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Federal Tax ADVISORY

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Equity Rollovers

In the current mergers and acquisitions (M&A) climate, transactions are frequently structured with a rollover equity component. Buyers want key management to remain incentivized, key management wants another opportunity for a big payday at the next exit, and equity consideration always comes in handy when cash is hard to come by. Many deal practitioners assume rollover equity is generally received on a tax-free basis, and while that may be a safe assumption with many private equity transaction structures, it's not always the case. The parties should understand the tax consequences of the equity received in M&A transactions at the letter of intent stage. Otherwise, they risk going down a path that unexpectedly triggers tax without a corresponding receipt of cash. While we won't scratch the surface of all potential tax issues arising from equity rollovers, we hope to remind you that proactive tax planning is the best way to ensure rollover equity structures meet client expectations.

Whether or not rollover equity can be received on a tax-free basis will depend on the tax classification of the target entity, the tax classification of the acquiring entity (and the entity issuing the rollover equity, if separate), and the mix of the consideration (i.e., how much equity and how much cash). Note that a more accurate description of a tax-free rollover is "tax-deferred rollover," since the government gets its share eventually (e.g., when the rollover equity is subsequently sold).

If private equity is the acquirer, it may be relatively easy to do a tax-free rollover. But if the acquirer is a large public corporation, it is not so easy.

Private equity acquirers can generally provide tax-free rollovers in one of two ways. If private equity forms a holding company by contributing, say, $100 million to a blocker corporation, the executives of the target that want to roll over their stock could contribute it to the blocker at the same time. That exchange of stock can be tax-free. Alternatively, if private equity owns an established corporation that will make the acquisition with borrowed cash, the rollover might be into the private equity partnership or a partnership owned by it; that can also be tax-free.

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When the seller is a partnership or S corporation and the owners of the seller want to roll over disproportionately compared to their ownership percentages in the seller, things become more complicated. If the entity sells assets, the gain will be taxed for all the owners, regardless of the rollover. To avoid this, the rollover owners of a partnership should push for an equity deal instead and contribute their partnership interest to the private equity vehicle, which will buy the rest. Alternatively, if the target is an S corporation, an acquirer may not be interested in acquiring the S corporation's equity, so the parties will need to work toward a mutually agreeable structure.

If the acquirer is not private equity but a public corporation, then tax-free rollovers are much more complicated. The best bet may be a tax-free merger with the corporate acquirer; however, these rules are much more burdensome than the rollover private equity structures and also generally require the equity rollover to comprise at least 40% of the total consideration. A public corporation's inability to offer a tax-free rollover may require the parties to get creative in other compensatory aspects of the deal.

And then there is another set of issues for the acquirer that wants to ensure an asset basis step-up for a part purchase/ part rollover of the target.

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