Tax Issues for Rollover Equity in M&A Transactions:
Key Considerations for Buyers and Sellers

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Tax Issues for Rollover Equity in M&A Transactions: Key Considerations for Buyers and Sellers

June 24, 2021
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Member, Morse
Rollover Equity

- Reasons for Rollover Equity:
  - Financial Buyers (including private equity buyers) have a preference for retaining and incentivizing management teams
  - Non-cash currency to increase overall deal value
Rollover Equity – Tax Considerations

• Tax Considerations in potential transactions may include:
  – Nature of Acquisition
    • Asset Purchase vs. Stock Purchase
    • Taxable Transaction vs. Tax Free Reorganization
  – Tax Status of Target and Buyer
    • S Corporation
    • C Corporation
    • Partnership
    • Hybrid Structures
    • Net Operating Losses
    • Basis of Selling Shareholders
• Tax Considerations in potential transactions:
  – Nature of consideration
    • Cash
    • Other property
    • Debt
    • Stock of Buyer
    • Mix of consideration
Rollover Equity

• Overview
  – Part I – Structures to Achieve Tax Deferred Rollover for Sellers
  – Part II – Structures to Achieve Step-Up in Basis for Buyer
  – Part III – 1202 Considerations
  – Part IV – Treatment of Management Equity
Part I
Structures to Achieve Tax-Deferred Rollover for Sellers
Section 1: Structuring To Achieve Tax-Deferred Rollover

• Optimal Structure will depend on a variety of factors:
  – Organizational structure of target
  – Buyer’s structure
  – Economics of transaction
Rollover Structures – Corporate Targets

Corporate Targets:
- Single Entity Equity Purchases
- Corporate Reorganizations
- Acquisitions by LLC Holding Company
- 351 Transactions
• Single Entity Equity Purchase:
  – Buyer purchases less than 100% of outstanding equity in existing corporation.
  – Rollover Equity in this case is just equity retained by Sellers
Single Entity Equity Purchase

Existing Equityholders

Target

Stock

Cash

Buyer
Single Entity Equity Purchase

- Buyer takes basis = purchase price in purchased equity

- Primary limitation:
  - Rollover Equity must be in existing corporation (cannot roll into buyer’s existing structure).
Corporate Reorganizations

- Types of Corporate Reorganizations in Acquisitions
  - Stock Acquisitions
    - B Reorganization – Control immediately following the exchange where Target stock acquired solely for Voting Stock
    - Reverse Triangular Merger (368(a)(2)(E))
      - Control acquired in exchange for voting stock
  - Asset Acquisitions
    - A Reorganizations – Statutory Merger
    - Forward Triangular Merger (368(a)(2)(D))
    - C Reorganizations – Transfer of substantially all assets of Target in exchange for Voting Stock
    - D Reorganizations – Transfer of substantially all where transferor or shareholder of transferor has control of Buyer
Corporate Reorganizations – General Requirements

- Continuity of Interest
  - Generally governs the percentage of stock in relation to the overall deal consideration that must be received by Target’s shareholders for a transaction to qualify as a reorganization.
  - Judicially determined to be as low as 38%, but most practitioners view 38%-40% as the minimum portion of stock to qualify.
  - Regulations now indicate that 40% stock will satisfy continuity of interest requirements.
• Corporate Reorganizations – General Requirements
  – Continuity of Business Enterprise (Reg 1.368-1(d)): Generally requires the Acquiror to either continue Target’s historic business or to use a significant portion of Target’s historic business assets in a business.
  – Business Purpose
  – Plan of Reorganization
  – Step Transaction Doctrine may be applicable
Corporate Reorganizations

- Triangular Mergers - IRC 368(a)(2)(D) – Forward Subsidiary Merger

Diagram:
- Buyer
  - Merger Sub
    - Stock
  - Merge
- Target
  - S/H
Corporate Reorganizations

- Effect on Target Shareholders – IRC 356
  - Gain recognized to the extent of the lesser of:
    - Gain realized on the exchange; or
    - FMV of Cash and Boot (other non-stock consideration)
  - No loss recognized
  - Basis in Buyer stock:
    - Basis in Target stock, less any gain realized as a result of transaction
Corporate Reorganizations

- Triangular Mergers - IRC 368(a)(2)(E) – Reverse Subsidiary Merger

Diagram:

