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Why Do We Roll This Way?

Tax Deferred Transactions in the Private Context

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October 28, 2025

Background – Why Do We Roll?

- Equity (nonliquid) consideration can provide important benefits in many private transactions
  - Preserves upside for founders
  - Addresses valuation gaps
  - Aligns interests with management equityholders
- In general, rolling equityholders will prefer tax deferral and maximizing basis recovery on their rollover equity
  - Maximizes after-tax proceeds of transaction
  - Purchasers prefer transactions structured for asset-basis step-up; however benefits of offering tax deferral where possible often outweigh potential step-up benefit

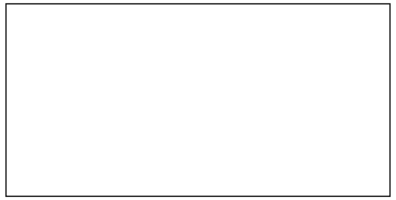
Theories for Deferral

- Transactions where there is continuing equity ownership of a sufficient size not a moment to tax
  - §351: Contribution to controlled corporation
  - §368: Reorganizations
- A business venture continuing through a partnership / not converted to cash not a moment to tax
  - §708: Partnership considerations
  - §721: Partnership formations
- Some deferral available if cash / property will be received later or subject to contingencies
  - §453: Installment sales

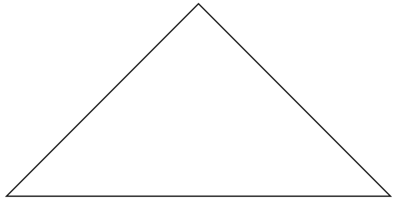
Some Considerations Common to Many Structures

- MIP / MEP plans and plan efficiency
  - Ability to impose vesting on rolled equity. Rev. Rul. 2007-49.
  - Ability to offer capital gains treatment to management
- Installment sale considerations
  - Often applicable because of long-tailed purchase price adjustment mechanics, escrows, earn-outs
  - Utility limited in certain circumstances
    - Interest charge
    - Basis recovery
    - Partnership / hot asset limitations

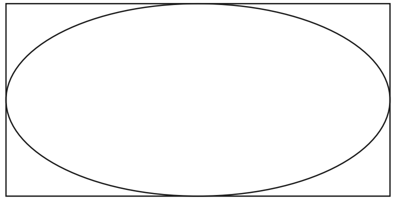
Key



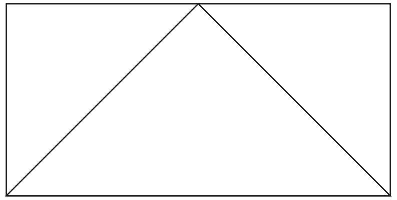
– Entity taxed as a corporation



– Entity taxes as a partnership



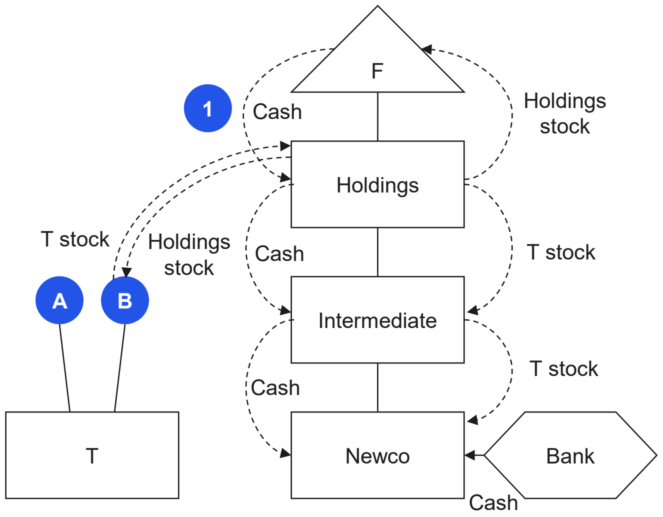
– Disregarded entity



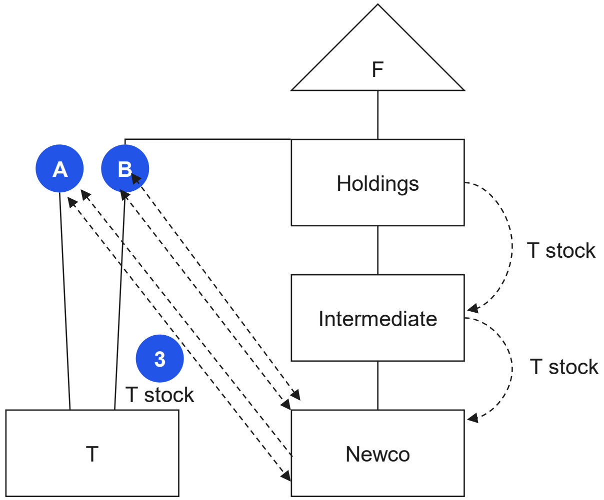
– S Corporation or other hybrid entity

Acquisition of Corporation

Example 1 – Typical C Corporation Structure, C Corp Acquiror

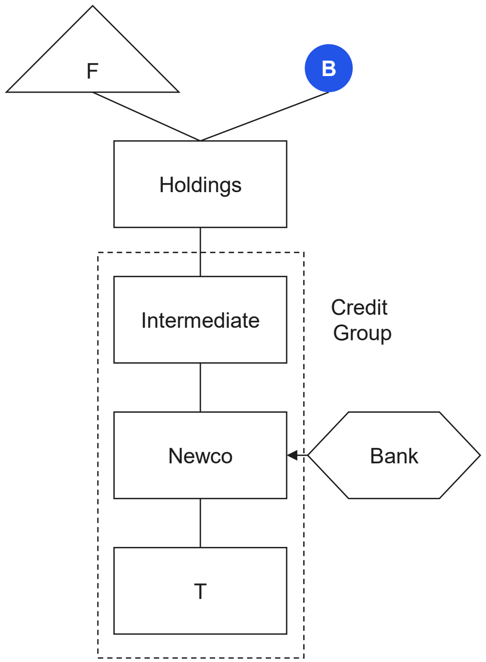


- F forms holding structure including Holdings, Intermediate and Newco
- F funds structure with equity cash Newco borrows from a third party bank
- B contributes T stock to Holdings in exchange for stock in Holdings
  - Holdings contributes such stock down the chain to Newco



- Newco purchases the remaining T stock for cash

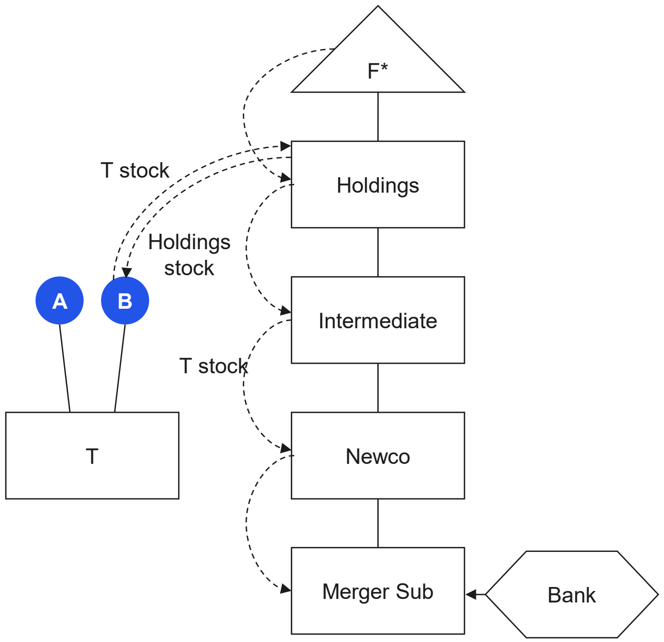
After



Example 1 – Why Do We Roll This Way?

