

Equity Rollovers in M&A Transactions

Negotiating and Structuring Rollovers; Tax Considerations for Buyers and Sellers

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Today's faculty features:

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Equity Rollovers in M&A Transactions

September 16, 2020

Ted Wern
Partner

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Profile and Assumptions

- Closely Held Private Company
- “Main Street” not “Wall Street”
- Continuity of Business and Management after Closing
- Platform investment, not add-on investment to existing operating company
- Rollover equity, not management “incentive” equity

Purpose of Rollover Equity

- Alignment of incentives
- Continuity of management
- Competitive advantage for buyer (vs strategic acquirer)
- “Second kick at the can” for Seller

Mechanics and Economic Terms

- How does the rollover occur?
- Impact on other M&A terms/agreements
- Intended tax treatment and basis issues
- Economic terms
 - “*pari passu*”
 - Impact of buyer leverage
 - Dividends/distributions
- PE fund management fees

Minority Rights

- **Basics:**
 - Pari passu treatment
 - Preemptive rights
 - Affiliate transactions (arm's length)
 - Amendment to transaction documents
- **More Controversial:**
 - Acquisitions/divestitures
 - Strategic matters
 - Debt/equity issuance
 - Other operational items

Liquidity Rights

- Sanctity of the exit to buyer/PE fund
- Put/Call Rights
- Transfer restrictions
- Drag/tag along rights

Other Key Terms

- Repurchase rights upon termination/other events
- Non-compete/confidentiality restrictions
- Board/observer rights
- Tax distributions

Questions and Contact Info

Questions?

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Tax Considerations for Equity Rollovers in M&A Transactions

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September 16, 2020

Agenda

- I. Deal Objectives
- II. Imposition of Vesting Restrictions on Fully Vested Stock
- III. 2017 Tax Reform & Cares Act – Increased Incentives for Asset Purchases
- IV. Basic Tax Consequences of Middle Market Acquisition Transactions
- V. Requirements for Stepped-Up Basis to Purchaser
- VI. Requirements for Tax-Free Rollover to Sellers
- VII. Structuring Opportunities to Harmonize Buyer and Sellers Objectives – Examples

I. Deal Objectives

I. Deal Objectives

- Buyer's objectives
 - Acquire control
 - Maximize after-tax returns
 - stepped-up asset basis
 - Minimize inherited liabilities, tax, and commercial
 - Preserve historic licenses
 - Provide or preserve economic incentives to existing management
 - Minimize fiduciary complexities or impediments to resale

I. Deal Objectives (con't)

- Seller's objectives
 - Achieve liquidity event
 - Maximize after-tax proceeds
 - one level of tax
 - tax deferral on rollover equity
 - Potentially (secondarily) to retain participation in post-transaction appreciation

I. Deal Objectives (con't)

- Harmonize objectives of buyer and seller
 - Achieve one level of tax to sellers (or tax-free rollover) with basis step-up to buyer
 - Ability to harmonize objectives depends on entity classification of the target company
 - partnership and flow-through entities
 - C corporations
 - S corporations

II. Imposition of Vesting Restrictions on Fully Vested Stock

II. Imposition of Vesting Restrictions on Fully Vested Stock

- When property is transferred in connection with the performance of services, the service provider recognizes ordinary income equal to the spread between fair market value of property and amount paid for property
- Service provider recognizes income at the time the property is either transferable or not subject to a substantial risk of forfeiture (e.g., vested stock)
- Service provider may elect to recognize the spread as income in the year of the transfer by filing an election within 30 days of the transfer (known as a “Section 83(b) election”)

