[40]

Turner Broadcasting System bought MGM from Tracinda Corp., which used part of the cash to buy a loss asset from MGM. If the form of the transaction were respected, MGM could recognize the loss, but it might be recharacterized as a distribution of the loss property to Tracinda after it acquired MGM, ignoring the cash. The court respected the form.

The IRS could make an argument similar to the argument it made in *Tracinda* to claim that the partnership exchanged 30 percent of its assets for stock, but why would it? In *Tracinda* the taxpayer was trying to avoid loss nonrecognition; in a circular cash flow, all of the partnership's asset gain will be recognized.[41]

### D. S Corporation Target

#### 1. Preliminaries.

S corporation targets are common and tailor-made for asset sales since the shareholders generally can get one-tier tax treatment. But they present special structuring problems. If the business is owned directly by the S corporation, the corporation may need to engage in an F reorganization so that the former corporation can be the DRE owned by its successor.[42] But sometimes coming up with a DRE is harder than it should be when the DRE is supposed to be a qualified subchapter S subsidiary.

If the shareholders contribute an S corporation that is a state law corporation to a NewCo state law corporation that is the successor S corporation, the contributed corporation can become a QSub if the election is made.[43] Then if NewCo sells some or all of the stock of the QSub, the buyer is deemed to buy assets and contribute them to a new C corporation.[44] One taxpayer that perhaps wanted to avoid that result converted the state law corporation to an LLC after it had inverted under the NewCo S corporation. Because the LLC wasn't a tax corporation when the election to make it a QSub was made, the election was invalid; it had to obtain a letter ruling to allow the election.[45]

**2. Liquidating the S corporation.**

Suppose R had incorporated the S corporation for $100, and its stock value and the inside asset value have both increased to $1,000, and the inside and outside basis have not changed. If the corporation liquidates, it will recognize $900 gain, which may be part ordinary income; R's stock basis will increase to $1,000; and R will recognize no gain or loss on exchanging the stock for the assets. In other cases when R had bought the stock from other shareholders, R may recognize a loss on the liquidation, which often will offset the passthrough gain, with some concern about character offsetting. In any event, those are the single-tier tax results that S corporations are supposed to offer and that can facilitate a rollover without deferral.

**3. Keeping S corporation.**

The S corporation can engage in a section 721 or 351 exchange as described above for part boot and keep the equity interest inside the S corporation and distribute the cash.

**4. Work with continuity.**

If B is willing to forgo an asset basis step-up, a merger of the S corporation into B for stock worth as little as 40 percent of the value of S can give the shareholders a 40 percent rollover plus cash. And if B is a public company, the target shareholders have complete freedom to sell as much of the B stock into the market as they want to reduce their rollover and not harm continuity. The ability to engaged in reorganization acquisitions is the reason the antique S corporation retains its popularity in the face of subchapter K dominance.

**5. UP-C.**

The S corporation can create an LLC/DRE with its business assets, the B can buy the majority for cash, and the S corporation and B will own the partnership, with the retained equity rolled over. This won't be an UP-C without an option to exchange the minority for B stock. Of course, the same technique can be used for an LLC owned by an individual R.

### E. C Corporation Target

#### 1. Stock sale rollover.

Except for private-equity partnerships that have their own reasons to invest in corporations, usually only corporations are willing to acquire corporations; after all, they are already in the double tax regime, and owning a subsidiary won't make that worse. That includes corporations owned by private-equity partnerships. Although it will not give B an asset basis step-up, a common transaction has R contributing her target stock to a TopCo partnership of a corporation while the corporation causes its MergerSub to merge into the target for cash in exchange for the rest of its stock.

One problem could arise if R owned more than 20 percent of the target. Then B will not have made a qualified stock purchase of the target. That precludes a section 338(g) election. It also precludes reliance on reg. section 1.338-3, which invests B with continuity for purposes of subsequent internal reorganizations. But when B owns 80 percent of the target, however acquired, B should be able to liquidate the target under section 332 if desired.

#### 2. LossCo.

If the target has sufficient net operating losses to substantially offset built-in gain, R could contribute her stock (less than 20 percent) to the TopCo partnership, and the B corporation could buy the rest of the stock as described above and make a section 338(g) election, which allows use of the target's NOLs to offset the deemed sale gain without application of section 382.[46] B will obtain a subsidiary with a cost basis in its assets. The gross-up mechanism will allow a deemed 100 percent asset purchase even though B did not buy all the stock,[47] except for the rollover stock, which will be "nonrecently purchased stock."[48]

When a partnership buys a corporation and some Rs roll over, and the buyer wants to make a section 336(e) election, the low 5 percent threshold of ownership of the partnership for attribution of the target shares can trip into the related-seller rule; that can be true even without a rollover.[49]

#### 3. Redemption.

As described above, R may contribute some of her target stock to a B partnership, which forms a MergerSub that merges into the target for cash. The resulting redemption of the target shares will be a section 302 event. If R rolled in part and got a redemption in part, R might have a dividend if her interest in B were large enough (unlikely).