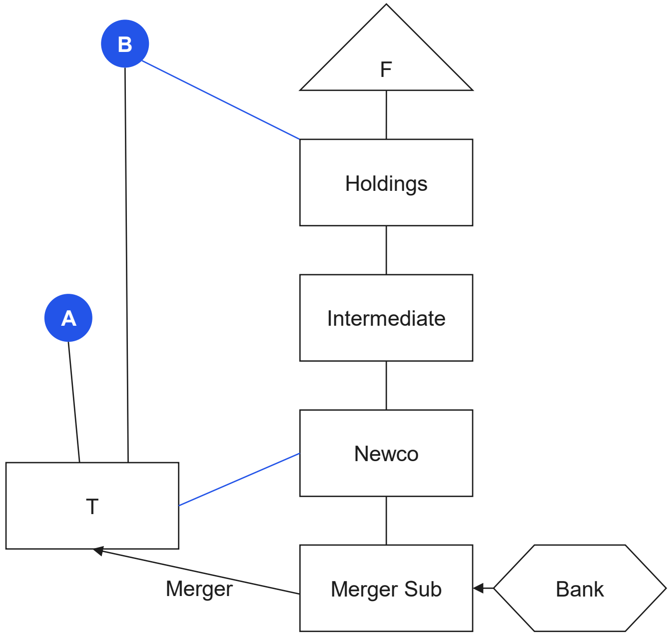
- F's holding strucutre facilitates an efficient financing structure, including a single point of enforcement for creditors (Intermediate) and a "clean" holding entity (Holdings) that has flexibility outside debt covenants
- Structure maximizes B's tax deferral
  - Transaction bifurcated into a §351 transaction for B's rollover equity and a cash purchase of stock
  - If sale and rollover occurred at the same level, B must recognize gain equal to lesser of gain realized or cash received
- Additional considerations
  - Whether there is §368(c) "control"
  - Nonqualified preferred rules

Example 1 – Merger Variation



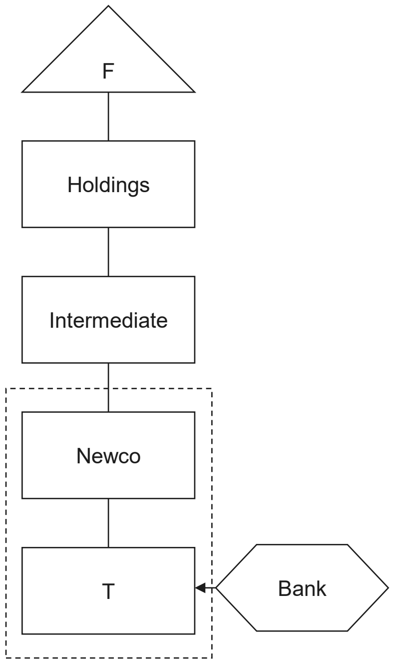
- Same as prior except Newco forms Merger Sub, which is the borrower on the new debt

*F's cash contribution not shown for simiplicity



- Merger Sub merges with and into T with T surviving
- Generally treated as a stock purchase. Rev. Rul. 73-427, Rev. Rul. 79-273

After

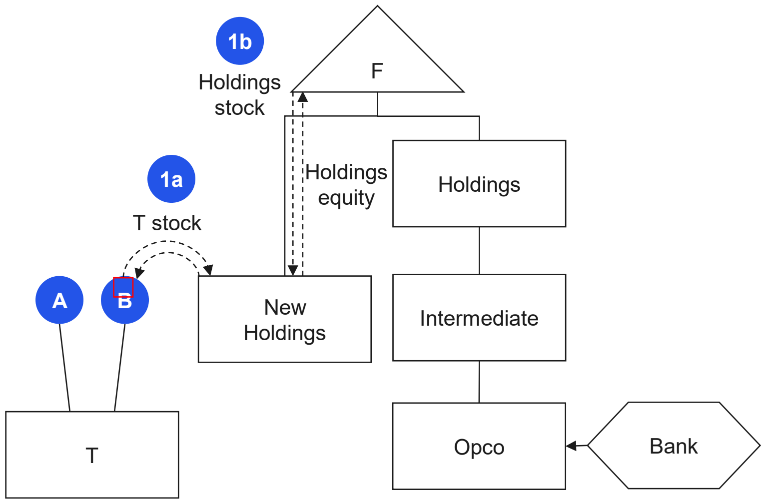


- May have corporate benefits (e.g., if T has a lot of shareholders)
- Places debt at T rather than above T
  - This could have state tax and other benefits

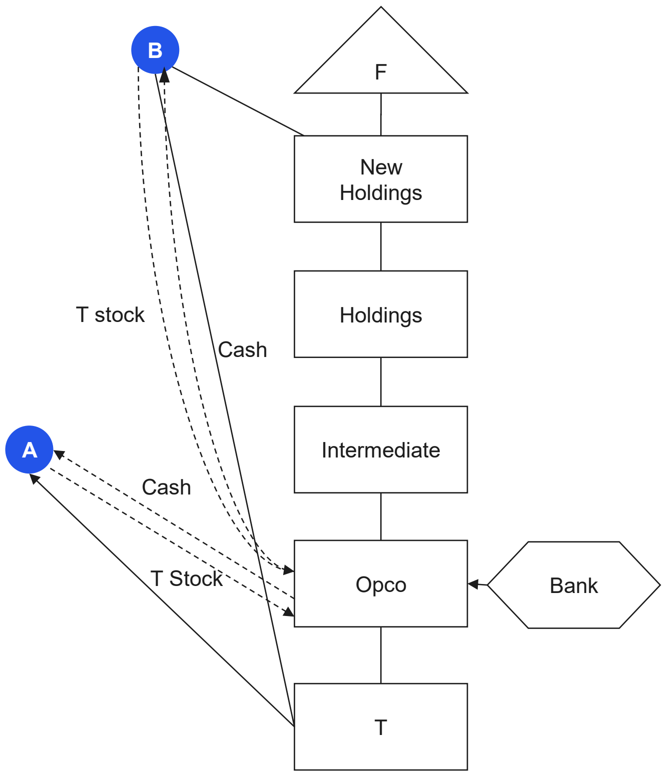
Example 1 – Reasons to Choose a Different Structure

- Holdings is old and cold and F is not making an equity contribution
  - Transaction does not quality for §351 because no contribution that satisfies §368(c) control rule
  - A contribution by F of capital must be sufficient subject to "accommodation transfer" rules
- Management equity plans
  - Most alternatives give rise to OI
    - Options
    - Phantom shares
    - RSUs
    - Restricted stock (but §83(b) elections available for future appreciation)