II. Imposition of Vesting Restrictions on Fully Vested Stock

- IRS Revenue Ruling 2007-49 provides guidance on certain transactions involving placing new vesting restrictions on fully vested stock
 - The imposition of vesting restrictions on fully vested stock, without any exchange of stock, is not a compensatory transfer
 - stock does not become unvested for purposes of Section 83
 - no new Section 83(b) election is required
 - consider whether the imposition of vesting restrictions is related to another transaction
- The receipt of unvested stock in a tax-free rollover transaction is treated as compensatory transfer
 - For example, receipt of stock with new buyback rights and / or transfer restrictions may result in substantial risk of forfeiture
 - Service provider should file a Section 83(b) election
 - No ordinary income recognition if Section 83(b) election is made
 - subsequent disposition of shares retain capital gain treatment
 - failure to make a Section 83(b) election results in ordinary income treatment for any appreciation following the exchange upon shares becoming substantially vested
 - Same tax treatment if the receive of unvested stock was in taxable transaction

III. 2017 Tax Reform & CARES Act – Increased Incentives for Asset Purchases

III. 2017 Tax Reform & CARES Act

- Tax Cut and Jobs Act of 2017, Public Law 115-97, Enacted Major Changes to Corporate Income Tax
- Significant Changes include:
 - 21% corporate tax rate - reduces relative importance of tax expense
 - 100% expensing of tangible property
 - new or used tangible property eligible for 100% depreciation if placed into service on or before December 31, 2022
 - asset sales and stock sales eligible for Section 338(h)(10) more attractive
 - NOL (100% to 80%)
 - Recent Coronavirus Aid, Relief, and Economic Security Act delayed NOL limitations and restored NOL carryback rule until 2021
 - Beginning in 2021, NOL can only offset 80% of income
 - corporations with pre – 2021 NOLs use prior law (full offset)
- TCJA Increases Incentive for Asset Purchases
 - Deal price allocable to tangibles can be immediately deducted
 - CARES Act also accelerated depreciation write-off for certain improvements to nonresidential real property

IV. Basic Tax Consequences of Middle Market Acquisition Transactions

IV. Basic Tax Consequences – Sale of Flow-Through Entities

- Sale of partnerships, branches, or disregarded entities
 - Transparent or flow-through entities for tax purposes
 - Buyer may buy ownership interest or assets
 - purchase price treated as paid for assets.
 - stepped-up asset basis increases depreciation and amortization deductions allowing tax-sheltered cash flow.
 - Sellers sell assets or ownership interest in the entity
 - sellers realize capital gain on assets (except certain items taxed at ordinary rate, e.g., receivables or depreciation recapture)
 - one level of tax

IV. Basic Tax Consequences – C Corporation

- Stock sale of C corporation
 - Sellers sell shares
 - realize capital gain on shares
 - one level of tax
 - Buyer buys shares
 - obtains a cost basis in shares
 - share investment not depreciable (reducing after tax cash flow); share basis will only produce a tax benefit when resold
 - corporate tax attributes (e.g., NOL, stay with the entity)
- Sale of C Corporation's assets
 - C corporation sells assets, then distributes after-tax proceeds to shareholders

IV. Basic Tax Consequences – C Corporation (con't)

- two levels of tax to sellers
- selling corporation pays taxes on asset gains at 21%; then shareholders pay taxes on their share gains when after-tax proceeds are distributed by selling corporation to them (assuming Section 332 not available)
- alternatively, may look to shareholder non-compete or personal goodwill to reduce two levels of overall taxes, if available
- Buyer purchases assets
 - buyer gets stepped-up (i.e., cost) basis in assets, value allocated to goodwill and going concern amortizable over 15 years (tangible property fully deductible)
 - generally does not inherit target C corporation's historic and contingent liabilities

IV. Basic Tax Consequences – S Corporation

- Sale of S corporation
 - Treated as modified flow-through
 - Sale of assets by S corporation
 - buyer receives stepped-up basis in assets
 - generally only one level of tax to selling shareholders. Asset gains may flow through and increase outside basis, eliminating the second level of tax (gains may be taxed at ordinary rates for receivables and depreciable assets)
 - consider Section 1374 entity level tax for S corporation that converted from C corporation or acquired assets from C corporations in a referenced basis transaction during the prior 5 years
 - Stock sale of S corporation
 - selling shareholders subject to one level of tax
 - buyer has cost basis in shares
 - no stepped-up basis in assets
 - Asset v. stock sale for selling shareholders
 - deferred revenue
 - differences between inside v. outside basis