#### 4. Investment company.

When a corporation or a partnership acquires target stock, the question arises whether B is an investment company, which can cause the nonrecognition rules not to apply.[50] That is particularly pertinent when it is a TopCo partnership that only owns the stock of a corporation, the ultimate destination of the target stock. The key to avoiding the investment company definition is that the partnership can look through to the assets of a corporation in which it owns more than 50 percent of the vote or value.

5. **National Starch.**

**Example:** B wants to buy target stock, but Founder refuses to sell, hoping to die with his 15 percent of the stock of the target, which is worth $1 billion in total. So B contributes $850 million to Sub, which contributes $850 million to MergerSub. Founder, here R, contributes his 15 percent of target stock to Sub for preferred stock that is not nonqualified preferred stock but can be redeemed at his death.[51] Section 351 will apply to his stock for stock exchange. MergerSub merges into target, and Sub acquires the rest of the target stock. Founder has rolled over, but B has not obtained an asset basis step-up unless a section 338 election will work.

Essentially the same transaction occurs when B buys the majority of the stock and contributes it to a HoldCo to which R also contributes her target stock for HoldCo stock. The difference is that R expects to keep the HoldCo stock.

0. **Leave management in place.**

Sometimes purchasers of stock of a target acquire all stock but that of the management and call those "management rollover shares." That may be more viable when the target is foreign.[52]

1. **Going private.**

In a common transaction, management puts its stock in public target into HoldCo along with cash investors; the cash goes into a MergerSub, which merges into target for cash.[53]

2. **Blank check company.**

An LLC owns a corporation NewCo that owns a MergerSub that merges into the target for cash contributed by the LLC. Management and some favored target shareholders are allowed to roll over their stock into NewCo for NewCo stock. They are on their own to figure out the tax consequences.[54]

3. **Recapitalization.**

The transaction was called a recapitalization when investors and rollover management put cash and target stock into MergerCo, which merged into the target with the common stock being cashed out and some other classes being converted into new classes.[55]

0. **Foreign stock.**

When foreign shareholders roll over their stock in a foreign target to a U.S. corporation buyer, they don't care about whether section 351 will apply.[56]

1. **Qualified small business stock.**

Section 1045 would allow R to sell her qualified small business stock to B for its stock without recognizing gain when section 351 couldn't apply. Section 1202 is the section on which it is based and allows nonrecognition of qualified small business stock sale.

## IV. The Relationship Rules

Each rollover structure described above that involves a purchase component in addition to a tax-deferred rollover can be subject to one or more of the following rules that limit various tax benefits based on the relationship of the parties to a transaction. This section doesn't attempt to relate the rules back to a specific structure discussed above, but it can serve as a checklist of issues to consider.

### A. Qualified Stock Purchase

B doesn't purchase stock for purposes of a qualified stock purchase (or qualified stock disposition if section 336(e) applies) if the seller is a person the ownership of whose stock would be attributed to B under section 318(a).[57] The relationship is tested immediately after the acquisition.[58] This might apply if R both sold some stock and contributed some stock or if the deal were fully taxable and R bought some B stock (or partnership interest if a noncorporate purchaser). Stock can be attributed to a corporation from its shareholder only if the shareholder owns 50 percent or more in value of the stock.

Of course, stock attributed to the stockholder (except by option attribution) counts toward the 50 percent, which is the primary culprit in sneaky creation of relatedness. For example, all stock actually or constructively owned by a partner will be attributed to the partnership.[59]

### B. Loss

Section 267 might apply to R's sale of some loss stock and contribution of the rest of her stock. It disallows the loss if the buyer is related. It also measures relatedness as ownership of more than 50 percent of value of the buyer with attribution. Presumably, relatedness should be tested after the sale.[60]

### C. Capital Gain

Section 1239 could apply to a sale by an S corporation of depreciable business assets to B even though section 1231 might otherwise create a capital gain; the result would be ordinary income. Relatedness here also means more than 50 percent of the value of a B corporation or partnership, with attribution. So, for example, if an S corporation were to sell its assets to a partnership comprising the corporation's shareholder, R, and an investor, R should receive no more than 50 percent of the stock or partnership interests in the rollover.