Example 1a – Double Dummy Alternative

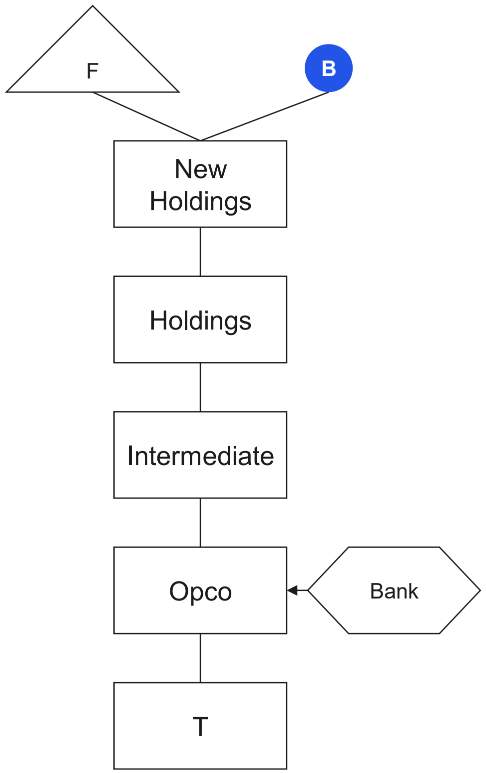


- Same as Example 1, but Holdings is parent of old and cold consolidated group and F not contributing any capital to Holdings to finance acquisition
- F forms new New Holdings in exchange for New Holdings stock and contributes 100% of Holding stock to it or B contributes rollover equity in exchange for Holdings stock



- Opco purchases remaining T stock for cash

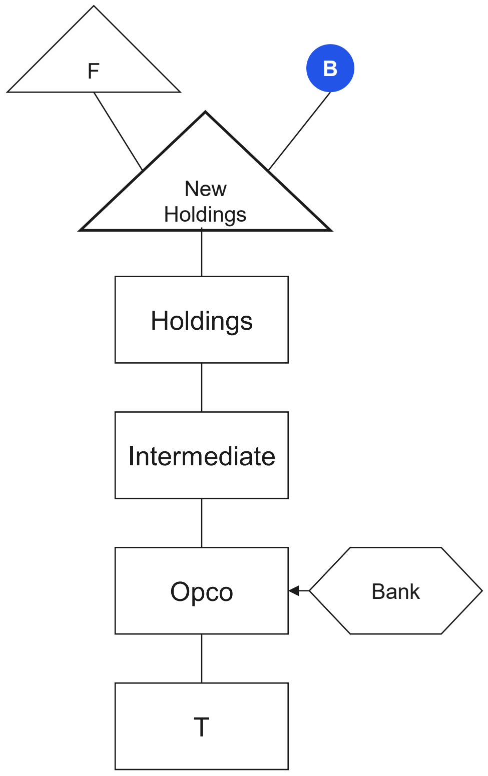
After



Example 1a – Why Do We Roll This Way?

- Structure adds F as a contributing party §368(c) control purposes, permitting §351 qualification
- Considerations / discussion points
  - Adds an extra layer of entities
    - What entity rationalization is possible and when?
    - What about “F reorganization” rules?
  - Cost / benefit of structure

Example 1a – Holding Partnership Alternative

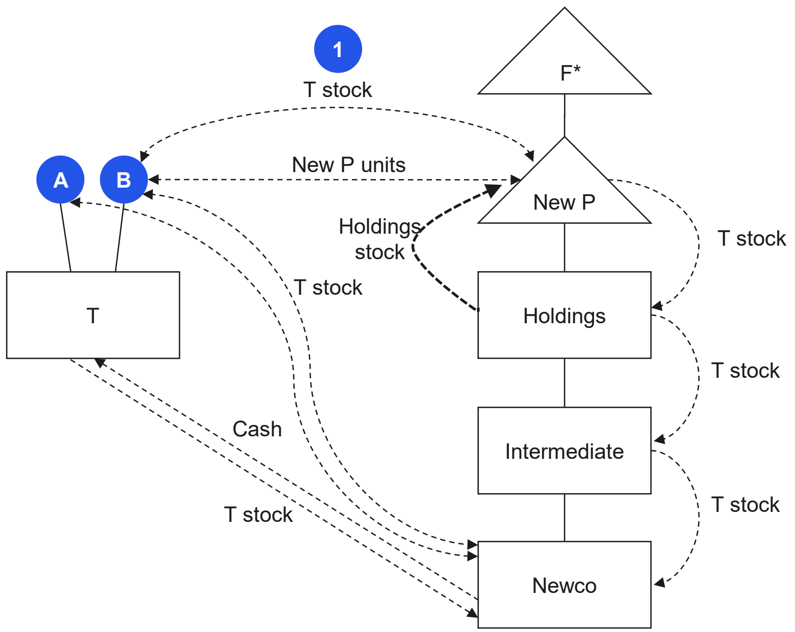


- Partnership structure does not require Section 368 control and provides additional economic flexibility
- May facilitate an efficient profits interest MIP / MEP structure
- Note that form of New Holdings as an LLC / LP may have non-U.S. tax implications

Example 2 – C Corporation Target, Partnership Acquiror

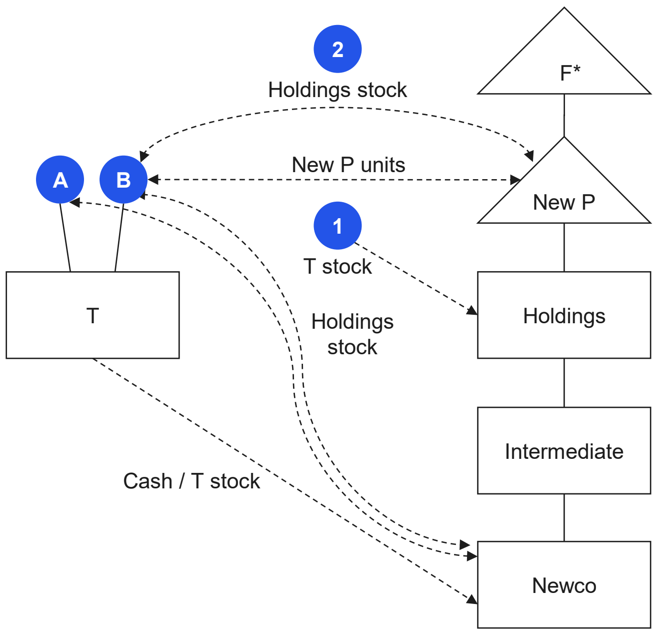
Compare

Structure 1



- B contributes T stock to New P for New P Units. §721 New P contributes stock to Holdings in exchange for Holdings equity. §351
- Remaining stock in T purchased by Newco for cash

Structure 2



- B contributes T stock to Hidings in exchange for Holdings stock (assumes New P also contributes cash in exchange for Holdings stock). §351
- B contributes Holdings stock to New P for New P Units. §721

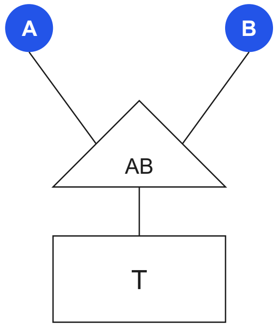
* F's contributions not shown for simplicity.

Example 2 – Why Do We Roll These Ways?