IV. Basic Tax Consequences – Section 338 Elections

- Section 338 Election
 - If election made in connection with a taxable stock sale, then transaction treated as a hypothetical asset deal for tax purposes
 - Section 338(g) election
 - unilateral election by the acquirer
 - acquirer generally bears the tax burden from the deemed asset sale
 - generally results in two levels of tax; only used when Target has NOL
 - Section 338(h)(10)
 - joint election by acquirer and sellers
 - seller bears tax burden from the deemed asset sale
 - only applies to acquisitions of corporate subsidiaries from consolidated group or S Corporations
 - Only a deemed asset sale – buyer inherits target’s commercial liabilities
 - Similar results may exist under Section 336(e)

V. Requirements for Stepped-Up Basis to Purchaser

V. Requirements for Stepped-Up Basis

- Asset basis step-up requires:
 - Asset purchase
 - A constructive asset purchase (purchase of flow-through entities such as partnership, branch or disregarded entities)
 - Deemed asset purchase under Section 338 or 336(e)
- Asset purchase may be prohibitively expensive if:
 - Seller is a C corporation with substantial asset gains
 - for example, self-created goodwill has a zero basis
 - Seller is a C corporation without a large NOL

V. Requirements for Stepped-Up Basis – Section 338 Election

- Section 338 Requirements
 - Qualified Stock Purchase:
 - buyer acquires 80% of vote and value of shares
 - share acquisition obtained by “purchase” (not non-taxable share contribution or tax-free reorganization)
 - share acquisition must occur within a 12-month acquisition period
 - Buyer must be a corporation
 - Buyer election 338(g) or mutual election by buyer and seller under Section 338(h)(10) with agreed upon purchase price allocation
 - Difficult for tax free rollover because all target’s assets will be treated as having been sold, so all selling shareholders will recognize proportionate share of taxable gain

V. Requirements for Stepped-Up Basis – Section 336(e) Election

- Section 336(e) Requirements
 - Qualified Stock Disposition:
 - at least 80% of the stock (vote and value) must be disposed (to one or more buyers)
 - share disposition must occur within a 12-month disposition period
 - tax-free dispositions (and transfers to related parties) will fail to be treated as a qualified stock disposition
 - U.S. Corporate Seller (or S corporation shareholders) and Target must enter into a binding written agreement to make the election (i.e., no IRS form to be completed)
 - Target must retain a copy of the binding written agreement
 - A Section 336(e) election statement must be included in Target's U.S. federal income tax return that includes the disposition date
 - No impact to Purchaser; Target receives step-up in basis of its assets
 - Buyer may be individuals, partnerships, or other noncorporate entities
- If a transaction qualifies for both Section 338 and Section 336(e) elections, a Section 338 election controls

VI. Requirements for Tax-Free Rollover to Sellers

VI. Requirements for Tax Free Rollover

- Generally all sellers will be taxed on cash received for target entity
- Compensatory shares will generate ordinary income to employees. Post closing vesting requirements may be inconsistent with rollover treatment
- Sellers either:
 - Don't sell (some or all sellers retain some or all equity) or
 - Exchange old equity for new equity in a tax free incorporation transaction
- Other potential tax deferral options

VI. Requirements for Tax-Free Rollover (con't)

- Consistency with buyer's asset step-up objectives
 - Targets that are classified as partnerships are most consistent with competing objectives
 - Sellers subject to one level of tax
 - Rollover opportunity
 - Asset basis step-up for buyer
 - Sellers retaining equity in excess of 20% can prevent Section 338(h)(10) election
 - Leveraged acquisition or rollover equity into buyer could cause transaction to flunk the 80% acquisition test required for 338(h)(10) election
 - Target S corporations and C corporations – certain structures exist