- **Buyer**
- **Merger Sub**
- **Target S/H**
- **Target**

Flow:

- Buyer → Merger Sub
- Stock
- Merger Sub → Target
- Merge
• Additional Requirements – Reverse Subsidiary Merger
  – Target shareholders must exchange an amount of stock representing control of Target for voting stock of Buyer.
  • “Control” is defined under IRC 368(c) as the ownership of:
    – stock possessing at least 80% of the voting power of all classes of stock entitled to vote; and
    – At least 80% of the total number of shares of all other classes of stock.
  • Result: Target shareholders may receive cash and other property for up to 20% of the stock of Target.
351 Transactions

- IRC 351 may allow tax free rollovers with corporate acquirors with lower % stock as consideration than may be permitted by Reorganization Requirements
- May require restructuring of Buyer’s existing entities
351 – General Requirements:

- Property transferred by one or more persons to a corporation, where the transferors control the transferee corporation immediately after the exchange, and the exchange is solely for common stock and/or preferred stock (other than non-qualified preferred stock) of the transferee corporation.

- “Control” – defined in 351 by reference to 368(c):
  - 80% of the total combined voting power of all classes of voting stock; and
  - 80% of the total number of shares of all other classes of stock
Horizontal Double Dummy Structure

Buyer S/Hs

Target S/H

New Holdco

Buyer

Target

Holdco Stock

Holdco Stock + $

Buyer Shares + $

Target Shares

Merge

Merge

Merger Sub I

Merger Sub II
• Transfer of stock of Buyer and Target to NewCo qualifies as contribution of property to new corporation satisfying requirements of IRC 351:
  – Merger of Buyer into New Holdco in exchange for Holdco stock, and merger of Target into New Holdco in exchange for Holdco stock are each treated as a contribution by Buyer/Target Shareholders of the stock of Buyer/Target into Holdco in exchange for Holdco stock
351 – Treatment of Target Shareholders

- Target Shareholders recognize gain on the exchange, but only to the extent of the value of the boot received (IRC 351(b); Reg 1.351-2)
  - No loss is recognized (351(b)(2))
- Basis in New Holdco stock equals basis in Target stock contributed, less gain attributable to cash received.
Horizontal Double Dummy - Alternative

Buyer S/Hs

Target S/H

New Holdco

Buyer Shares + $ + Target Shares

Holdco Stock

Holdco Stock

Target Shares

Target Shares

Merge

Merger Sub I

Merge Sub II
Horizontal Double Dummy - Alternative

- Alternative allows Target Shareholders to sell stock directly to Buyer, prior to 351 contribution
  - Shareholders can bifurcate sale, so as to offset basis of sold shares against gain
  - Also allows shareholders to identify which shares should be sold, and which shares can be contributed to Holdco.
• Buyer structured as LLC Holding Company permits greater flexibility for issuing rollover equity
  – No minimum % equity required
• Also may allow for more flexible planning opportunities for Target Shareholders
LLC Holding Company Structure

- Step 1: Target Shareholders contribute stock into Buyer in exchange for equity in Buyer (tax free contribution under 721)
LLC Holding Company Structure

- Step 2: Buyer contributes Target Equity to Operating Company in a 351 contribution
• Step 3: Merger Sub of Operating Company merges with and into Target. Remaining Target shareholders receive cash for Target stock (taxable transaction – stock purchase)
LLC Holding Company Structure

- Treatment of Target Shareholders
  - Target Shares contributed to Buyer in exchange for Buyer equity is tax-deferred under IRC 721 (contributions to partnership)
  - Target Shares cashed out pursuant to merger receive sale or exchange treatment, and gain/loss is taxable.
    - Shareholders with multiple blocks of stock may identify which shares to contribute and which shares to sell
    - Shareholders with a loss on certain shares may recognize that loss upon the sale pursuant to the merger.
Partnership Target Companies

• Partnership Target Structures
  – Single Entity Equity Purchase
  – Acquisition by LLC Holding Company
  – 351 Transactions

• Partnerships not eligible for Corporate Reorganization structures

• Ability to roll-over equity on a tax deferred basis may depend on buyer’s structure
Partnership - Single Entity Purchase

Existing Equityholders → Partnership Equity → Buyer

Target → Cash ← Buyer
• Purchase of equity of existing partners:
  – Target equityholders recognize ordinary income on the transferred portion of 751 property (unrealized receivables and substantially appreciated inventory items)
  – Capital gains treatment on remainder of gain
Partnership - Single Entity Purchase