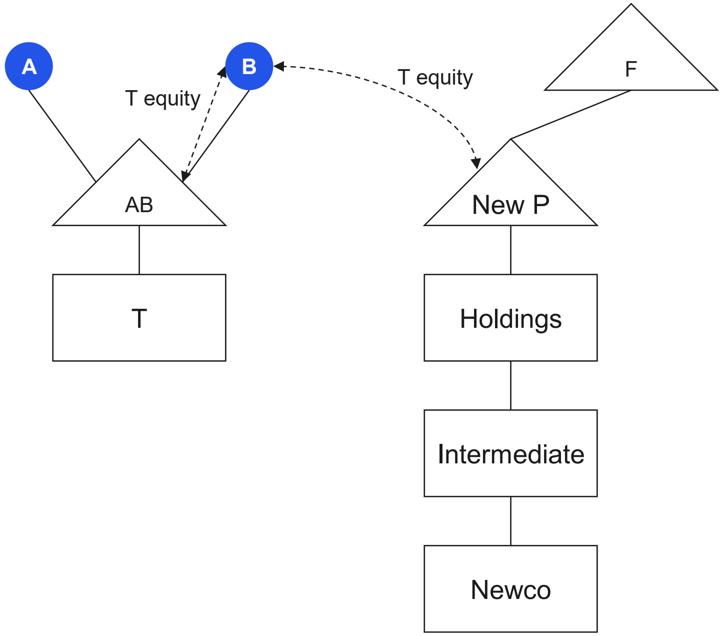
- Structure 1
  - Flexible structure does not require a contribution by New P (though example assumes one)
  - Equity issuance advised to preserve identification of §704(c) property. Treas. Reg. §1.704-4(d). Is book entry sufficient?
  - Works for a corporate T – may not work where T is a flow-through and F has investors that are ECI / CAI sensitive
- Alternative B
  - Clearer identification of §704(c) property
  - Less flexible – requires contribution by New P
  - §368(c) control"?
    - Transfers among members of control group

* What if New P contributes cash in exchange for plain vanilla evergreen preferred?

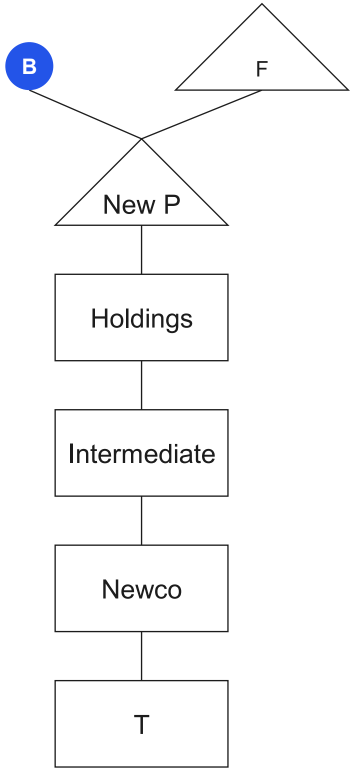
Example 3 – What if the Target is Already Owned by a Partnership?



- Buyer usually does not want to acquire AB
- If AB sells T stock directly, rolls over the remainer for acquiror equity, and distributes such equity in part to B, gain allocation will be distorted



- Solution is to put T equity directly in B's hands as a first step, followed by B rolling T equity into Buyer's structure
- Cash acquisition steps omitted for simplicity

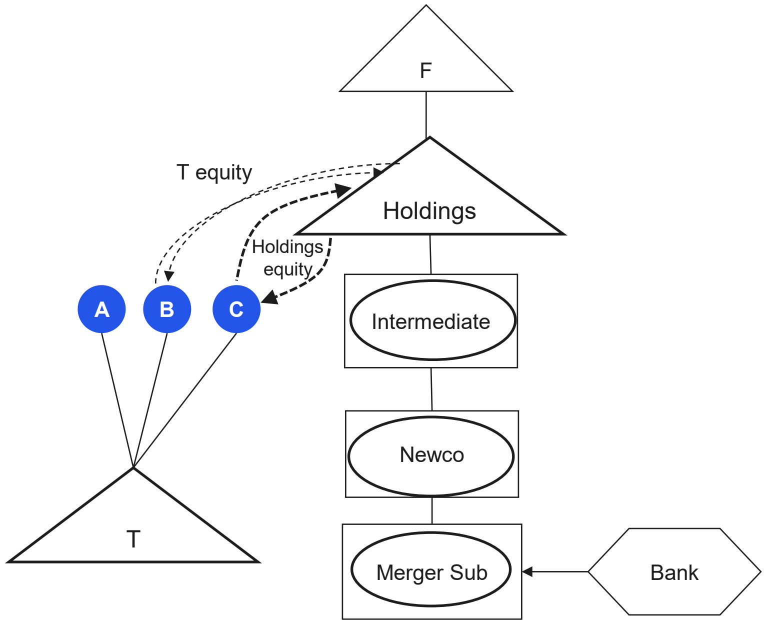


Example 3 – Considerations

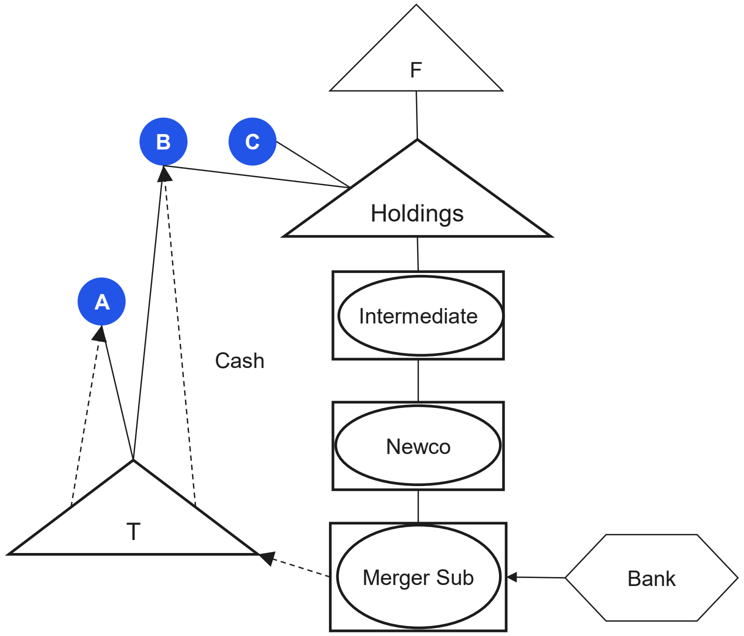
- Should B's interest in AB be fully liquidated or can B be partially redeemed in an amount equity to the rollover value?
  - Turns AB into a DRE in this example; if there were a third partner, C, should the whole partnership be liquidated?
- How should purchase price adjustments be handled?
- The diagram shows a partnership holding structure – why do we roll this way?
  - Facilitates MIP / MEP plan offering profits interests, which is likely similar to previous structure
  - Note that this could be accomplished using Structure 1 or Structure 2 discussed previously.