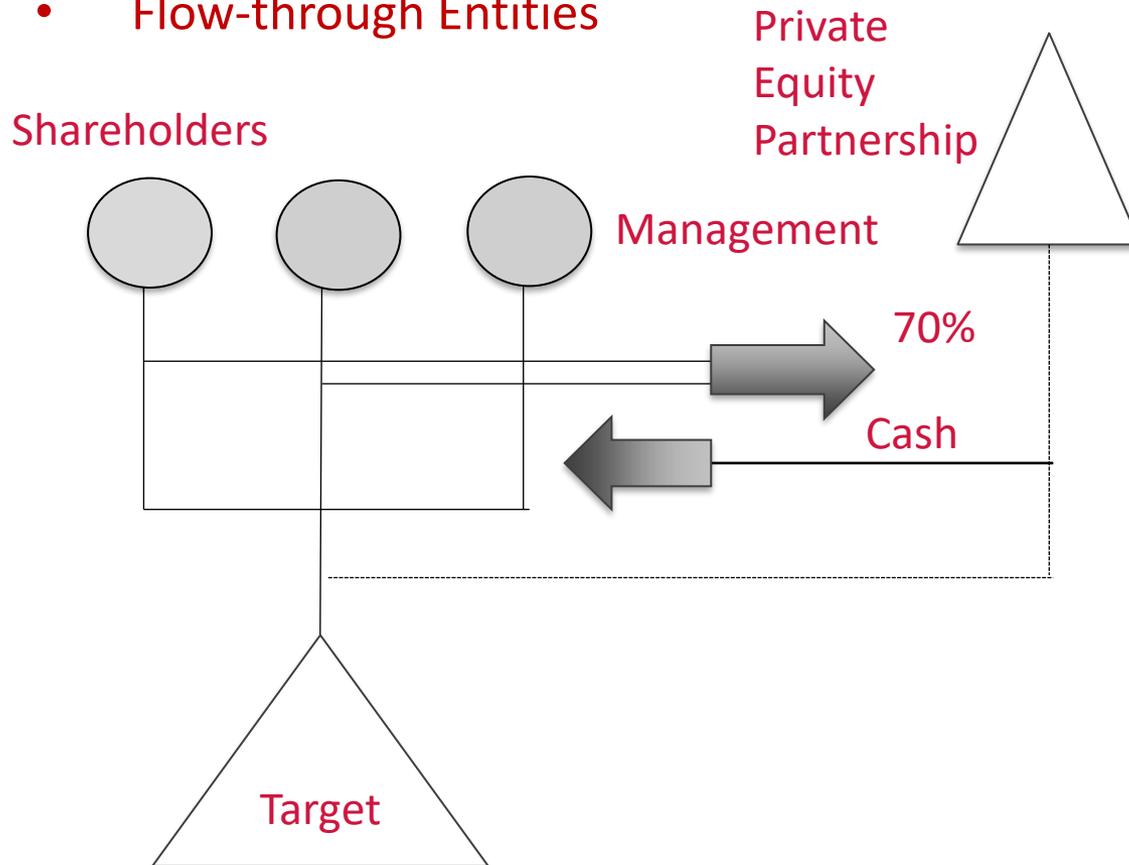
VII. Structuring Opportunities to Harmonize Buyer and Sellers Objectives - Examples

VII. Harmonizing Buyer and Seller Objectives – Flow-Through Entities

- Partnerships and disregarded entities are generally not taxed as entities. Instead, taxable income follows through to owners
- Flow through entities most easily accommodate harmonization of buyer's stepped-up basis objective with seller's tax-deferred rollover objective
- Seller rollover can be proportionate or disproportionate