### D. Bonus Depreciation

Bonus depreciation isn't allowed for used property purchased from a related person.[61] This also uses a "more than 50 percent of value of the buyer" standard, with attribution under alternative rules.[62]

### E. Acquisition of Control

Although we hope that none of the rollover transactions could run afoul of section 269, acquiring control of a corporation for purposes of tax avoidance can cause the IRS to assert it. Control means 50 percent of vote or value without attribution.

### F. Section 304

If R controls both the target corporation and a corporation acquiring its stock by purchase or a section 351 exchange with boot, section 304 can recharacterize the gain as a dividend. Control means 50 percent of vote or value, with attribution. Control counts stock acquired in the transaction.[63]

### G. Intangibles Amortization

An amazing number of businesses date back to 1993, and their owners fear that some intangibles existing 29 years later date back to that year. If so, and if section 197 otherwise would apply to allow a 15-year depreciation of purchased intangibles, cross ownership can prevent that under what is called the anti-churning rule. This time relatedness starts at 20 percent of value.[64] Others have extensively analyzed the problem.[65]

### H. Vesting

In management rollovers, B may want to impose a vesting requirement on its stock issued to management in rollover for their vested target stock. That can make the B stock taxable compensation when vested unless a section 83(b) election is made.[66]

## V. Conclusion

Rollovers are all about who wants what. If some target owners get cash, the value of what they get is clear; but for an R that gets B's stock or partnership interest, the value may not be clear, especially when B has other businesses and preexisting value that may be uncertain. Therefore, along with all the other considerations, the structure selected to accomplish the rollover may have to be tailored to value concerns as well.

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***Endnotes***

1 *See* Global SPAC Partners Co., SEC Form 425 EX-99.1 (Mar. 16, 2022).

2 Scott W. Dolson, "Rollover Equity Transactions 2021," Frost Brown Todd's Tax Law Defined Blog, Jan. 28, 2021. This law firm regularly updates that review, which is remarkably complete and detailed.

3 *See* Emily Foster, "M&A Dealmakers Tackle COVID-19 and Tax Policy Uncertainties," *Tax Notes Federal*, Nov. 9, 2020, p. 988.

4 Tarena International Inc., SEC Form SC 13D/A EX-99.G (May 3, 2021).

5 *See* Robert S. Reder and Katherine H. Monks, "Chancery Court Refuses to Dismiss Aiding and Abetting Claim Against Target Company Financial Advisor, but Grants Dismissal to Outside Counsel and Buyer," 74 *Vand. L. Rev.* 445 (2021); and Janine M. Salmone and Dawn M. Jones, "Keeping Management in the Game Without Tainting the Sale Process," 2012 *Bus. L. Today* 1 (2012).

6 *See* New Frontier Health Corp., SEC Form SC 13E3 EX-99.(D)(16) (Oct. 5, 2021).

7 8 Del. Code section 251(g).

8 Rev. Rul. 70-140, 1970-1 C.B. 73.

9 Jasper L. Cummings, Jr., "Incorporating Reorganizations," *Tax Notes Federal*, Mar. 14, 2022, p. 1537.

[10] Section 362(b).

[11] *Cf.* section 362(a).

[12] Section 731(a).

[13] Section 734.

[14] Reg. section 1.707-3.

[15] Reg. section 1.707-3(a)(2).

[16] *See* Rev. Proc. 77-37, 1977-2 C.B. 568, section 3.07.

[17] *See* Cummings, "Incorporating Reorganizations," *supra* note 9; and Cummings, "Section 351 Loss of Control," *Tax Notes Federal*, Nov. 9, 2020, p. 949.

[18] Section 351(b).

[19] Rev. Rul. 68-55, 1968-1 C.B. 140.

[20] *Id.*

[21] LTR 201006002 (rulings 9 and 11); LTR 200845044 (ruling 17) more clearly indicates that the transferor's recognized gain on "each asset" is added to the basis of "each asset" by the corporation. *See also* LTR 8512071, LTR 8516031, LTR 8517041, LTR 8528030, LTR 8541058, and LTR 200845044.

[22] *Complex Media Inc. v. Commissioner*, T.C. Memo. 2021-14.

[23] *Id.* at 77.

[24] *See* reg. section 1.1060-1(b)(8).