Acquisition of a Partnership or Disregarded Entity

Example 4 – Typical Flow Through Acquisition Structure

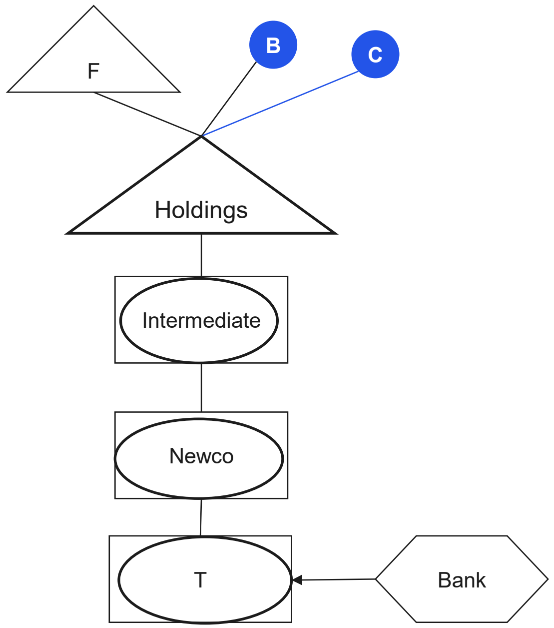


- F newly forms Holdings, Intermediate, Newco and Merger Sub and funds with equity cash (not shown)
- B and C contribute T equity to Holdings in exchange for equity in Holdings
  - Holdings contributes such equity down the chain to Newco (disregarded)



- Merger Sub merges with and into T with T surviving.
- Remaining T equity holders receive cash in the merger.

After



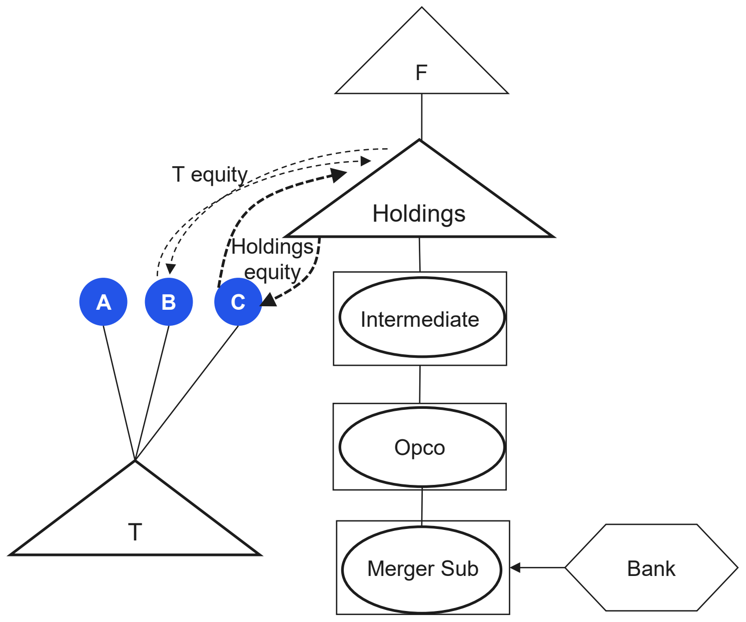
Example 4 – Why Do We Roll This Way?

- F's holding structure facilitates an efficient financing structure, including a single point of enforcement for creditors that has flexibility outside debt covenants
- How should debt be treated? Often ordered to obtain some deferral for B and C, but maximize F's step-up under Section 743
  - Note that B and C may prefer a different financing structure/order that might permit them to extract more of their basis without tax.
  - The step-up generated by the purchase is only attributable to F under this structure and generally is not shared by B and C
- It may be preferable for B and C to hold their equity through an aggregator
  - F may wish to have more control over any tag and drag rights
  - May permit B and C to be W-2 employees rather than receiving guaranteed payments

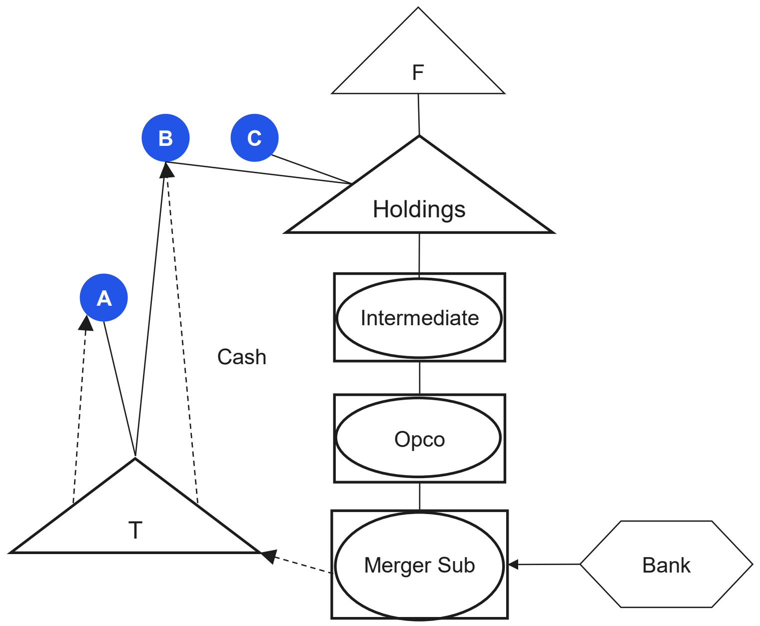
Example 4 – Additional Considerations

- Additional considerations
  - Holdings is a “continuation” of T under Section 708; F likely wishes to insist on a “push out” election under Section 6226
  - Debt is likely treated as “non-recourse” for purposes of Section 752 and Section 1001
  - F likely needs a “blocker” structure in respect of UBTI/ECI/CAI, depending on tis investor profile
  - Parties should carefully consider “hot asset” and Section 704(c) rules

Example 4a – Partnership Merger Alternative

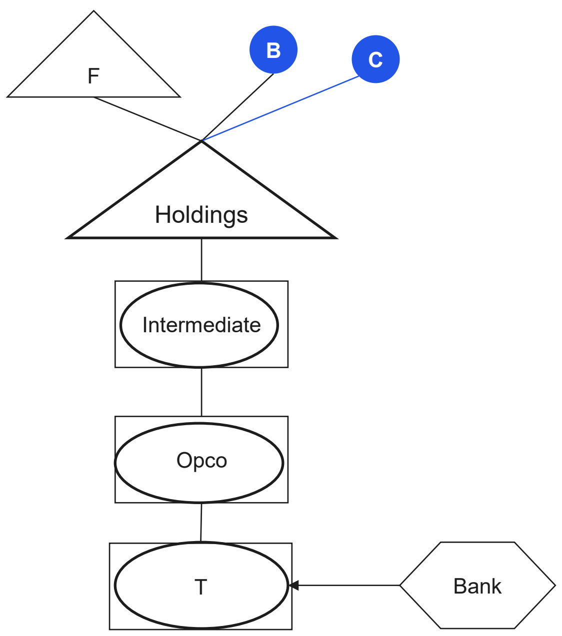


- Holdings is an old and cold operating partnership
- B and C contribute T equity to Holdings in exchange for equity in Holdings
  - Holdings contributes such equity down the chain to Newco (disregarded and not shown)



- Merger Sub merges with and into T with T surviving
- Remaining T equity holders receive cash in the merger
- Assume that F holds more than 50% of Holdings post-transaction