Alternative Structure

- Existing Equityholders
- Buyer
- Target
- Newco
  - Equity and Cash
  - Cash
  - Assets
LLC Holding Company Structure with Partnership Target essentially achieves same result for rollover equity as achieved with Corporate Target.
• Similar treatment to 351 transactions involving corporate targets
• Contribution of assets is treated the same as a contribution of stock for 351 purposes.
Part II
Structures to Achieve Step Up in Basis for Purchasers
Part II – Achieving Stepped-up Basis for Purchaser

• Purchaser Goal – Increase basis in Target Assets, reducing future taxable income
  – Achieved through:
    • Taxable asset purchase
    • Taxable stock purchase with 338(h)(10) election (or 336(e) election)
    • Partnership acquisitions with 754 election
To achieve a stepped-up basis in a stock sale will require a 338(h)(10) election or a 336 election.

Transaction will be taxable as an asset sale to Target, followed by a deemed liquidation of target.
• **338(h)(10) Requirements:**
  – Buyer acquires 80% by vote and value of outstanding stock of Target through a Qualified Stock Purchase
    • Must be accomplished within 12 month period
  – Target structure
    • Subsidiary in a consolidated group (or a subsidiary in an affiliated group that does not file consolidated returns)
    • S Corporation Target
Stepped-Up Basis – Stock Sale

Existing Equityholders -> Stock (>=80%) -> Buyer

Cash -> Target

Target

Buyer
338(h)(10) Elections

• Effect on Target and Target Shareholders of S Corp.
  – Deemed sale of assets of Target, followed by liquidation of Target
    • Gain on asset sale is recognized by Target in its final year tax return
    • S-Election generally terminates
      – Resulting company may file new election, but only if remains eligible for S-Corporation status
  – Retained Stock in Target
    • Sellers retaining stock in Target treated as acquiring retained stock on the day after the acquisition date for its fair market value (Reg. 1.338(h)(10)-1(d)(5)(ii).
    • Result – fully taxable transaction for Sellers
Alternative to 338(h)(10) – LLC Drop Down

Step 1: S-Corp Target contributes assets to new LLC/Partnership

- S-Corp Target
- Assets
- Newco

Newco is initially a disregarded entity
Step 2: Purchaser purchases equity in Newco from S-Corp
• Tax Treatment:
  – Situation 1 of Revenue Ruling 99-5, 1999-1 CB 434
    • Deemed taxable purchase of portion of assets by Buyer from Seller
    • Followed by contribution by Buyer and Seller of assets of Target to new partnership
  – Buyer receives stepped-up basis in purchased assets (fully taxable sale by Seller)
  – Seller receives rollover equity on tax deferred basis
Part III
1202 Considerations
1202 Considerations - Sellers

• For Corporate Targets, shareholders may hold qualified small business stock, and may be entitled to gain exclusion under IRC 1202, either upon the occurrence of the acquisition, or upon future disposition of rollover equity.
  – Availability of future benefits under 1202 will depend on the transaction structure through which holders obtain their rollover equity.
• 1202: General Framework
  – $10M exclusion from capital gains for investments into Qualified Small Business Stock
  – QSB Stock Requirements:
    • C Corporation
    • Engaged in a Qualified Trade or Business for the duration of the holding period of the stock
    • QSB Requirement (Gross Assets Test)
      – Aggregate gross assets must not have exceeded $50M at any time after August 10, 1993
      – Immediately after the issuance, the aggregate gross assets of the corporation must not exceed $50M
  • Acquired by original issuance from a C Corporation
  • 5 year holding period
• QSB Requirements (continued)
  • Original Issuance
    – Stock must be acquired at original issuance from corporation in exchange for money, property or services (excluded – issuance of new stock for existing corporate stock)
    – Certain redemptions occurring within 12 months prior to, or within 12 months after issuance may negate the original issuance requirement.
  • Certain Transfers permissible to retain 1202 Benefits
    – Transfers by a partnership to a partner
    – Certain gifts and es
  • Transfers that do not preserve 1202 benefits
    – Contribution of stock by a stockholder to a partnership
QSB – Reorganizations and Incorporations

- If any QSB stock is exchanged for any other stock in a Section 368 reorganization or in a transaction qualifying under Section 351, the newly acquired stock is treated as QSB stock acquired on the same date as the QSB stock surrendered in the transaction (1202(h)(4)(A)).