VII. Harmonizing Buyer and Seller Objectives – Flow-Through Entities

- Flow-through Entities

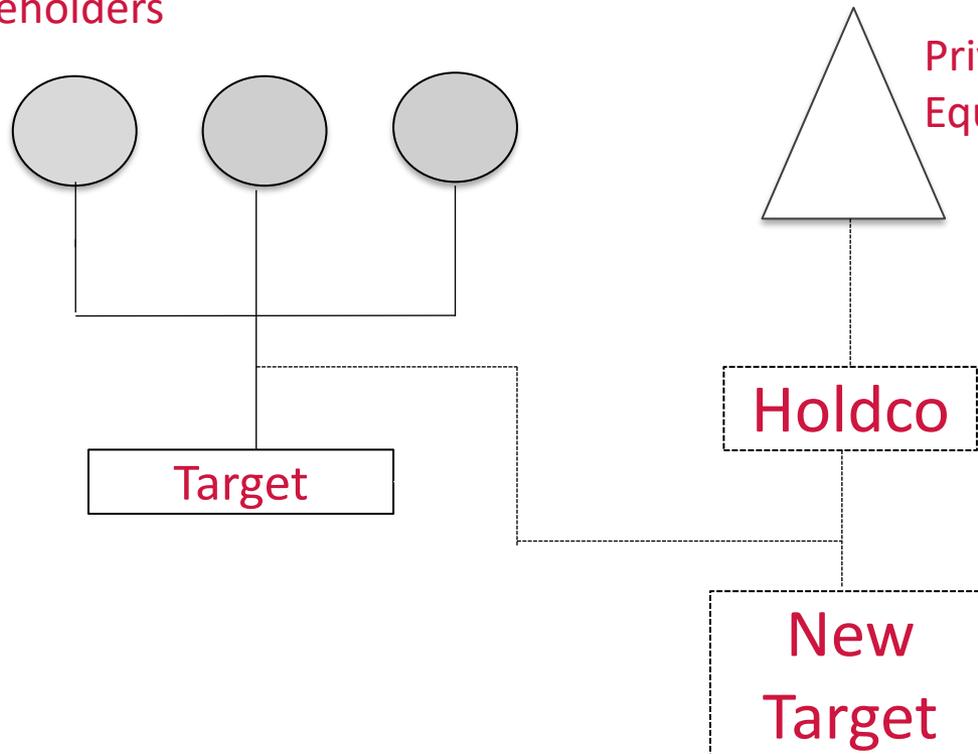


- Buyer obtains a basis step-up in partnership assets for its purchase price (Sections 754 and 743)
- Sellers retained rollover shares can be proportionate or disproportionate
- Introducing new holdco can complicate analysis (see Sections 708 and Rev. Rul. 99-6)