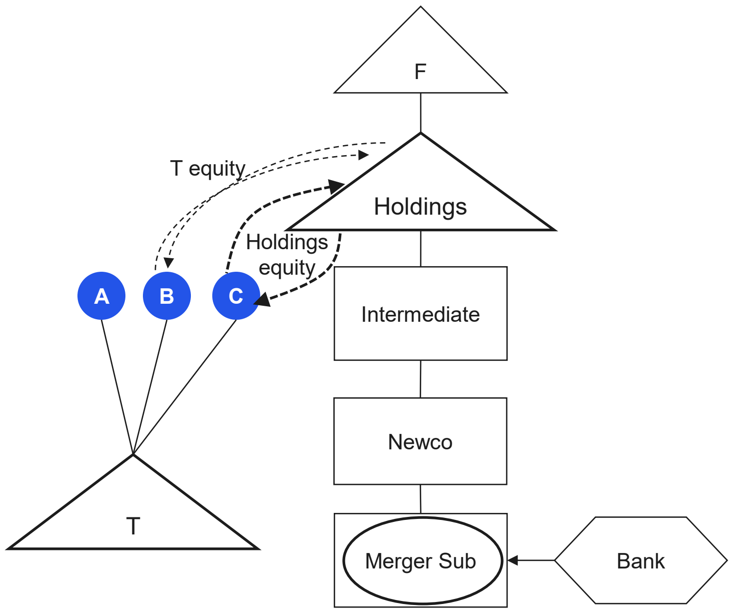
After



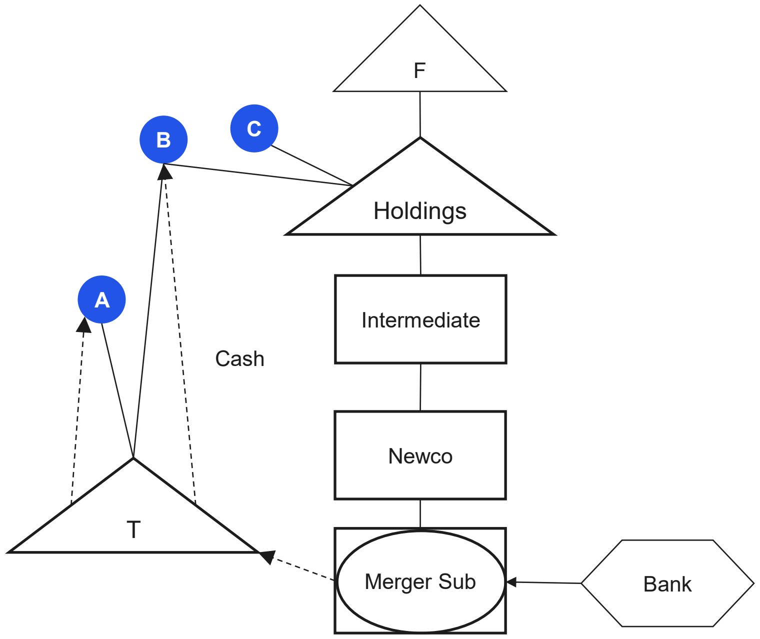
Example 4a – Considerations

- Partnership merger regulations of Treas. Reg. §1.708-1(c) apply
  - Treated as if T contributed its assets and liabilities to Holdings in exchange for Holdings equity and cash and liquidated, distributing the consideration to the partners
  - Treas. Reg. §1.708-1(c)(4) likely beneficial and should be stipulated in agreements (disguised sale risk)
- Note that if B and C hold more than 50% of Holdings post-transaction, the transaction would be characterized as if Holdings contributed its assets and liabilities to T despite the corporate form
- Could partnership merger rules apply in Example 4 if Holdings is formed with 2 members (e.g., parallel funds)? Does it matter how long Holdings has been in existence and if it has been funded?

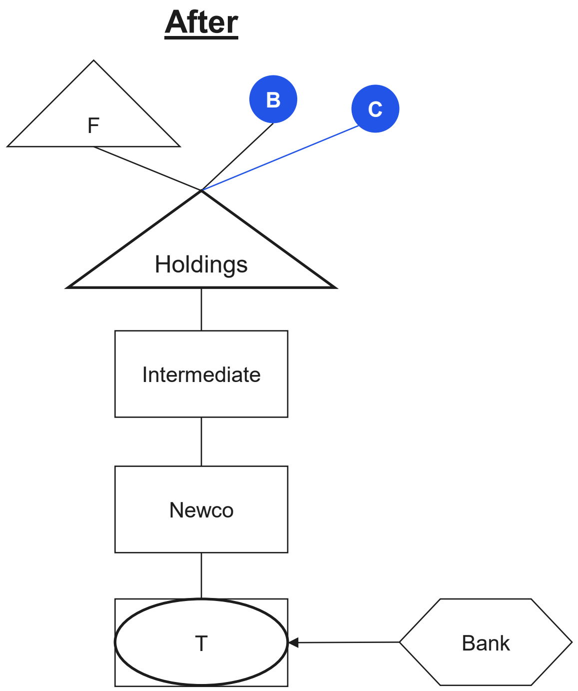
Example 5 – Acquisition of Partnership by C Corporation



- F newly forms Holdings, Intermediate, Newco and Merger Sub and funds with equity cash (not shown)
- B and C contribute T equity to Holdings in exchange for equity in Holdings
  - Holdings contributes such equity down the chain to Newco (not shown)



- Merger Sub merges with and into T with T surviving.
- Remaining T equity holders receive cash in the merger.



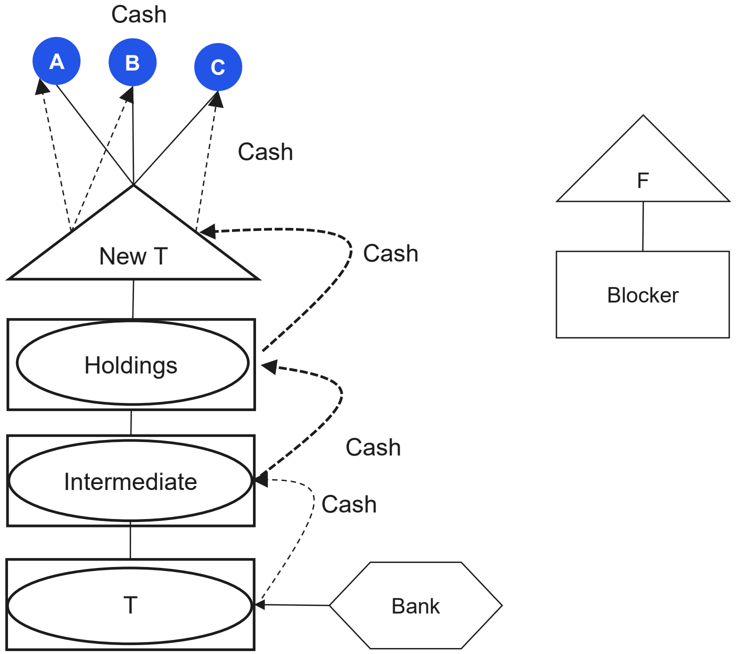
Example 5 – Considerations

- Rollover of T equity tax-deferred under Section 721, whether or not F makes equity contribution
  - But F may not be able to tolerate the risk of “flash ECI” and therefore will require this to be structured in accordance with Structure 2 instead, described above, which generally does require equity contribution
  - Note that Structure 2 may not permit deferral if the Holdings group is old and cold and F does not make an equity contribution; consider “double dummy” alternative or Example 5a
- Should Holdings be treated as a continuation of T? Or should the momentary ownership of T equity be ignored, and the transaction be treated as a Section 721 contribution followed by a Section 351 contribution and a Rev. Rul. 99-6 acquisition of assets?
  - Consider purchasing T assets instead or use Structure 2 if there is any concern