- Gain is limited to the gain inherent in the stock at the time of the 368 reorganization or 351 transaction, unless the new stock is being issued by a qualified small business (1202(h)(4)(B)).
1202 Rollover - Single Entity Equity Purchase

- **Target**
- **Existing Equityholders**
- **Stock** ➔ **Buyer**
- **Cash** ← **Target**
Forward or Reverse Triangular Mergers

- **Buyer**
- **Merger Sub**
- **Target**
- **Target S/H**

Arrows indicate the flow:
- Stock from Buyer to Target S/H
- Merge from Merger Sub to Target
1202 Rollover - Horizontal Double Dummy

**Buyer S/Hs**
- Buyer Shares + $
- Holdco Stock

**Target S/H**
- Target S/H
- Target Shares
- Holdco Stock + $

**New Holdco**
- Merge

**Merger Sub I**

**Merger Sub II**

Merge
1202 Rollover - LLC Holding Company

- **Buyer**
  - Operating Company
- **Target S/H**
- **Target**

Arrows indicate:
- Partnership Interests from Buyer to Target S/H
- Target Stock from Target to Buyer
Part IV
Management Equity
Rollovers
Part V – Management Rollover Equity

• How to treat:
  – Options
    • Incentive Stock Options
    • Nonqualified Stock Options
  – Phantom Equity/Management Carve-Out Plans
• Issuing Buyer Equity in exchange for the above may be fully taxable
Management Equity –
Single Entity Equity Purchase

- Existing Equityholders
- Target
- Stock
- Cash
- Buyer
• Single Entity Equity Purchase
  – Options: May be flexibility on whether to cash out, or whether to leave outstanding awards in place
  – Phantom Equity/Management Carve-Out Plans
    • If subject to 409A, will generally need to follow the terms of the applicable plan
    • If exempt from 409A (short term deferral plan), may have greater flexibility in structuring
Forward or Reverse Triangular Mergers

Buyer → Merger Sub → Merge → Target → Target S/H → Stock
Incentive Stock Options

- Incentive Stock Options
  - Substitution of a new ISO for a prior ISO or the assumption of a prior ISO by an eligible corporation is permissible if the substitution or assumption is by reason of a “corporate transaction” and certain other conditions are satisfied.
  - “Eligible Corporation” – corporation that is the employer of an optionee or a parent or subsidiary of the employer corporation.
Incentive Stock Options

• “Corporate Transaction”
  – Corporate merger, consolidation, acquisition of property or stock, separation, reorganization or liquidation
  – A distribution (excluding an ordinary dividend) or change in the terms or number of outstanding shares of the corporation
  – Such other corporate events as may be prescribed by IRS
Incentive Stock Options

• Conditions to be satisfied (IRC 424(a)(1); Reg 1.424-1(a)(5)(iii)):
  – Spread (Intrinsic Value) Test: The excess of the aggregate FMV of the outstanding shares under the option over the aggregate exercise price after the substitution or assumption must not exceed such excess that existed prior to such substitution or assumption
  – Ratio Test: The ratio of the option exercise price to FMV of the stock subject to the option must not be more favorable to the optionee than the ratio before the substitution or assumption
Non-Qualified Stock Options

- IRC 409A governs the treatment of Non-Qualified Stock Options (and certain other stock right):
  - Not treated as a modification if the requirements of Section 1.424-1 are met (Generally same as ISO Rules)
  - “Eligible Corporation” requirement is disregarded
• Ratio Test:
  – Deemed satisfied if the ratio of the exercise price to the FMV of the shares immediately after the substitution or assumption is not greater than the ratio of the exercise price to the FV of the shares immediately before the substitution or assumption (Reg. 1.409A-1(b)(5)(v)(D))
  – 409A seems to eliminate Ratio Test, leaving only the Intrinsic Value Test
Management Equity – LLC Holding Company Structure

Buyer

Operating Company

Target S/H

Target Stock

Partnership Interests
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As a corporate attorney and chair of the firm’s tax practice, Dave is exceptionally proficient in guiding clients through a wide range of transactions, including mergers and acquisitions, private equity transactions, venture capital financings, joint ventures, and entity formations.

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