VII. Harmonizing Buyer and Seller Objectives – C Corp

- C Corporation Target - Rollover and Step-Up Together are Difficult

Shareholders

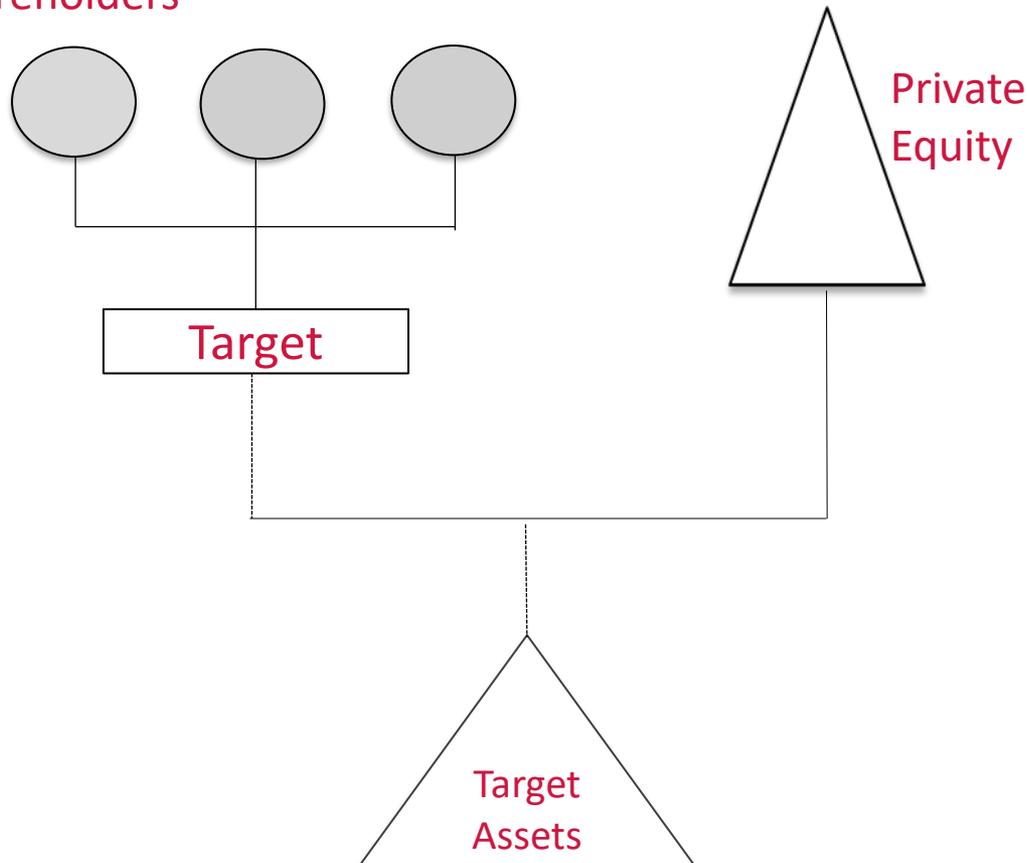


- Rollover without step-up - shareholders sell some shares to P.E. fund in taxable transaction; some shareholders retain (or contribute to holdco) rollover equity
- No offset basis step-up to buyer or holdco!! (Might consider interest expense on acquisition debt at holdco offset or shareholder level goodwill)
- Rollover can be proportionate or disproportionate

VII. Harmonizing Buyer and Seller Objectives – C Corp

- C Corporation Target - Basis Step-Up But With Two Levels of Tax

Shareholders



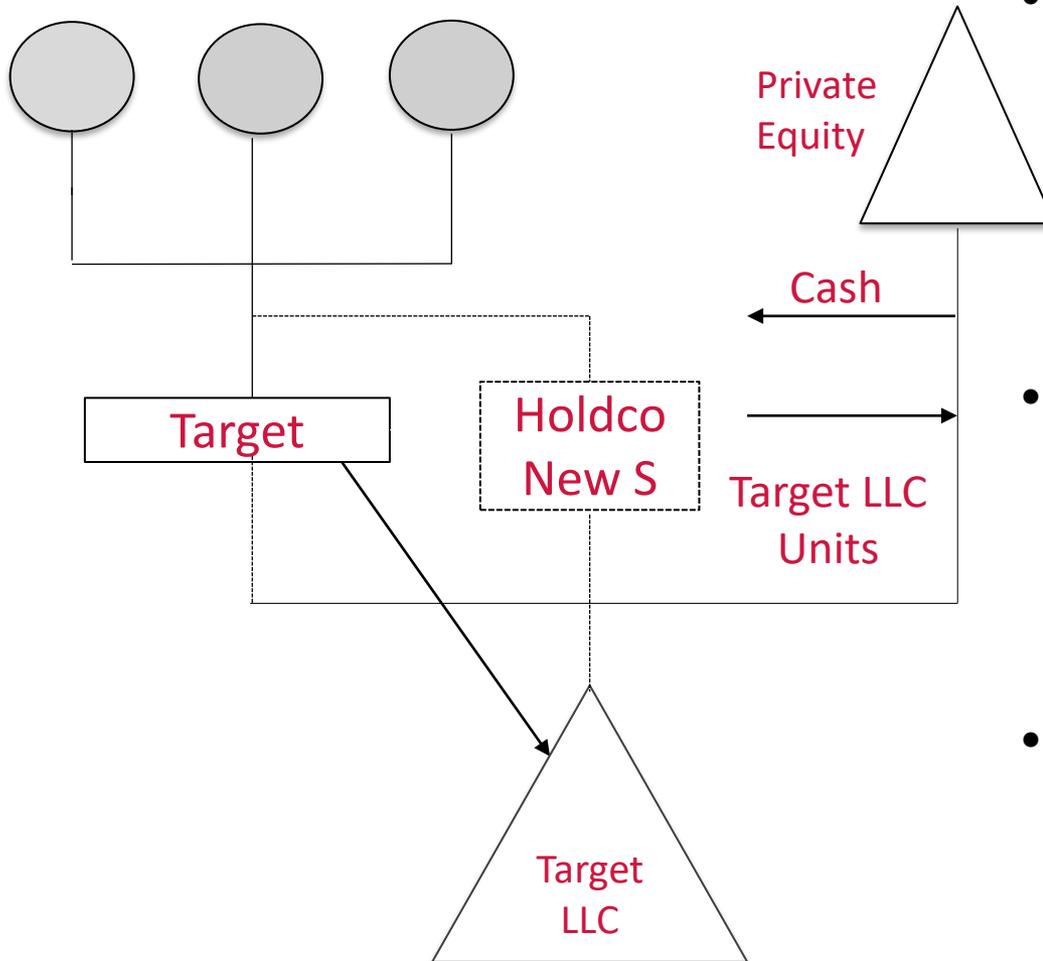
- Target transfers assets to a wholly owned LLC
- Part sale/part retained ownership. Assume P.E. fund purchases 70% of the LLC for cash
- P.E. fund buyer gets asset step-up
- Selling shareholders have two levels of tax on cash portion of the transaction