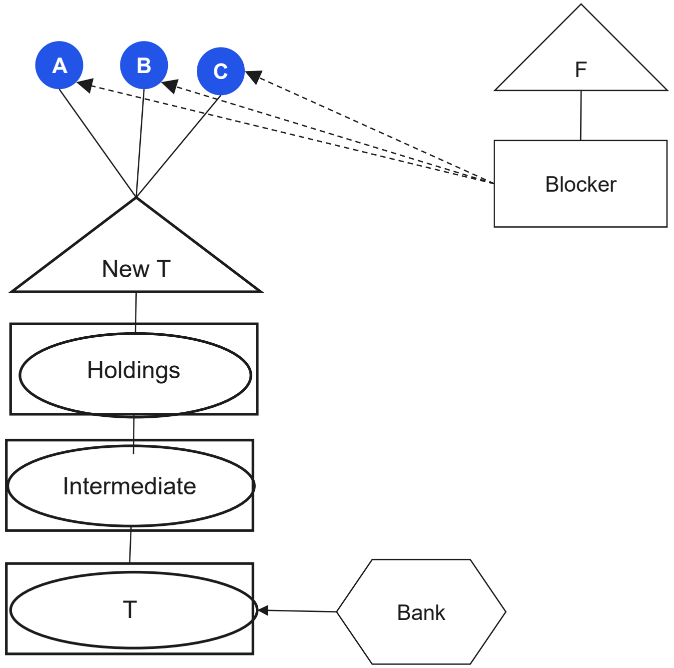
Example 5 – Considerations, cont'd

- B and C lose benefit of flow-through structure
  - But B and C share in any step-up benefit generated by the Holdings group taxable purchase indirectly through their ownership in Holdings
- B and C may prefer this structure from an administrative perspective because their state tax filings are likely greatly diminished and they may receive additional "profits interests"

Example 5a – "Up-C" Style Alternative

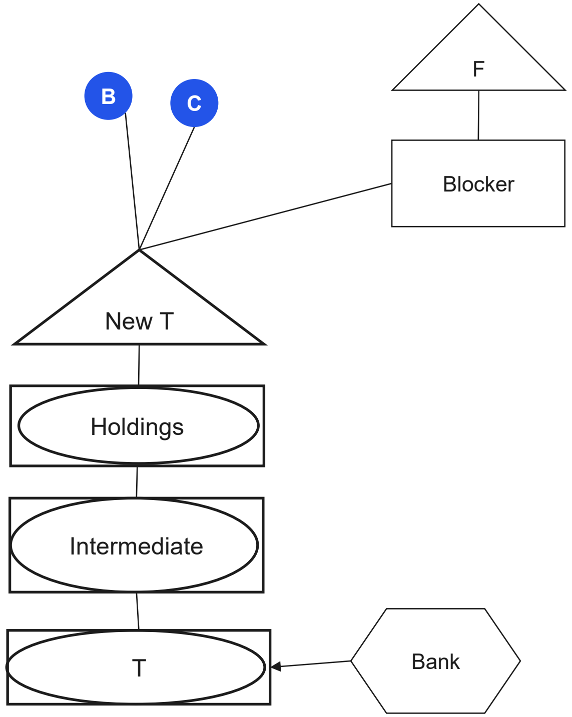


- F newly forms Blocker and funds with equity cash (not shown)
- A, B and C contribute T equity to Holdings in exchange for equity in Holdings
  - Holdings contributes such equity down the chain to Intermediate (not shown)
- T borrows and distributes the proceeds up the chain.
  - New T distributes cash to A, B, and C



- Blocker purchases all of A's T interests and some of B and C's interests for cash

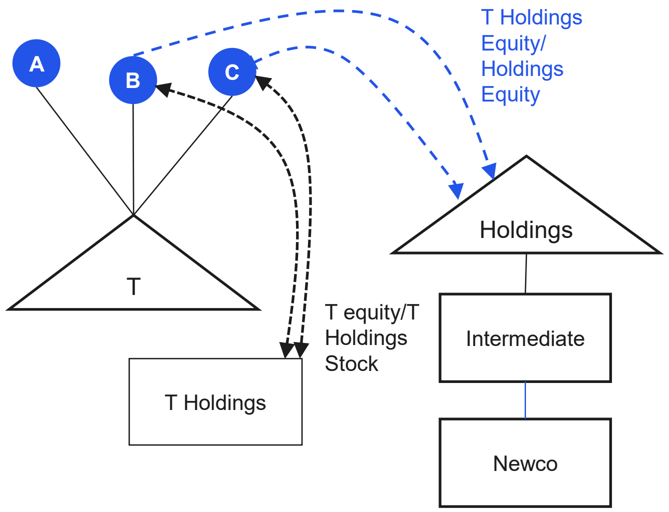
After



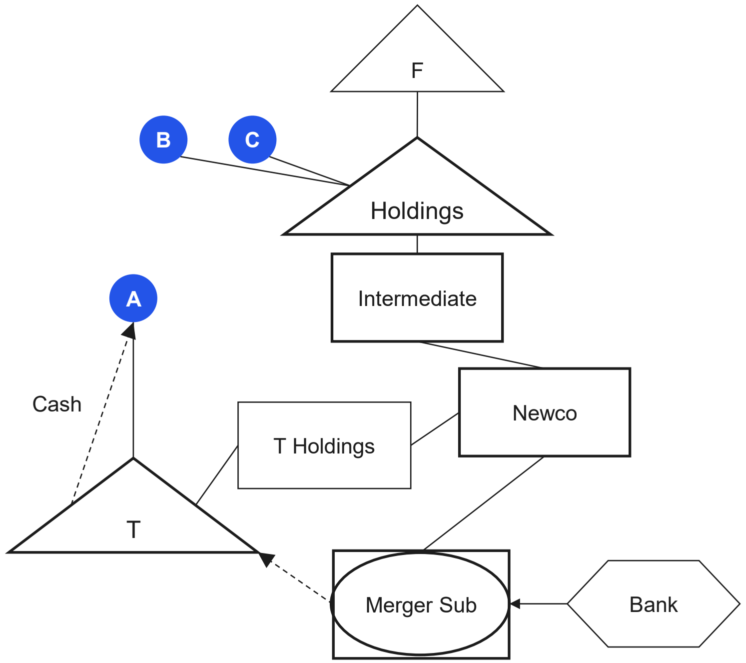
Example 5a – Considerations

- B and C's "rollover" is tax-deferred because they do not realize any gain on the unsold portion of their equity
  - Creation of New T and its subsidiaries is disregarded
- B and C may prefer that the borrowing/debt financed distribution occur *after* Blocker's purchase as this may maximize basis recovery/tax position for them
  - For non-tax reasons they may prefer that the debt is not authorized by New T directors prior to Blocker's purchase. A "dummy merger" mechanic may be used to facilitate a pre-purchased debt financed distribution
- Blocker receives a step up in T's assets under Section 743
  - F should negotiate ability to sell Blocker on exit
  - Blocker may prefer for corporate purposes to receive equity in a "primary". Disguised sale of partnership interests (Section 707)

Example 5b – Alternative Rollover Structure?