[25] GCM 37409 (1978), citing reg. section 1.358-1(b)(1) and (2). The memorandum also stated that the buyer shareholder need only have received a "minimal" amount of its ultimate stock holding from the corporation.

[26] Rev. Rul. 99-6, 1999-1 C.B. 432.

[27] REG-149519-03 (published Nov. 26, 2004, and withdrawn Jan. 21, 2009). *See* Bradley T. Borden et al., "A Financial Analysis of Disguised Sales of Partnership Interests," *Tax Notes Federal*, July 19, 2021, p. 373.

[28] Arthur B. Willis, Philip F. Postlewaite, and Jennifer H. Alexander, *Partnership Taxation*, para. 4.06 (2017).

[29] *See* CNL Strategic Capital LLC, SEC Form 8-K EX-10.1 (Dec. 9, 2021).

[30] Section 7704.

[31] Specialty Building Products Inc., SEC Form S-1 EX-2.2 (Jan. 4, 2022).

[32] Rev. Rul. 99-6, Situation 2.

[33] *Bradshaw v. United States*, 231 Ct. Cl. 144 (1982); *Principal Life Insurance Co. v. United States*, 70 Fed. Cl. 144 (2006).

[34] Reg. section 1.358-2.

[35] Cummings, "Circular Cash Flows and the Federal Income Tax," 64 *Tax Law.* 535 (2011).

[36] *Labrot v. Burnet*, 57 F.2d 413 (D.C. Cir. 1932).

[37] *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991).

[38] Rev. Rul. 78-397, 1978-2 C.B. 150; Rev. Rul. 74-564, 1974-2 C.B. 124. *See also* Rev. Rul. 57-469, 1957-2 C.B. 521 (ignored circular cash flow to help the taxpayer have a tax-free, like-kind exchange).

[39] *Tracinda Corp. v. Commissioner*, 111 T.C. 315 (1998).

[40] ILM 201320014.

[41] *Cf. Six Seam Co. v. United States*, 524 F.2d 347 (6th Cir. 1975) (transfer of cash to wholly owned subsidiary for additional stock, immediately after which subsidiary purchased operating assets from parent; held to be section 351 exchange with carryover basis, not a sale).

[42] *See* Michael P. Spiro, "Drop-and-Check F Reorganizations and Transferee Liability," *Tax Notes Federal*, Sept. 28, 2020, p. 2365; and Spiro, "Tax-Deferred Management Rollovers in Acquisitions of Pass-Through Entities," 110 *J. Tax'n* 345 (June 2009).

[43] Rev. Rul. 2008-18, 2008-1 C.B. 674. The same is true if the S corporation was an LLC electing to be treated as a corporation.

[44] Section 1361(b)(3)(C).

[45] LTR 201314003.

[46] Reg. section 1.338-10(a)(1).

[47] Reg. section 1.338-4(c).

[48] Section 338(b)(4).

[49] American Bar Association Section of Taxation, "Comments on Regulations Enabling Elections for Certain Transactions Under Section 336(e)" (July 21, 2015).

[50] Section 721(b); reg. section 1.351-1(c)(4); LTR 200211017. *See* Cummings, "Who Wants an Investment Company?" *Tax Notes*, May 23, 2016, p. 1075.

[51] Section 351(g)(2)(C)(i)(I).

[52] White Mountains Insurance Group Ltd., SEC Form 8-K (Items: 1.01, 9.01) (Oct. 10, 2020).

[53] Cellular Biomedicine Group Inc., SEC Form PRER14A (Nov. 17, 2020).

[54] Concrete Pumping Holdings Inc., SEC Form 10-K EX-10.1 (Jan. 12, 2021).

[55] Berry Plastics Corp., SEC Form 8-K EX-2.1 (July 3, 1996).

[56] Neogenomics Inc., Form 8-K EX-2.1 (May 5, 2021).

[57] Section 338(h)(3)(A)(iii).

[58] Reg. section 1.338-3(b)(3)(ii)(A)

[59] Section 318(a)(3)(A).

[60] Reg. section 1.267(f)-1(c)(1)(iii) says so for section 267(f), and the words of the statute don't differ between (b) and (f) on this point.

[61] Section 168(k)(2)(E)(ii)(II).

[62] Section 179(d)(2)(A), (B), (C), and (d)(3).

[63] Section 304(c)(2)(A).

[64] Section 197(f)(9)(C).

[65] *See* Spiro articles, *supra* note 42.

[66] Rev. Rul. 2007-49, 2007-2 C.B. 237. *See* Cummings, "Property for Services," *Tax Notes Federal*, June 6, 2022, p. 1565.

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