VII. Harmonizing Buyer and Seller Objectives – S Corp

- S corporation target
 - Section 338(h)(10) election available to treat stock sale as an asset purchase
 - Buyer must acquire 80% by “purchase”; all assets deemed sold
 - S corporation’s taxable gain allocated to selling shareholders on a pro rata basis. Sellers seeking rollover will be subject to tax
 - Buyer acquires historic entity with any tax contingencies
- F reorganization structure
 - Preserves historic licenses
 - Buyer avoid tax contingencies from the sale and mitigates inheritance of historic tax contingencies

VII. Harmonizing Buyer and Seller Objectives – S Corp

Shareholders



- F reorganization steps:
 - Sellers drop target S corp into new holdco and elect Q sub status for target – tax free Section 368(a)(1)(F) reorg
 - Target merges or converts into an LLC
- Buyer purchases all or most of LLC. Not a Section 338, but an asset purchase by buyer followed by contributions by Holdco and Buyer to a partnership (Rev. Rul. 99-5). Can acquire less than 80%)
- Buyer gets stepped-up basis; sellers get one level of tax (pro rata). Proportionate rollover opportunity

Takeaway/Questions

- Recent trends
- Questions

David R. Hardy Bio



David's practice focuses on corporate and international tax including the tax issues affecting corporations in the energy industry. He has been involved in cross-border merger transactions, including public company stock acquisitions, joint ventures, project financings, cross-border security issuances, inbound and outbound securities, real estate and private equity partnerships. David is the past President of the International Tax Institute in New York, past chair of the Taxation Committee of the International Bar Association and a longtime member of the Executive Committee of the NYS Bar Tax Section. In addition, he is a frequent speaker at tax conferences and frequently writes on various topics. He has been the principal author of a number of NYS Bar Tax Section reports on subjects including the base erosion and anti-abuse tax, the anti-double dip finance provisions, the anti-hybrid provisions of the U.S.-Canada treaty, the non-recognition rules regarding the outbound transfers of intangible property, and the consistency principle in tax treaty interpretation.

Education

New York University Law School, LL.M.

Georgetown University Law School, J.D.

Reed College, B.A. (Phi Beta Kappa)

Andrew M. Granek Bio



Andrew's practice concentrates on a variety of U.S. federal income tax matters in connection with domestic and cross-border transactions, including public and private mergers, acquisitions, private equity, financings and restructurings. Prior to joining the Osler, Hoskin & Harcourt LLP, Andrew worked at a Big Four accounting firm where he advised public corporations and private equity funds on a variety of tax matters related to domestic and cross-border leveraged buyouts, spin-offs and internal restructurings.

Education

Brooklyn Law School, J.D.

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