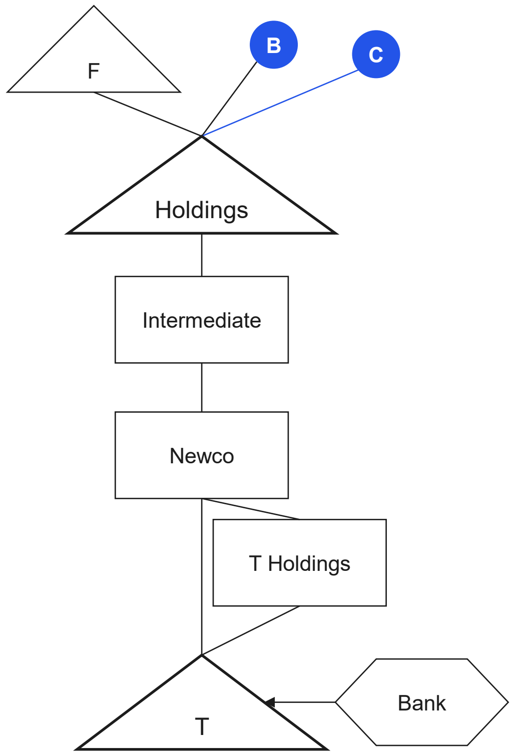


- As a first step, B and C contribute T equity to T Holdings in exchange for 100% of T Holdings stock
- B and C contribute T Holdings equity to Holdings in exchange for equity in Holdings
  - Holdings contributes such equity down the chain to Newco (not shown)



- Merger Sub merges with and into T with T surviving.
- Remaining T equity holders receive cash in the merger.

After

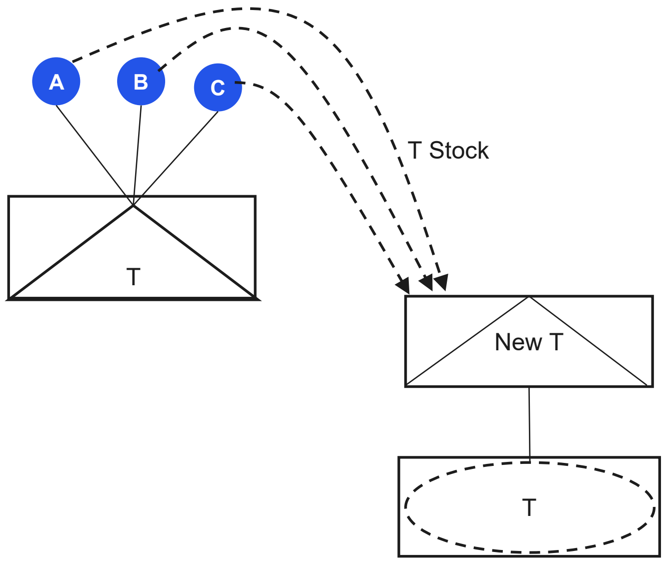


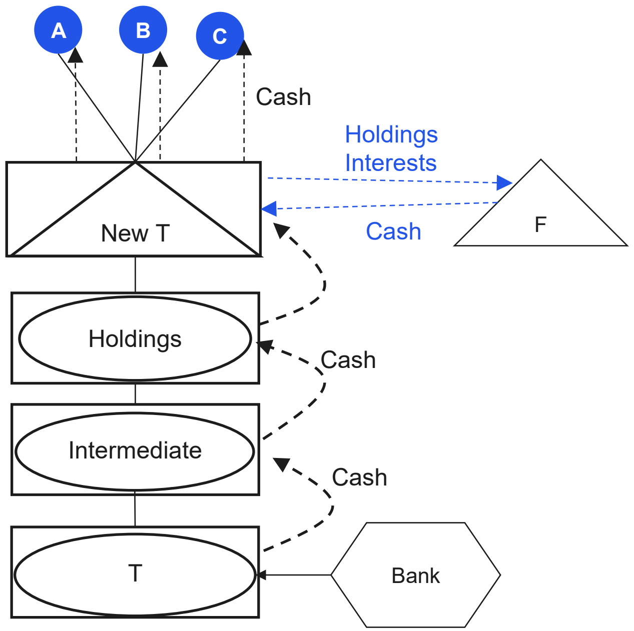
Example 5b – Considerations

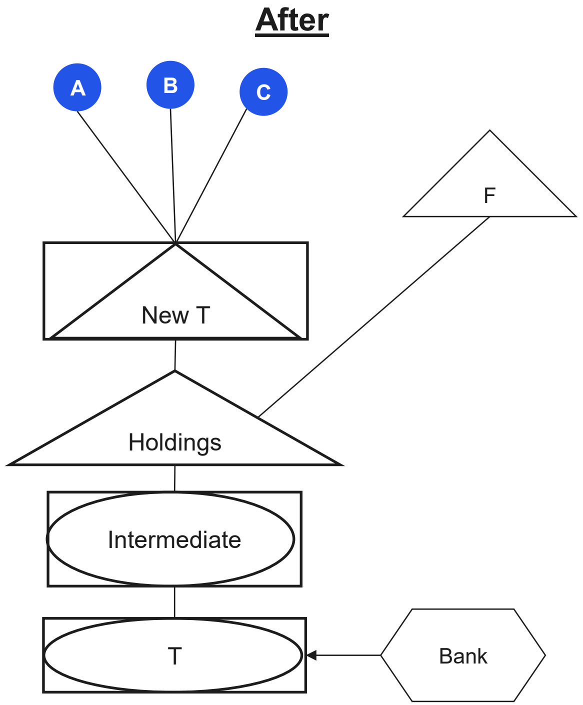
- No operating assets run through Holdings, even for an instant, alleviating "flash ECI" concerns
- Section 351 Considerations
  - Is there Section 368(c) control immediately after the exchange? Rev. Rul. 2003-51
- T remains a partnership
  - What entity rationalization is possible and when?
  - Are there potential detriments to the Holdings group of this structure?

Acquisition of an S Corporation

Example 6 – S Corporation "JV" Alternative







- A, B, and C form New T and cause it to elect to be treated as an S corporation.
- A, B and C contribute T equity to New T in exchange for equity in New T.
- New T converts to an LLC under applicable state law.

- New T creates a financing structure by creating Holdings and Intermediate.
- T borrows and distributes proceeds up the chain to New T, which distributes such proceeds to A, B, and C pro rata.
- F purchases an interest in Holdings; New T distributes the proceeds to A, B, and C pro rata.

Example 6 – Why Do We Roll This Way?

- Permits a step-up in T’s assets and permits both F and the shareholders to hold in flow-through form.
  - F reorganization of T is non-taxable to shareholders of T.
  - Other step-up alternatives (e.g., Section 338 election) may not be available and do not permit deferral.
  - While S corporations are flow-through, Section 311(b) does apply to distributions from S corporations.
  - Section 368 reorganization/Section 351 contribution alternatives may be available, but do not permit step-up or holding in flow-through form.
  - Permits future MEP/MIP grants to be made as profits interests at Holdings level outside S corporation restrictions

Example 6 – Considerations

- Rollover required to be pro rata because of S corporation rules.
  - There are complex structures that may be possible in non-pro rata rollover fact patterns, but they are very difficult.
- Step-up arises as a result of a Rev. Rul. 99-5 transaction generating common basis.
  - F may wish for “remedial” allocations.
  - This structure may not work for a pre-1993 business because of anti-churning rules under Section 197.
    - Solution is to create a partnership in the first step, e.g., by distributing receivables, contributing assets held outside the S corporation.
- Permits future MEP/MIP grants to be made as profits interests at Holdings level outside S corporation restrictions